

**Partner Selection Methodologies for Preferential Trading Arrangements**

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## **I. Introduction**

On July 22, 2006, the Director General of the World Trade Organization (WTO), Pascal Lamy, announced the indefinite suspension of the Doha round of multilateral trade negotiations. The reaction to this announcement was an immediate collective expression of disappointment among all involved countries, that the major players in these discussions had been unable to bridge their differences and reach an agreement that would reduce barriers to international trade. Following this setback, interest by political leaders in bilateral and regional trade negotiations has surged. The sense of practitioners in the field of trade negotiations is that governments have given up hope for trade liberalization through multilateral negotiations in the near term and are now willing to engage in discussion towards a second best alternative, trade liberalization through bilateral and regional trading arrangements.

Within this new environment with its focus on bilateral and regional initiatives, the choice of partners with whom to negotiate appears quite random for many countries. For instance, the U.S. has chosen to negotiate preferential trading arrangements with countries such as Morocco, Jordan and the Dominican Republic, with whom they have very little trade and, at the same time, with Korea and Australia, countries with whom they have substantial trade. Another example is the partners selected by Chile, this group includes significant trading partners such as the U.S., E.U. and China as well as less important trading countries such as Singapore, Brunei and Cuba. It is this apparent randomness of the partner selection for preferential trade negotiations that has prompted this research.

This paper will provide an examination of the current state of economic theory to find any underlying economic rationales that might aid countries in deciding how to choose partners for preferential trading arrangements. This is a particularly important goal given that countries are likely to negotiate preferential trading arrangements even without such an understanding. A secondary goal is to examine the record of Canada in selecting bilateral and regional preferential trading arrangement partners in order to provide a real world comparison against this theory.

At this time there is not a coherent body of economic literature dedicated to studying these questions, therefore, in order to provide as comprehensive an examination as possible, we will conduct this research following a careful structure. We will start by trying to determine what the goal should be when choosing a negotiating partner. In this section we will find support for the assumption that countries should choose negotiating partners based upon whether such a preferential trading arrangement will lead towards global free trade.

The most substantive section of this paper will be an examination of the “stepping stone” and “stumbling block” effects of preferential trading arrangements. Much work has focussed on this topic and it can usefully be divided into several additional subsections. The first subsection will examine the current economic literature in which this question is studied using both game theory and conventional modelling techniques. The goal is to ascertain situations in which the optimal choice of countries is to use preferential trading arrangements as a stepping stone to global free trade and

when choosing to participate in a preferential trading arrangement will have a stumbling block effect. As will be seen, while most papers treat the decision to enter into an initial preferential trading arrangement, as well as the initial tariff levels of countries as exogenous to their model, different starting assumptions can have a significant impact on the results of the model. A key conclusion in this section is that preferential trading arrangements are most likely to serve as stepping stones to global free trade if the partner countries are relatively asymmetric in the size of their economies with none of them having global hegemonic power.

## **II. Background and Assumptions**

There is one significant assumption required throughout this paper, that trade in services is not an issue. While this omission may be considered problematic from a real world perspective, there are a couple of rationales behind it. First, early preferential arrangements (sometimes referred to as 'first generation' agreements), e.g., the free trade agreement under negotiation between Canada and the European Free Trade Association (EFTA)<sup>1</sup>, do not include any obligations in the area of services. Second, countries seldom, if ever, impose tariff barriers on trade in services. As will be noted below, we assume that a preferential trading arrangement is defined by the elimination of tariff barriers between partner countries, considerations of services would

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<sup>1</sup>EFTA consists of four European countries who for various reasons have decided not to join the EU: Norway, Iceland, Switzerland and Liechtenstein. Canada and EFTA began negotiations in 1998. Should agreement be reached in the future, it would be considered somewhat unusual in its exclusion of any obligations related to services.

therefore be difficult to incorporate.

Another concept that arises in this paper is that of the welfare effects of a preferential trading arrangement. In general welfare calculations used within the various studies analysed here are based upon the gains from trade, that is: 1) the overall benefits that a country will receive from the implementation of a preferential arrangement by focusing production on the goods for which they have an advantage in production, and 2) the reduced prices that will be paid on imports of those products for which the partner country has an advantage.

#### *What is a Preferential Trading Arrangement*

We start this paper, however, with a simple definition and description of what a preferential trading arrangement entails. Alan Deardorff in his Glossary of International Economics credits the term preferential trading arrangement to Jagdish Bhagwati and defines it as a "group of countries that levies lower (or zero) tariffs against imports from members than outsiders" (Deardorff, 2006<sup>2</sup>). Included in this definition are free trade agreements, customs unions, and common markets. Deardorff specifies that the term free trade agreement should be applicable only to group of countries whose internal tariffs are zero (Deardorff, 2006). Throughout this paper we will differentiate between a customs union and a free trade agreement on the basis of the external tariffs applied to non-members. In a customs union the member countries apply a common external

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<sup>2</sup>On-line reference available at: <http://www-personal.umich.edu/~alandear/glossary/p.html>

tariff while under a free trade agreement each country is free to set its own external tariffs but levies no tariffs on imports from other members.

This definition is not the one used in the political discourse. Despite the fact that it would be a highly unusual preferential trading arrangement that eliminated tariffs on all products, particularly on agricultural products which are often excluded from tariff elimination, the term free trade agreement is used indiscriminately to describe trading arrangements as diverse as the North American Free Trade Agreement (NAFTA) which excluded many agricultural tariffs from elimination, and the free trade agreement between the European Free Trade Association (EFTA) and South Korea, which completely excludes agricultural tariffs from elimination. At the very least, the application of the term free trade to describe these agreements is somewhat misleading.

#### *History and Legal Underpinnings of Preferential Trading Arrangements*

Bilateral and regional preferential trading arrangements have been a fact of life for centuries. Examples can be found as far back as 1707 when a commercial union was reached between England and Scotland (albeit more than 100 years after political unification had already been attained).<sup>3</sup> Since the General Agreement on Tariffs and Trade (GATT) was formed in 1947 - succeeded by the World Trade Organization (WTO) in 1995 - preferential trading arrangements have followed a much more

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<sup>3</sup>See Irwin (1993) for an detailed examination of the history of Preferential trading arrangements.

formalized process.

The founding principle of the GATT is that of non-discrimination between products from other countries, also known as Most Favoured Nation (MFN) treatment. MFN in the GATT/WTO requires that a country may not treat imports from one member country any better (or worse) than what it grants to another member. The most important outcome of this requirement is that a country may only have one set of tariffs that applies to goods that are imported from any other member country, thus providing equal treatment to all imports regardless of where they originate.

There is, however, a significant exception to the MFN principle. It can be found in GATT Article XXIV - Customs Unions and Free-trade Areas. This article explicitly allows for preferential trading arrangements so long as the duties and other trade restrictions are removed on "substantially all the trade ... in products" between the countries. In practice this means that so long as tariffs are removed for almost all of the products that are actually traded between the countries<sup>4</sup>, no other country can claim a breach of the MFN principle despite not receiving the same preferential benefits as another GATT/WTO member (i.e. the partner country).

There are two other points to note about preferential trading arrangements under the GATT/WTO. The first is that in order to ensure that the preferences provided to a

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<sup>4</sup>Note that this allows a country to retain tariffs on goods that would be imported from the partner country but for the existence of the tariff.

partner country are not provided to imports from the whole world, countries have set up complex 'rules of origin' that are unique to each preferential trading arrangement. The rules of origin dictate the requirements for a good to qualify for the tariff preferences under the preferential trading arrangement. For instance, in the North American Free Trade Agreement (NAFTA), in order to qualify under the rules of origin, a vehicle manufactured in North America must have 62.5% of the value of its parts manufactured within the region. Compliance by importers and exporters with these rules is a cost of trade that in some cases exceeds the benefits of the preferential tariff. The need for rules of origin stems from the arbitrage opportunities that would arise if a good could be imported into one country first at a low (or zero) tariff and then transshipped to the partner country duty-free. This is an important point because many countries do not charge duties on imports if they are intended, as would be the case in this arbitrage example, for re-export. The second note is that the countries invoking article XXIV must formally notify all other members of their intention to implement a preferential trading arrangement and it must be reviewed for consistency with GATT/WTO principles. While the review process has been a formality for most preferential arrangements to date, efforts have been under way for a number of years to increase the level of scrutiny within this process, in particular by defining what "substantially all the trade" means.

What is not entirely clear from the historical record, however, is the extent to which the rationale for allowing preferential trading arrangements within the context of the GATT/WTO was based upon economic analysis as opposed to political reality or

other considerations. However, given that what is considered by many to be the seminal economic work on this topic was written by Jacob Viner in 1950 - at least partly as a reaction to this clause - economic considerations as the driving force behind this decision is not very plausible.

### *Trade Creation versus Trade Diversion*

In 1950, shortly after the General Agreement on Tarrifs and Trade was signed,<sup>5</sup> Viner (1950, pp. 41-81) started the debate about the merits of preferential trading arrangements by identifying two competing effects involved in the creation of a customs union. It should be noted, however, that his discussion is equally applicable to free trade agreements. The competing effects, discussed below, are trade creation and trade diversion. A preferential trading arrangement will be beneficial if the trade creation impacts are greater than the trade diversion effects; this determination must be made for each potential preferential arrangement on its own merits.

For a customs union to be a shift towards free trade, it "must be predominantly a movement in the direction of goods being supplied from lower-cost sources than before" (Viner, 1950, p. 42). This is the trade creation effect. The the opposite effect, i.e. goods being supplied from a higher-cost source than before because of the new

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<sup>5</sup>The GATT was signed in 1947 by: the Commonwealth of Australia, the Kingdom of Belgium, the United States of Brazil, Burma, Canada, Ceylon, the Republic of Chile, the Republic of China, the Republic of Cuba, the Czechoslovak Republic, the French Republic, India, Lebanon, the Grand-Duchy of Luxemburg, the Kingdom of the Netherlands, New Zealand, the Kingdom of Norway, Pakistan, Southern Rhodesia, Syria, the Union of South Africa, the United Kingdom of Great Britain and Northern Ireland, and the United States of America.

preferential tariff, is called trade diversion. In the formation of a customs union both effects can happen. Without a preferential trading arrangement, a product will be imported if the domestic cost of production is greater than the cost of production elsewhere plus the cost of the import tariff. With the preferential trading arrangement, however, the product will be imported from the new partner country even if the production cost in the partner country is higher than the previous supplier, but only so long as it is higher by less than the cost of the tariff. In this case, the product is now being imported from a less efficient source than was previously the case, i.e. a diversion of trade from a more efficient source to a less efficient source. A preferential trading arrangement creates trade when foreign production is cheaper than domestic production by less than the amount of the customs tariff implying that the preferential trading arrangement induces a shift in supply from the local producer to the cheaper source thereby creating trade and improving welfare. These two ideas have formed the starting point for much of the debate discussed later in this paper.

This idea is not, however, without its detractors. Wonnacot (1996) identifies five reasons that may ameliorate or even negate the negative impacts of trade diversion. The additional benefits he identifies that stem from preferential trading arrangements are: 1) increased economies of scale for producers in the partner countries; 2) reduced technical inefficiencies in production; 3) elimination of the relatively least efficient industries in each of the countries; 4) increased investment bringing about world-class technologies that would not otherwise have been created; and, 5) a reduction in the size and political influence of import-competing industries thus reducing resistance to

multilateral tariff elimination.

### **III. The Economically Efficient Goal of Trade Liberalization: Preferential versus Multilateral Trade Agreements**

The idea that global free trade should be the ultimate goal of international trade negotiations is an assumption that is sometimes taken for granted. A few authors are explicit about this assumption, such as Aghion, Antràs and Helpman (2004) who state that “although the desirability of free trade can be questioned, for the purposes of this paper we assume that free trade is desirable” (p. 2). In other instances, however, the assumption is implied rather than stated. For example, even the title of Raymond Reizman’s (1999) article, “Can Bilateral Trade Agreements Help to Induce Free Trade”, suggests that the reader will have to start with this assumption. That global free trade should be the ultimate goal of international trade negotiations is not, however, universally accepted.

There is a large body of economic literature which examines the negative impacts of freer trade on the environment, on the working conditions of labourers and on the distribution of wealth. These arguments are also often debated in the public arena by a number of non-governmental and labour organizations. A famous example of this is U.S. Presidential candidate H. Ross Perot when he campaigned on a platform of stopping a “giant sucking sound” of jobs being moved from the U.S. to Mexico under the proposed North American Free Trade Agreement (NAFTA). He suggested that U.S.

employers would move their operations to Mexico to take advantage of substantially cheaper Mexican labour rates. The debate on these issues is ongoing, a reader interested in this topic may wish to start with a 2002 book by Douglas Irwin entitled *Free Trade Under Fire*, which is written at a popular level and addresses many of the individual issues in an effort to debunk the naysayer's of free trade.

However, even when we move away from these issues and look at the economic literature focussed specifically on the welfare effects of free trade, dissenting views from this proposition are not a particularly unusual phenomenon. For instance, the next section of this paper examines several articles that identify situations in which bilateral preferential trading arrangements may have greater world-wide welfare enhancing effects than global free trade.

#### *Welfare Increasing Preferential Trading Arrangements*

Saggi and Yildiz (2005) address the question of whether aggregate world welfare would be higher if preferential trading arrangements were not allowed under international trading rules, requiring instead that trade liberalization occur on a multilateral level only. They construct a model which assumes that there are only three countries in the world and examine two tariff games. In the first, the countries are able to negotiate either preferential or multilateral trade liberalization. In the second preferential arrangements are forbidden. The question that is examined is about the incentives for countries to reach agreement on multilateral tariff elimination in either circumstance. One result from this model is that when two of the three countries are

high-cost producers and the third is a low-cost producer, the welfare of the world is maximised when the low-cost country negotiates two separate preferential trading arrangements, one with each of the high-cost countries. This outcome stems from global diversion of production from the high-cost countries to the low-cost country.

McCalman (2002) also identifies a model whereby preferential trading arrangements can bring about equal or higher worldwide welfare to global free trade. This outcome is premised on a model that contains one leading (hegemonic) country and a large number of small countries, and where the leading country has the monopoly power in world markets to use optimal tariffs to the greatest benefit for themselves. This model also requires that the MFN clause found in the GATT/WTO is in place, and that countries have private information about the benefits they would receive from multilateral tariff elimination. In bilateral negotiations between the large country and a small country, there is no private information about the gains from the trade liberalization, i.e. each country knows the full value of the arrangement to the other. The existence of private information in multilateral negotiations implies that some small countries will offer fewer concession in the negotiations than would be most efficient if they negotiated based on the true value to themselves, in effect they would be "free riders" on the multilateral negotiations. Since they could not obtain this free-ride if free trade was obtained through a series of bilateral negotiations, which in this model would only require each small country to have a bilateral preferential trading arrangement with the large country, a higher level of world welfare can be obtained in some circumstances via the preferential route.

### *Welfare Increasing Multilateral Free Trade*

This perspective, however, is countered by a broad array of literature that supports exactly the opposite conclusion, namely that multilateral free trade has greater worldwide welfare effects than preferential trade agreements (e.g. Brown, Kiyota and Stern, 2006; Bagwell & Steiger, 1998; Saggi and Yildiz, 2005; McCalman, 2002). Indeed the above identified works also support this conclusion in a variety of scenarios that differ only slightly from those described in the last section. For instance, the scenario outlined in Saggi and Yildiz (2005), while seemingly quite realistic from a practical perspective, (i.e. there are a number of examples where two large countries have preferential trading arrangements with a single smaller country but not with each other), is considered by the authors to be an exceptional circumstance rather than a common occurrence. In the case of McCalman (2002), it is shown that the scenarios in which global free trade is less welfare enhancing than preferential trading arrangements are reduced as the number of countries involved in the global negotiations increases. With all but two countries in the world having membership in the WTO<sup>6</sup>, large numbers would not appear to be a realistic problem. In addition, McCalman ignores the reality that the largest economies in the world were among the initial members of the WTO and were able to negotiate specific terms of accession for new members on an individual basis, thereby eliminating some of the potential sources of negative externalities.

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<sup>6</sup>The two countries who have not applied for membership in the WTO are North Korea and Libya. Libya has recently signalled that it may have an interest in membership.

Bagwell & Steiger (1998) use a simple two-country, two-good model premised on each country setting their initial tariff structure based on a politically motivated trade-off between distribution and efficiency. From this point they demonstrate that a government will not unilaterally set tariffs at the most efficient level because an increase in tariff rates above the most efficient level moves costs from the importing country onto the exporter, thus the only way efficient tariffs can be set is through the multilateral system. However, Bagwell & Steiger suggest that this conclusion is only tenable in the multilateral system as it is currently formulated under the GATT/WTO, with the foundations of reciprocity and non-discrimination. It also requires that these principles be backed up by a strong enforcement mechanism. Without the capacity to enforce the obligations countries have under the GATT/WTO, even within the scenarios described by Bagwell and Steiger, a stronger case could be made for preferential trading arrangements.

### *Empirical Research*

Some empirical research also backs the position that global welfare would be best served by multilateral arrangements rather than bilateral preferential trading arrangements. Brown, Kiyota and Stern (2006) examine possible trade policies in the U.S. and Japan encompassing a wide range of potential policies from unilateral tariff elimination to global multilateral free trade and a large number of possible preferential trading arrangements (e.g. preferential trading arrangements between the U.S. and the South African Customs Union and between Japan and Malaysia). Using a computable general equilibrium model they demonstrate that:

The welfare gains from both unilateral trade liberalisation by the United States and Japan and from global (multilateral) trade liberalisation are shown to be rather substantial and more uniformly positive for all countries/regions in the global trading system as compared to the welfare gains from the bilateral FTAs analysed (p. 853).

### *Conclusions*

Despite the existence of some economic literature supporting the idea that preferential agreements can be a more desirable proposition than global free trade, the picture that emerges from the above discussion is more supportive of global free trade as the final goal. Interestingly, however, one can find examples that would appear to match what Saggi and Yildiz (2005) suggest would be the circumstances under which the world is better off with preferential arrangements than under global free trade. For example, the U.S. and Japan, both of whom have high wage rates and production costs, have preferential trading arrangements with Mexico, a country with low wages and production costs, but not with each other. Other examples include both Canada and the European Free Trade Association (EFTA) who each have a preferential trading arrangement with Chile but not with each other, and the European Communities<sup>7</sup> and the U.S. who share a common preferential partner in low-cost Jordan but do not have such an agreement with each other.

The question that remains to be addressed in this paper is, assuming that global free trade is the desired outcome and noting that preferential trading arrangements are

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<sup>7</sup>The EC is itself a preferential arrangement involving a large number of countries who have formed a customs union.

becoming increasingly prevalent throughout the world, can we identify any selection methodologies that countries could use that would lead to, or at least not inhibit, the attainment of global free trade. We start the search for an answer to this question with a section that examines the existing literature on whether or not preferential trading arrangements can provide impetus for countries to liberalize trade in a multilateral setting.

#### **IV. Stepping Stones versus Stumbling Blocks**

Following on the previous section which provides the basis for our assumption that global free trade should be the goal, a significant amount of research has focussed on the question of whether preferential trading arrangements can serve to lead countries towards global free trade (Bhagwati, 1993; Krugman, 1993; Bagwell & Steiger, 1998; Summers, 1991; Baldwin, 1994; Freund, 2000; Campa and Sorenson, 1996; Reizman, 1999; Kose and Reizman, 2000; Kreuger, 1997; Aghion, Antràs and Helpman, 2004; Perroni and Whalley, 2000). The literature falls into three basic categories: i) those who feel that preferential trading arrangements serve only as a mechanism for countries not to work towards free trade (the stumbling block argument); ii) those who feel that preferential trading arrangements provide an incentive for further trade liberalization with global free trade as the eventual result (the stepping stone argument); and, iii) those who suggest that this distinction depends significantly upon the assumptions used or the circumstances of the particular preferential trading arrangement in question.

Before looking at the economic literature on this topic, there is one argument that is often used by governments as supporting preferential trading arrangements. This argument suggests that once a country has a preferential trading arrangement, it dilutes the market access of non-members and therefore provides an incentive for the non-member countries to want a preferential trading arrangement with that country. For example, the fact that Canada has a preferential trading arrangement with the U.S. provides an incentive for other countries (e.g. Mexico) to try and gain the same level of access to the U.S. market as their Canadian competitors. If every country is involved in at least one preferential trading arrangement, the result of this process should be an incentive for all countries to seek the same level of preferential access to all other countries. Neglecting the serious considerations of rules of origin, this would be global free trade. To a lesser degree this argument also appears in academic literature. For instance, Mansfield (1998) argues that while preferential arrangements are formed as insurance policy against potential future trading disruptions, the key reason they expand is because the initial creation of a preferential arrangement displaces trade from non-member countries. This process creates an incentive for other countries to seek the same preferential treatment that the initial partner countries have. This analysis ignores the counterargument that once a country has preferential access to another market it will also have an incentive to protect that access and not have it eroded by granting it to others through expansion of the preferential trading arrangement.

While this is an interesting line of thought, it does not provide a solid economically rational process for choosing whether or not a country should engage in a

preferential arrangement with another country. The alternative methodology which is followed here, is to focus on determining the welfare cost and benefits of preferential arrangements with the goal of determining if an optimal trade scenario can be reached with preferential arrangements along the path.

### *Preferential Trading Arrangements as Stumbling Blocks*

Krugman (1993) developed one of the earliest economic models to examine the stepping stone versus stumbling block effect of preferential trading arrangements. Unlike some of the more recent work on this subject, Krugman uses a static model with many countries who can choose to form trading blocks or cooperate towards global free trade. In his model the decision to cooperate, either multilaterally or bilaterally, or to not cooperate, along with the setting of tariff levels, are all decisions made at a single point in time. A distinctive feature of this model is that when there are a large number of small countries, each has limited market power and therefore sets a low tariff on imports. However, when a preferential trading arrangement is formed, the market power of the combined economies increases, thus providing incentive to increase protection. This simple model clearly shows that the formation of preferential trading arrangements inhibits, or even blocks, the attainment of global free trade. Interestingly, based on difficulties being encountered in the GATT/WTO at the time of his writing, Krugman does not base the conclusions of his paper solely on his model, but suggests that there may still be merit to preferential arrangements, but only because he believes

multilateral negotiations are not likely to be successful<sup>8</sup>.

Bhagwati (1993) argues that preferential trading arrangements modify the incentives of countries to negotiate towards multilateral free trade, including by providing incentives for countries to raise other forms of protection such as by using anti-dumping duties and voluntary export restraints against non-members. He suggests that the rules governing these preferential arrangements have to be modified in ways that would change these incentives to ensure that after implementation, countries and their affected interest groups still see increased value in global free trade. Bhagwati suggests several changes that would have the desired effect on these incentives, among them are: a requirement that common tariffs adopted upon implementation of a customs union be no greater than those of the lowest initial tariffs<sup>9</sup>; and, increased guards against the use of anti-dumping and voluntary export restraints. He also explores the idea of a change to the GATT that would require the overall arrangement to create more trade than it diverts - a change from the current requirement that it cover substantially all the trade between the parties. While this might be considered an ideal option, economists do not yet have the forecasting abilities, including the ability to

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<sup>8</sup>This was written at a time when the Uruguay round of negotiations was stalled at the GATT/WTO. This round was successfully completed in 1994 after 8 years of negotiations. Comparisons can naturally be made to the current situation with the stalled Doha round. As appears to have been the case at the time Krugman wrote his paper, this is serving as an impetus for countries to shift their focus to preferential trading arrangements and away from the multilateral system.

<sup>9</sup>Under current GATT/WTO rules a country can raise its tariffs, but where this affects trade, equivalent compensation must be made to the affected trading partners in the form of lower tariffs applied on other items.

predict future trade patterns, that would be required to do this with a practical degree of accuracy.

Bagwell and Steiger (1998) use a two-country, two-good model along with political considerations, i.e. the GATT/WTO rules of reciprocity<sup>10</sup>, non-discrimination (MFN) and enforcement of rules, to argue that bilateral preferential trading arrangements “cannot serve to implement an efficient agreement” (p. 1181). They argue that preferential trading arrangements, by their very definition, undermine the principles of the multilateral system, and it is only by these principles that an efficient tariff outcome can be achieved because without these principles the incentive for countries to defect from a cooperative regime is too strong. The single exception to this analysis is the very limited circumstances where all members of a customs union (but not a free trade agreement) have similar underlying political preferences for the trade-off between economic efficiency and equity in the distribution of benefits, effectively implying that this group becomes another tariff-setting entity similar to any other single country in the model.

### *Preferential Trading Arrangements as Stepping Stones*

Summers (1991) argues that all trade liberalization measures, be they unilateral, preferential or multilateral, are likely to be good. He argues that preferential trading

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<sup>10</sup>Bagwell & Steiger (1998) define reciprocity as referring “broadly to the ideal of mutual changes in trade policy that bring about equal changes in import volumes across trading partners” (p. 1171).

arrangements are likely to be stepping stones to multilateral trade because the global result, which is best for everyone, is most likely to be negotiable among a few larger trading blocks with an overall large payoff than among a large number of smaller players each with a small payoff (i.e. consensus among a few big players is easier to reach than consensus among a large number of small players). Summers also argues that all trade liberalization is likely to be more trade creating than diverting because preferential trading arrangements, both those existing and many of those proposed, are usually formed between countries that can be considered "natural trading partners". He further argues that even if a preferential trading arrangement is trade diverting, it will increase overall consumer welfare due to a link between trade and investment. This trade-investment link is based on the idea that most U.S. imports originate from U.S. subsidiary companies located abroad, this means that a preferential trading arrangement will affect investment decisions rather than cause real trade diversion (i.e. replacement of efficient production with inefficient production). He also suggests an additional benefit to preferential trading arrangements not mentioned anywhere else, that even if there is no clear economic justification for a particular preferential trading arrangement, the economic restructuring required for a developing country may be of benefit. In other words, an incremental step by a developing country to restructure their market, even if to become the second best producer (and therefore best priced due to preferential treatment), would be a positive step.

Baldwin (1994) provides a political economy model which examines the influences affecting the choice of countries to join a pre-existing regional preferential

agreement. He proposes that a country will wish to join a regional preferential trading arrangement when their access to a large export market, such as the U.S. or the EU, is threatened by preferential access into that market by another country that is seen as a competitor for their exports and for incoming foreign investment. Baldwin demonstrates that the more dependant a country's exports are on the market of the larger preferential group, the more likely the country is to apply to join the pre-existing preferential trading arrangement. This leads to an increased likelihood that a "domino" effect will occur, whereby one new country that applies for membership prompts a chain reaction of others that now meet a threshold where such membership makes sense both economically and politically. For evidence of this process in action, Baldwin looked at the EU expansion taking place in the 1994-1995 period where a number of EFTA countries sought accession to the EU at nearly the same time and applied for membership in the order that his model would predict.

Stepping outside the bounds of the ideas presented specifically in Baldwin's analysis, it seems that there may be some real world merit to the general results of his work. For instance, upon the signing of the NAFTA in 1994 a significant number of Central and South American countries began to seek preferential access to the U.S. market. Baldwin's analysis may also provide some rationale behind the large number of WTO/GATT accessions experienced earlier this decade. Should his ideas hold in the even larger case, an area for possible future study, one could reasonably infer an expectation that global free trade may also one day come about when a threshold level of acceptance to a single common preferential grouping begins a larger domino effect,

i.e. a preferential trading arrangement acting as a stepping stone towards global free trade.

Collie (1997) takes a somewhat different approach to preferential trading arrangements by arguing that the stepping stone approach to free trade has distinct advantages in non-tariff aspects of trade, export subsidies in particular, over attempts to follow the strictly multilateral approach to attainment of global free trade. Collie acknowledges that export subsidies are currently banned under the WTO, but notes that related government programs such as export credits or export credit insurance are often used as a replacement. Using a model with a large number ( $n$ ) of identical industrialised countries and ignoring the impact that tariffs might have on country decisions, Collie characterizes the Nash equilibrium of the export subsidy game and the impact that the creation and enlargement of trading blocks has on the export subsidies. He finds that equilibrium export subsidies are reduced as symmetric trading blocks are enlarged along with world welfare. Collie's model further suggests that trade block enlargement makes the elimination of export subsidies a more sustainable global strategy in an infinitely repeated game by reducing the one-time welfare gain for the trading block that first defects from free trade, this makes free trade a more sustainable strategy.

Freund (2000) examines the effects on total world welfare if global free trade is reached with preferential trading arrangements versus when it is reached strictly via multilateral negotiations. This is done by developing a model with a total of three

countries with identical economies in terms of size and production capacity and examining the welfare effects of each path to global free trade through two time periods. In the first case, she assumes that a welfare enhancing preferential trading arrangement is formed between two countries in the first period followed by global free trade in the second period. In the second case, no preferential trading arrangement is initially formed and the three countries move straight into a global free trade environment. The results in the first case show that firms in the partner countries are able to set up their distribution networks to maximize the impacts of the preferential arrangement. She shows that if the sunk costs of changing business systems around a more liberalized trade regime are large enough, the countries essentially have a first-mover advantage in the market of the third country. In this scenario, however, the welfare of the country that is not a party to the preferential arrangement is reduced, even when global free trade is attained in the second period, compared to what it would have been had this preferential trading arrangement been avoided. In the second case, where global free trade is not preceded by a preferential trading arrangement, there are no first-mover effects and the welfare gain from this path are less than would have occurred had a preferential trading arrangement been in place first. Freund contends that this welfare effect is due to the incentive to increase production that the introduction of a preferential trading arrangement creates in the founding countries. When output is expanded in the partner countries, there is a further increase in consumer surplus in the following free trade period that is greater than that which would have been created by global free trade on its own.

### *Model Features Lead to a Stepping Stone or Stumbling Block Effect*

Campa and Sorenson (1996) develop a model in which there are only three countries in order to analyse the sustainability of free trade in two situations. The first where one of the economies is a single economy (single country) and the other is a series of small economies. In this case, so long as the decision of each country is based on an infinitely repeating game, global free trade may be sustainable if-and-only-if the smaller group of countries can form a preferential trading arrangement with each other, thereby creating a strong group that could retaliate together should the large economy decide to defect from the global free trade scenario. Without the preferential trading arrangement, the optimal response of the larger economy would be to defect, thereby increasing its own welfare at the expense of the smaller economies. The incentives are, however, inverted in the second scenario examined by Campa and Sorenson. In this scenario the preferential trading arrangement formed by the smaller economies is larger than the large economy. In this case, the incentive to defect lies with the preferential trading group. Free trade in the Campa and Sorenson model becomes more likely if the world, which started out as an unarranged group of asymmetric economies, divides into symmetric trading blocks using preferential trading arrangements.

Reizman (1999) uses a simple general equilibrium model in which the world consists of only three countries and compares the welfare incentives for each economy to: i) form a free trade agreement with another; ii) form a customs union with another; iii) cooperate with the others for worldwide free trade; or iv) implement their optimal

non-cooperative tariff regime. The author then conducts two policy experiments: identifying the outcomes of the game if all preferential trading arrangements are banned, and identifying the outcomes if only customs unions are banned.

In his first experiment, where the world economy is dominated by a single large country, when all bilateral agreements are allowed, the feasible efficient outcome is global free trade. On the other hand, Reizman finds that without the threat of the smaller economies forming a customs union that would decrease welfare for the large economy, the large economy has no incentive to cooperate with the others and the non-cooperative equilibrium is the outcome. Similarly, with a ban on customs unions only, the outcome is a free trade agreement between the smaller economies despite this not resulting in as large a welfare gain as either global free trade or a customs union between them. In the second experiment, where two of the economies are roughly identical in size and the third is slightly smaller, and all preferential trading arrangement options are left open, leads to an equilibrium where the two larger economies form a customs union at the expense of the globally optimal solution. On the other hand, when all bilateral agreements are banned, Reizman finds that global free trade is the result. This is the same result when only customs unions are banned, i.e. free trade agreements are benign.

The implications of Reizman's analysis is that where there is a single powerful trading block in the world, in order to reach the economically efficient goal of world-wide free trade, smaller countries should use customs unions as at least a threat to the large

economy. However, if world economies are relatively similar in size, banning customs unions would be the most effective method of achieving free trade.

Kose and Reizman (2000) also construct a three-country general equilibrium model with endogenously determined tariff rates and measure the country-specific and global welfare effects for three different scenarios: i) an immediate move to global free trade; ii) a free trade agreement between two countries; and, iii) a customs union between two countries. Their analysis shows that welfare is maximized under the global free trade situation, and that there are global welfare gains under most assumptions about the division of endowments among the countries. On the other hand, they also use their model to demonstrate that after the creation of a free trade agreement there are still welfare gains to be made for all countries by a move to global free trade; this is not the case when countries have form a customs union. Thus they propose that it is not preferential trading arrangements themselves that are stepping stones or stumbling blocks. Rather, they propose that the type of preferential trading arrangement has a significant bearing on this determination, i.e. free trade agreements can serve as stepping stones while customs unions serve as stumbling blocks.

Kreuger (1997) builds on previous knowledge about the nature of preferential trading arrangements and the underlying dynamics that differentiate customs unions and free trade agreements, to reach the exact opposite conclusion from Kose and Reizman (2000). She claims that because free trade agreements are inherently more trade diverting than customs unions, and free trade agreements create a constituency

that will oppose further multilateral liberalization, it is only customs unions that can be considered stepping stones, while free trade agreements will be stumbling blocks to global free trade.

Taking the view that the U.S. has a disproportionate level of influence on the method of trade liberalization followed by countries around the world, Aghion, Antràs and Helpman (2004) develop a three-country game-theory model in which a single leading country decides upon the trade liberalizing path that will be followed. Required in this model is an assumption that utility can be transferred in the course of trade negotiations through side payments, such as those commonly found that set out labour or environmental objectives to be met by the smaller economy. They find that if the outcome of successful global free trade negotiations is greater than any combination of all countries in preferential arrangements - termed grand coalition superadditivity - then global free trade is the only outcome, whether it is arrived at through sequential bargaining or multilateral negotiations. However, even if this grand coalition superadditivity assumption does not hold, for instance if markets are not competitive or utility calculations for some countries include political variables, the building block or stumbling block effects are highly dependant on initial assumptions about relative resource endowments.

As noted earlier, Saggi and Yildiz (2005) developed a scenario under which the right combination of preferential trading arrangements could provide greater welfare than global free. However, they also examine other situations in which preferential

trading arrangements form both stepping stones and stumbling blocks to global free trade. They do this by constructing model containing a total of three countries and only two goods and where the formation of preferential trading arrangements is exogenously determined. They then examine the incentives to form global free trade. They conclude that when countries are relatively symmetric in terms of costs of goods production, a preferential trading arrangement forms a barrier to further global trade liberalization. This occurs because the optimal external tariffs of the partner countries on the outside country are relatively low, creating an incentive for the non-member to free-ride on the benefits of the free trade agreement. On the other hand, they also show that as countries become more asymmetric in production costs free trade is more difficult to obtain through multilateral negotiations and preferential trading arrangements become more desirable.

#### *Other Rationales for Preferential Trading Arrangements*

Given the obvious political nature of the negotiation, implementation and partner selection of preferential trading arrangements, it is not surprising that other rationales have been postulated as driving forces behind their creation. There is one in particular that is interesting to note.

Perroni and Whalley (2000) examine several recent preferential trading arrangements, they noticed that fewer concessions are often made by a large economy compared to smaller participants. These recent experiences are examined in light of a model that compares the optimal retaliatory tariffs facing the countries in the event of a

trade war. Their model suggests that a large country such as the U.S. would be impacted much less by an unconstrained trade war than would a smaller economy such as Canada. They conclude that the one-sided concessions they find in the trade agreements are reflective of insurance premiums that smaller countries are willing pay to the larger ones in order to be less impacted in the event of a trade war.

### *Empirical Research*

Freund (2000) followed up her theoretical research (discussed earlier) which suggested that the formation of a preferential trading arrangement prior to global free trade increases the welfare benefits of moving to a global free trade regime, with an empirical study of the process of European Union enlargement. She found support for her theoretical results by finding a significant relationship between the amount of trade between individual ER members and the date they joined the union. The largest advantage in trade increases was found with the original six members of the union. This result was shown to hold even when accounting for the possibility that the original members of the union may have initially formed the union for reasons related to underlying geographic and political considerations.

Baier and Bergstrand (2004) conducted an empirical study of the determinants of free trade agreements by looking at 54 countries (for a total of 1431 possible free trade agreement pairings) and compared them to records of existing free trade agreements<sup>11</sup>.

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<sup>11</sup>Note that Baier and Bergstrand specifically exclude from their analysis those free trade agreements that do not cover the full range of products as well as customs unions.

By using a form of the gravity model of trade, they are able to predict 85% of the free trade agreements in place in 1996. Their gravity model takes into consideration the characteristics of partner countries such as the distance between them and their isolation from the rest of the world, along with GDP, capital stock per worker and tariff rates. These results are supported by the theory that countries will tend to reach a free trade agreement with their natural trading partners, defined as those both geographically close together and close together in economic size and countries that are more isolated from the rest of the world (i.e. separated by large distances or on separate continents from the rest of the world). According to the authors, free trade agreements between natural trading partners should generally be more trade creating than trade diversionary because transportation costs of distant countries, even those with lower production costs, make them less likely to be able to serve a market at lower cost than a natural trading partner whose production costs may be slightly higher.

*Implications: What Makes a Good Partner for a Preferential Trading Arrangement*

While this issue is clearly still open for debate, there does appear to be some agreement that preferential trading arrangements are not all negative. Rather, in almost all the models developed to study this question, there is at least one scenario under which preferential trading arrangements provide an inducement to further trade liberalization. This statement even applies to the models presented earlier demonstrating why preferential trading arrangements serve as stumbling blocks to free trade, although in these cases the arguments for the preferential arrangements stem

less from economic theory than political or realism considerations. For example, Krugman's (1993) model which supports the stumbling block argument but which concludes with support for the second best alternative, preferential trading arrangements, because of a belief that multilateral negotiations are not politically feasible.

Before turning to some of the common elements that emerge from this body of work, a note should be made of a practical issue that arises from the implications of several of the models discussed above. Some of the results depend upon the ability of a country to shift their external tariffs either up or down when a new preferential trading arrangement is introduced. While countries are completely free to unilaterally reduce external tariffs, and it is technically possible for them to raise tariffs (given the sovereign rights of states), to actually raise tariffs in response to the implementation of a preferential trading arrangement would likely be viewed by the international community as an attack on the GATT/WTO whose goal is fewer trade barriers. A country that raised its external tariffs would likely face significant pressure, possibly including retaliatory action, from its trading partners. Further, such a move would imply an attack on the legal basis under which countries formulate preferential arrangements (the GATT).

These argument stems from two facts. First, all but two countries are members, or in the process of attaining membership, of the GATT/WTO and have agreed to operate under its principles. Second, most countries are involved in at least one

preferential trading arrangement. Countries therefore have both agreed to not increase tariffs within their GATT/WTO commitments, and do not want others to do so either. To the extent, therefore, that threats of retaliation provide an effective means of ensuring that trade barriers will not be increased to the rest of the world following a preferential trading arrangement, models requiring this outcome for their conclusions are not entirely realistic.

On the other hand, rather than increasing trade barriers as suggested in the models, it is possible for a country to refuse to lower their barriers when all others agree to do so, for instance following the conclusion of a GATT/WTO negotiating round. This relative increase in tariffs may have some offsetting impacts for a country whose preferred course of action absent the GATT/WTO rules would be to raise tariffs.

The first element that appears in multiple articles is the impact of asymmetry in the size of the economies of the partner countries to a preferential arrangement. For example Saggi and Yildiz (2005) and Reizman (1999) both suggest that some asymmetry between partners means that global welfare can be maximized by the use of preferential arrangements. These authors, however, offer very different explanations of the process followed to get to this welfare maximizing state and in their rationale for why this should be the case<sup>12</sup>. In addition, Campa and Sorenson (1996) take this

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<sup>12</sup>Recall that Saggi and Yildiz even devised a scenario under which global welfare was maximized under preferential trading arrangements over global free trade, the usual welfare maximizing situation.

asymmetry for granted and determine that preferential trading arrangements should be used along the path to global free trade, although their ideal situation implies that countries should, near the end, be divided into relatively symmetric blocks.

A second element that appears more than once in the literature, is that the type of preferential arrangement matters. For example Kose and Reizman (2000) suggest that customs unions are obstacles to global welfare maximization (free trade) and free trade agreements are conducive to the opposite, while the analysis presented by Kreuger (1997) suggests the opposite because free trade agreements create groups who will oppose further multilateral liberalization.

The literature also provides some insight into partner country characteristics a country should avoid in the selection of preferential trading partners. The first lesson that falls into this category is a preferential arrangement between a small economy and a hegemonic power. Such an arrangement would reduce the welfare incentive for the large economy to move to a global free trade scenario. The second lesson is that a preferential agreement that involves side-payments from one partner to the other may be undesirable. This is the case because side payments may either indicate a welfare-reducing preferential arrangement (Perroni and Whalley, 2000), or because the welfare gains of following the preferential route to global free trade would be reduced or distorted (Aghion, Antràs and Helpman, 2004).

## **V. Real World Experience in Preferential trading arrangement Partner Selection: The Case of Canada**

Having some theoretical background upon which to base judgements, we now turn to the question of what is happening in the real world. Are countries actually working towards preferential trading arrangements that will lead to a maximization of world welfare? While as of September 2006 the WTO reported that there were 211 preferential trade agreements which are in effect and for which they had received notification<sup>13</sup>, we will focus on those involving Canada. Canadian preferential trading arrangements include free trade agreements with five countries, and a further 31 countries with whom the government is either negotiating or actively looking to negotiate<sup>14</sup>.

Canada's first real free trade agreement was signed with the U.S. 1988. While there are other historical examples of preferential trading arrangements before 1988, such as the 1965 Auto Pact with the U.S. which partially liberalized trade in automobiles between the two countries, these were largely incomplete and we would not be well served by analysing them in this context. The Canada-U.S. free trade agreement, on

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<sup>13</sup>Further details and information on the preferential arrangements notified to the WTO and the rules surrounding these notifications can be found on the WTO website at: [http://www.wto.org/english/tratop\\_e/region\\_e/region\\_e.htm](http://www.wto.org/english/tratop_e/region_e/region_e.htm)

<sup>14</sup>These 31 countries consist of 15 members of the Caribbean Community and Common Market (Caricom), the four members of the European Free Trade Association (EFTA), the Central America Four, and the five-member Andean Community. In these cases, Canada would negotiate a single preferential arrangement that would cover the group of countries as a whole. For more details, go to <http://www.international.gc.ca/tna-nac/menu-en.asp>.

the other hand, was fairly comprehensive, including tariffs on most products phased-out over a maximum of ten-years. While the U.S. was able to maintain a number of protectionist policies, such as a ban on using foreign-built ships for transporting goods between points in the U.S, Canada was also able to maintain policies such as high tariffs on agricultural goods such as milk and cheese. This agreement also included provisions to liberalize trade in services and investment and, most controversially, added means by which companies could sue governments for failing to live up to their commitments. In 1994, the Canada-U.S. free trade agreement was overtaken by the North American Free Trade Agreement (NAFTA) which added Mexico to the partnership.

Since the NAFTA was negotiated, Canada has added free trade agreements with Chile (1996), Israel (1996), and with Costa Rica (2001). While the agreement with Israel is essentially limited to tariff elimination on goods, Canada's general position has been to use the NAFTA as a model from which negotiations should start. Ongoing negotiations with South Korea, EFTA, Singapore, the Central America Four and others essentially follow this same pattern, with EFTA being limited to tariff elimination on goods only<sup>15</sup>, and the others following the more extensive NAFTA model.

It should be noted at this point that Canada has only negotiated free trade

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<sup>15</sup>In this case, an agreement that excluded services and investment may also have been a strategic position in that the EFTA countries may have more liberal regimes in this regard than Canada.

agreements (as opposed to customs unions), largely due to concerns over the loss of sovereignty that would occur if tariff policy could be determined (or even negotiated) by other countries. There are no known plans to change this strategy in the near future. Given this background, the debate over the type of preferential arrangement that might lead to global free trade is worthwhile exploring in the Canadian context. Recall that Krueger (1997) suggested that free trade agreements create an incentive for certain constituencies to oppose further trade liberalization in the multilateral context. This theory does not appear to hold in the case of Canada. Despite the existence of substantial volumes of trade within the free trade areas, the Canadian government is able to continue a stated policy of preferring multilateral trade liberalization to regional or bilateral initiative<sup>16</sup>. The only significant Canadian constituencies that oppose this policy are those that have already been exempted from liberalization in the free trade agreements<sup>17</sup>.

We can look next at some of Canada's current and potential partners in preferential trading arrangements to examine Canada's rationales for having such an

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<sup>16</sup>For example, in a public on November 17, 2006 the Department of Foreign Affairs and International Trade Canada issued the following statement "Canada reaffirms its commitment to more liberalized trade, the rules-based multilateral trading system, and the objectives of the Doha Development Agenda..." (Available on-line at <http://www.international.gc.ca/tna-nac/WTO/resumption-en.asp>)

<sup>17</sup>In this regard it is Canada's supply managed agricultural sectors that oppose further liberalization of Canada's markets to imports. The five supply managed sectors are: dairy (e.g. milk and cheese), chicken, turkey, table eggs and broiler hatching eggs.

agreement<sup>18</sup> and to see if there might be any obvious concerns or advantages that can be identified based upon the conclusions reached above. We will start this discussion with a host of small countries such as Chile, Costa Rica, the Dominican Republic, Singapore, Central America Four (CA4), Andean, Israel and Caricom. Free trade agreements with these countries and regional groups might be considered “developmental” agreements. Developmental agreements are clearly prefaced on political concerns as opposed to the welfare benefits that might stem from them. In many of these cases for instance, total bilateral trade with Canada is less than one billion dollars<sup>19</sup>, with potential welfare gains being only a small fraction of this, and some gains clearly being trade displacement rather than trade creation.

Canada currently has several preferential trading arrangements that are developmental in nature, including a free trade agreement with Chile and another with Costa Rica. In these agreements, the concessions made by Canada are greater than those made by the partner country. For instance, in its agreement with Costa Rica, Canada agreed to eliminate almost all tariffs immediately with most of the remaining being eliminated within a period of 5 years. Costa Rica, on the other hand, retained a large number of tariffs for eight, ten, and even 15 years. The use of preferential agreements for development purposes has a number of implications for the lessons

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<sup>18</sup>The most informative public document in this regard is an annual report on Canada’s International Market Access Priorities (CIMAP) which is available on-line at: [http://www.international.gc.ca/tna-nac/2006/pdf/ITC\\_06-en.pdf](http://www.international.gc.ca/tna-nac/2006/pdf/ITC_06-en.pdf), it is not, however as helpful as would be desired for those agreements that have been in place for awhile.

<sup>19</sup>Canada’s total GDP is now well over one-trillion U.S. dollars.

taken from section IV. First, it indicates that these preferential arrangements do not meet the criteria to be insurance policies for the smaller countries, i.e. Canada did not extract concessions from its partners as insurance premiums, nor did Canada seek to gain some of the welfare increases that the agreement would create in the partner countries, in exchange for the guaranteed market access in the event of a global trade war (i.e. side payments). In section IV, no circumstances were identified suggesting that side-payments would be made by a large economy to a small economy in order to obtain a preferential trading arrangement. It is also not clear if such side-payments made by the larger economy would be welfare reducing, although a more rigorous analysis of this issue would be required for more conclusive results. Second, concerns about preferential agreements between small and large countries would not reasonably be an issue in these examples because, on a global scale, Canada is not a large economy, and even the partnerships between Canada and these small countries would not render the combined entity large on a global scale, particularly when compared against the largest groups such as the NAFTA and the E.U.

While potential Canadian free trade agreements with South Korea and EFTA would hold more significance than those discussed previously, the joint size of the preferential partners in these cases is also relatively small on a world scale of preferential trading partners. Size consideration are also the reason any concerns that might be expressed about an agreement between asymmetric partners with the larger having a hegemonic position in the world can also be dismissed. In addition, in these cases there is no agreement that has been signed and it is not clear either that any

side-payments would be involved or which way they would be expected to flow should they be included in the agreement. An additional consideration applicable to the particular case of EFTA is the already low tariffs faced by any exporter to these markets. Norway, for instance, applies no tariffs on industrial goods except for those on textiles and apparel, leaving little room for distortion, particularly on imports from Canada given the lack of Canadian capacity in the area of textiles and apparel.

It is the North American Free Trade Agreement that appears to be the best candidate to meet the stumbling block criteria identified in the literature, particularly at the time of its inception in 1994. There are some positive aspects about the NAFTA from the lessons learned. First, the U.S., Canada and Mexico have relatively asymmetrically-sized economies and second, they signed a free trade agreement rather than forming a customs union. In addition, it is quite clear that they meet many, if not all, of the requirements of Baier and Bergstrand's 2004 econometric model describing natural trading partners.

The NAFTA, however, also meets some of the criteria gleaned from the negative lessons learned in section IV. In the first instance, it is not unreasonable to think of the U.S. as having a global economic hegemony and Canada and Mexico as being small economies (even if only relative to the U.S.). The result of this agreement combined with the other 17 small countries with whom the U.S. also has free trade agreements<sup>20</sup>,

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<sup>20</sup>The 18 countries with whom the U.S. has signed free trade agreements are: Israel (1985), Canada and Mexico (1994), Jordan (2001), Chile (2004), Singapore (2004), Australia

certainly give the appearance of meeting the requirements to distort U.S. incentives to further liberalize trade multilaterally, which would serve to make global free trade less likely. In addition, side payments, such as an allowance by Canada and Mexico for the U.S. to retain a series of non-tariff barriers to exports (e.g. the Jones Act, which bans imported vessels from engaging in the transport of merchandise between points in the U.S. and labour and environmental regulatory changes in Mexico). The more side payments, whether for insurance purposes, or to capture welfare increases beyond those required for the countries to sign the agreements, the greater the distortion on the possible stepping stone route of preferential arrangements to global free trade.

Given that the NAFTA is in place, that the vast majority of Canadian international trade is conducted within the NAFTA countries, and that this may have had a large distortionary impact at its inception, it is possible that any further trade liberalizing step would be an improvement of the situation. This benefit would stem from diversions that could occur away from imports from the U.S. to another country with a comparative advantage in a given good. While this might not be the perfect situation, it is certainly an improvement from the status quo where relatively less efficient U.S. producers continue to supply the Canadian market due to the import tariffs imposed on third country imports. The vast amounts of trade between Canada and the U.S. and the high-cost nature of both economies suggest that trade diversion from new agreements

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(2004), Morocco (2005), El Salvador, Honduras, Guatemala, Nicaragua, Dominican Republic and Costa Rica - CAFTA-DR - (2006), Bahrain (2006), Oman (2006), Peru (2006) and Colombia (2006). The last two have not yet been presented to congress for ratification.

is most likely to be away from existing producers in the NAFTA region.

## **V. Conclusion**

This paper has provided a critical assessment of the current state of the economic literature with a view to determining first, what would define a good partner for a preferential trading arrangement, and second how a country would go about choosing partners that meet these criteria. In this regard, we have concluded that a good preferential trading partner is one that after an agreement is reached does not adjust domestic incentives, based on economic welfare considerations, away from global free trade. A driving impetus for this paper is the current global situation, where the numbers of such preferential arrangements are growing quickly and without regard for economic rationales which should be at their foundation.

The key findings from our search of existing economic literature on this topic are:

- i) that a preferential trading arrangement is more likely to serve as a stepping stone to global free trade if the parties are relatively asymmetric in size, but with none being a hegemonic power;
- ii) the type of arrangement negotiated may matter (free trade agreements versus customs unions). On this second point economists disagree on which is better, however, experience in the Canadian context shows that free trade agreements have not shifted Canadian preferences away from a goal of global trade liberalization.

Applying the common factors from the economic literature to the example of Canada, it is suggested that the only preferential agreement that might be of concern is the NAFTA, which was among the earliest agreements of its kind. Given the political realities that the NAFTA is not likely to be cancelled and global free trade is still a long way off, perhaps second best, i.e. the reduction of distortions by the granting of preferences to additional preferential partners, is all that can realistically be attained at this time.

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