

BOOK REVIEWS

Termites in the Trading System: How Preferential Agreements Undermine Free Trade

Jagdish Bhagwati

New York: Oxford University Press, 2008, 139 pp.

This may sound like a “man bites dog” story—“Leading free trade economist denounces free trade agreements!”—but it is not such a strange tale in the world of international economics. Since the pioneering work of Jacob Viner in the 1950s, economists have known that bilateral and regional trade agreements can actually reduce a nation’s welfare by merely diverting trade rather than creating new trade. In his latest book, Jagdish Bhagwati of Columbia University makes a tough, passionate, and concise, if not airtight, argument that the proliferation of such agreements is fatally undermining the global effort to advance free trade.

Bhagwati is a longtime critic of what he rightly calls “preferential trade agreements,” or PTAs. He has authored or coauthored numerous books and papers that analyze the economic shortcomings of PTAs. This short volume sponsored by the Council on Foreign Relations attempts to, in the author’s words, “provide every scholar and policymaker with a comprehensive and analytically coherent, if brief, overview of the arguments that must be confronted if we are to cut through the fog that surrounds this important and, in my view, pernicious development” of proliferating PTAs.

Like all his writings, this book is a pleasure to read even if trade is not your specialty. Bhagwati explains economic concepts clearly and enlivens the argument with anecdotes and brief profiles of

Cato Journal, Vol. 28, No. 3 (Fall 2008). Copyright © Cato Institute. All rights reserved.

fellow economists and policymakers. If only more free-trade economists could communicate this well.

The first of the book's four chapters documents the checkered history of regional and bilateral agreements in the 20th century and their rapid spread in the past two decades. One feature of the disastrous "beggar my neighbor" trade policies of the 1930s was the fragmentation of the global economy into competing trading blocs and preferential arrangements. The United States and 22 other major trading nations sought to undo the damage by creating the General Agreement on Tariffs and Trade in 1948. The GATT not only sponsored reciprocal reductions in tariffs but required that they be applied according to the "most favored nation" (MFN) principle. That is, tariff reductions must be applied in a nondiscriminatory manner to all signatories to the agreement.

While the MFN principle was a cornerstone of the GATT, exceptions were granted almost from the get-go. In the 1950s, six European countries were allowed to form a common market under the exception granted by Article XXIV of the GATT charter. In the 1970s, less developed members were allowed to sign PTAs with each other that were riddled with loopholes and exceptions, while the rich countries eliminated duties on a selective basis to imports from certain poor countries.

In the past 20 years, the number of PTAs has exploded. At latest count, a cumulative 350 PTAs have been reported to the WTO, with more than 200 currently in effect. The trend accelerated in 1991, and Bhagwati offers several explanations. One is that free trade became more fashionable among politicians after the demise of the Soviet Union, and politicians in favor of free trade naturally sign "free trade" agreements.

Another reason was the bad example set by the United States, which up until the 1980s had resisted any deviation from the MFN principle it fought so hard to enshrine in the GATT. But when the U.S. government failed to persuade GATT members to launch a new round of negotiations in 1982, it embarked on a series of bilateral negotiations itself, first with Israel, then with Canada. Even after the Uruguay Round was successfully launched in 1986, the United States joined with Canada and Mexico to sign the North American Free Trade Agreement in 1992. Although other countries have signed more PTAs, the United States continued along the path under the

“competitive liberalization” agenda of former U.S. trade representative Robert Zoellick.

Bhagwati has nothing good to say about the spread of PTAs. He argues that they are bad for smaller countries who find themselves bullied by the bigger “hegemons,” such as the United States and European Union, to accept terms against their interest. One of his strongest examples of this is the inclusion of “trade-unrelated agendas” such as labor and environmental standards and intellectual property enforcement. The book includes a telling picture of a visibly uncomfortable President Alan Garcia of Peru standing between two smiling Democratic members of Congress after he was forced to rewrite his country’s domestic social regulations according to their dictates as the price for a trade agreement with the United States.

Developing countries are rightly suspicious of the demand that social standards be grafted into trade agreements. The AFL-CIO and its allies in Congress claim they only want to improve living conditions in poor countries, but as Bhagwati accurately observes, “The use of trade treaties to incorporate labor standards is widely seen now as a form of ‘export protectionism’: aimed at raising the cost of production of foreign rivals by forcing on them the same labor standards as in the United States.”

For the global trading system as a whole, Bhagwati complains that PTAs create a bewildering “spaghetti bowl” of discriminatory tariff rates, rules of origin, and content requirements. They legitimize inclusion of nontrade issues in trade agreements. And they undercut the enthusiasm of WTO members to pursue nondiscriminatory multilateral agreements. All those charges have a ring of truth.

In the final chapter, “What Do We Do Now?” the author concedes that, “Halting the formation of PTAs is no longer a possibility.” He also dismisses the idea of consolidating agreements into less discriminatory regional blocs or encouraging PTA members to lower their external barriers. The only realistic solution will be to reduce global MFN tariffs to such negligible levels that PTAs no longer matter. And that will require another round of negotiated reductions in the WTO. No supporter of free trade would quibble with that proposal, though it is much easier said than done.

As somebody who has supported various U.S. bilateral and regional trade agreements, including NAFTA, I think Bhagwati states the case against them too starkly. While trade diversion certainly exists,

he presents no evidence that it has outweighed trade creation in any major PTA. He hints that Mexico's economy may have actually been hampered by NAFTA, but he makes no effort to separate the effects of NAFTA from the many challenges Mexico's economy still faces, from fallout of the 1994 peso crisis to inefficient state monopolies, inflexible unions, and a weak judicial system. Far from being a hindrance, NAFTA has been an important cornerstone in Mexico's political and economic modernization.

The book also exaggerates the impact of PTAs on multilateral negotiations. Some of the strongest proponents of the WTO process—Chile, Australia, the United States itself—have also aggressively pursued PTAs. To back his thesis, Bhagwati partly blames the failure of the 1999 WTO ministerial in Seattle on the fact that Charlene Barshefsky, the U.S. trade representative, was distracted by a trade agreement she had been negotiating with China just prior to the meeting. Of course, that agreement was not a PTA of the sort Bhagwati opposes but China's accession agreement to the WTO. The spread of PTAs is more plausibly a symptom of dysfunctional WTO negotiations than a cause.

Bhagwati's warnings have merit in the abstract, but his fears do not seem to be playing out in practice. The "pandemic" of PTAs since the early 1990s has coincided with the dramatic expansion of global trade, cross-border investment, and output. Global supply chains are more complex than ever as regional integration in North America, East Asia, and Europe continues to deepen. Amidst the PTA pandemic, the middle class has rapidly expanded in emerging markets while poverty has fallen. PTAs may be a poor substitute for unilateral and multilateral liberalization, but they do not appear to be an obstacle.

For supporters of a more open global economy, Bhagwati's book is a healthy reminder that we should not reflexively support every agreement with "free trade" in the title. He is certainly right that many of the 200 preferential agreements in the world today are not worth the reams of paper they are printed on and are probably doing modest harm to the global trading system. But he fails to make a convincing argument that we should reflexively reject every such agreement.

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