

The WTO: Friend or Foe of Free Trade?

One of the most important international economic issues at the moment is why the World Trade Organisation (WTO) is having such difficulty promoting further trade liberalisation on a multilateral basis. It is widely believed that the Uruguay round, the latest set of world trade negotiations completed in 1994, took too long and achieved too little given the resources expended. And general enthusiasm for another world trade round remains weak. Yet many believe that the world would benefit from further liberalisation.

The fear is that the widely documented polarisation in world trade arrangements towards three regional blocks is damaging the process of further multilateral trade liberalisation. The last seven years has seen consolidation of trading arrangements by European nations within the European Union (EU), formation by The US, Canada and Mexico of the North American Free Trade Alliance (NAFTA), and the Asia Pacific Economic Cooperation (APEC) forum set up by countries in the far east. It is natural to worry that if countries form a trade block they will become more insular, trading more with each other and less with the outside world.

The current wrangle over bananas between the EU and the US is a case in point. The US claim that EU countries are giving favoured access to banana producers from former colonies, and closing out imports from US owned banana plantations. And it is almost certainly the case that the European Union has enabled members to stand firm against US objections. Individual members acting alone would probably have backed down over this issue long ago.

Under certain circumstances, getting together to stand up to a foreign power is a good thing. But the situation with bananas is almost certainly not one of them. Most estimates suggest that European consumers are paying well over the odds in quota rent - the difference between the market value of high price protected bananas and the cost of buying them elsewhere. Less than 10% of the cost of the quota is reckoned to end up in the hands of the developing countries that this policy is aimed at assisting. Martin Wolf provides an excellent overview of this issue in the *Financial Times* (24/3/99). We would not wish to criticise the desire to help the economies that are favoured by these policies, merely to argue that there are more efficient ways of doing so.

Perhaps the most pernicious effect of this strategy is the retaliation that it has provoked. European policy makers may argue quite convincingly that they are protecting jobs in Europe's territories and its dependencies by imposing these measures. What they do not say is that trade partners that are hurt by these measures will tend to respond by becoming more protectionist. In anticipation of the WTO ruling on this issue, the US imposed tariffs at a rate of 100% with effect from the 3rd of March 1999, on a range of imports from Europe. So while jobs appear to be saved by restricting imports, more may be lost when exports fall under retaliation.

It is difficult to hold a serious discussion about the banana issue because in wider circles it is seen as being so trivial. But the gravity of the situation comes with the fact that it may spread to a full scale trade war involving many more goods, and perhaps many more countries. And it is sensible to argue that in an environment not just of countries but of trade blocks the risks that this may happen are heightened. Why? Because rather than facing a cold lonely world if it does come to an all out trade war, countries know that at least they will be able to fall back on trade with other members of their block.

Conventional thinking has it that the WTO will prevent a trade war. But more than this, its rules are designed to ensure that trade block formation promotes rather than penalises the multilateral liberalisation process. Article XXIV, the WTO's set of

rules governing trade block formation, states that countries are allowed to form a block on the condition that they do not become more protectionist towards outsiders. And the WTO has an arbitration process through which such rules can be enforced, attested by the current proceedings against the EU. To rationalise Article XXIV, the reasoning goes as follows. In addition to the fact that block members are not allowed to become more protectionist, one of the features common to all trade blocks is that they remove protectionist measures against members. Providing that trade block formation leaves members better off, so the argument goes, this process can be expected to continue until all countries are a member of one all encompassing trade block, equating to free trade.

Whilst this argument is appealing in its simplicity, recent research that we have undertaken argues that it is wrong*. Trade block formation under Article XXIV will not bring about free trade.

The point overlooked by the conventional wisdom is that even if blocks do not become more protectionist against non-members, trade block formation will still make members better off, and furthermore that this will be at non-members' expense. The implication of block formation that has been overlooked can be explained most easily as an exchange rate effect. Take, as an illustration, the efforts being made within the EU to form a single market. The principle intention of this is to increase trade between member states. With all else equal they will trade less with the rest of the world as a result. Consequently, their currencies will appreciate against those of non-Europeans like the yen and the US dollar. This increases the purchasing power by Europeans of non-European goods, making them better off. Conversely, it reduces the purchasing power of non-Europeans over European goods, to their detriment. All this happens because trade within the Union is facilitated, and happens even if trade with outsiders is made no more difficult.

How does this relate to whether trade block formation will lead to global free trade? The key insight is simple. If the benefits from membership of an exclusive club are derived partly by making outsiders worse off, then the club will not throw open its doors to all comers. At its most basic level this works on nothing more than the principles of kudos and envy. It becomes particularly interesting to economists when the mechanism through which members benefit and outsiders are made worse off operates through the market.

Facilitating trade between block members has exactly this effect. The purchasing power of block currencies increases, whilst that of outsiders declines. Consequently, trade blocks do not have an incentive to allow all applicants to join, because some of the benefits of membership come from being able to purchase the products of outsiders more cheaply on world markets. So there is a limit to the expansion that can be expected from existing blocks, and free trade between all countries will not result from this process.

In conclusion, there are many reasons why countries might have seemed more interested in becoming part of a trade block than engaging purely in multilateral trade liberalisation. The surprise is that WTO officials, in trying to understand why this is happening, should look to the incentives created by their own rules for at least part of the answer.

* Zissimos, B. and Vines, D. (1999) "Is Article XXIV Bad?" CSGR discussion paper, forthcoming.

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