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THE INTERNATIONAL COMMERCIAL SYSTEM

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INTERNATIONAL FINANCE SECTION

DEPARTMENT OF ECONOMICS
PRINCETON UNIVERSITY
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CONTENTS

THE INTERNATIONAL COMMERCIAL SYSTEM

I don't mean the General Agreement on Tariffs and Trade (GATT). And I don't mean the World Trade Organization (WTO). At least, I don't mean only the GATT and WTO. I refer, instead, to a more comprehensive framework within which countries individually and jointly conduct their trade policies and which has been evolving for more than half a century. Parts of this framework (such as the GATT and WTO) reflect conscious design and parts do not. In this essay, I hope to show that such an international commercial system does, indeed, exist, to describe the economics of the system, and to demonstrate that an analysis of it is worthwhile.

Although Frank Graham had a deep interest in international trade and economic policy, he could not have addressed my subject, for it had not fully come into existence during his lifetime. I shall try, however, to adopt something of the argumentative and assertive approach that characterized his work.

1 Introduction

There are three constituent parts of the international commercial system:

- *Multilateralism* refers to the GATT rounds of negotiations and the WTO. It is a central part of the system and has been developing for over fifty years.
- *Unilateralism* refers to the means by which countries individually alter their trade barriers, either directly or by inducing bilateral negotiations. It consists of a set of rules—explicit and implicit—by which national governments respond to domestic political pressures for protection. The set changes over time, both in its composition and in its pattern of usage. The oldest of the three constituent elements, unilateralism has always been with us, but it changes in response to changes in multilateralism.
- *Regionalism* refers here to the "new regionalism" prominent since the late 1980s. In this sense, it is the most recent of the three constituents.

I am grateful to Arye Hillman, Henrik Horn, and an anonymous referee for helpful comments and suggestions.

I am concerned with the relations among these three components and with the nature of the system they jointly determine. In particular, I want to know how the three components, and the interactions among them, determine the pace of trade liberalization, the rate of technological advance, and the success of "outliers" in reforming themselves and joining the world trading system.

In the following discussion, I shall first describe the three components in greater detail, arguing that each can usefully be reduced to a few basic principles. I shall then present a simple abstract framework for analysis, featuring high initial tariff barriers and many countries, the governments of some of which wish to negotiate gradual tariff reductions.[1] Unilateralism and multilateralism will develop endogenously in this framework, embodying the principles actually observed. Finally, I shall argue that some governments, initially aloof from multilateral liberalization, will attempt to enter the multilateral system as participation gradually appears to promise larger benefits. Regionalism will develop endogenously to facilitate this entry.

My approach is positive rather than normative, with the consequence that some familiar parts of the international trade-policy scene will appear in a new light that is more favorable than before. My conclusion is that it is a mistake to evaluate these parts in isolation from the overall system and in ignorance of the reasons for their existence.

2 Multilateralism

I describe multilateralism first because it is the simplest of the three components and the least controversial. Although I have in mind the entire GATT/WTO structure, my present purpose will be better served

[1] The argument that follows draws heavily upon my own work of the past decade or so. Instead of annoying you with repeated references to myself, I shall instead unleash a single barrage of self-serving advertisement (I dismiss out of hand the third alternative of simple silence). For international economies of scale, see Ethier (1982a, 1995); for a theory of dumping, see Ethier (1982b); for the old regionalism, see Ethier and Horn (1984); for the theory of antidumping policy, see Ethier and Fischer (1987) and Ethier (1992a, 1993); for foreign direct investment, see Ethier and Horn (1990), Ethier (1992b, 1994a, 1994b, 1998e), and Ethier and Markusen (1996); for a treatment of the nature of voluntary export restraints (VERs) with an emphasis on the importance of discrimination, see Ethier (1991a); for a theory of VERs, see Ethier (1991b); for the nature of unilateralism, see Ethier (1994c); for aggressive export promotion, see Ethier and Horn (1996); for a survey of some approaches to endogenous regionalism, see Ethier (1998a); for a nontechnical treatment of the new regionalism, see Ethier (1998b); for multilateralism and regionalism, see Ethier (1998d); for unilateralism and multilateralism, see Ethier (1998c).

if I imagine this structure to be distilled into just three basic elements. These are:

- Successive *rounds* of multilaterally negotiated tariff reductions,
- An emphasis on *tariffs* as instruments of protection, and
- *Nondiscrimination*, whereby each country is a most favored nation (MFN) of every other, so that a trade concession made to one partner is extended to all partners.

The discussion that follows identifies multilateralism with these three principles.

Multilateral liberalization has increasingly shifted focus from further reducing already reduced tariffs to broadening liberalization into additional areas, such as agriculture, services, and intellectual property. As a consequence, attention has necessarily shifted to government policies other than tariffs. Consideration of these developments would not alter the argument that follows, and I do not intend to address new issues the developments raise. In the interest of simplicity, therefore, I shall abstract from all this and pretend that continued multilateral liberalization is nothing more than the continued reduction of tariffs.

3 Unilateralism

My description of unilateralism is probably the most controversial of the three descriptions I offer. It is necessary, first, to draw a distinction between the traditional theory of protection and contemporary unilateralism: the elements of the "new protectionism" are *rules for intervention* rather than *tariff rates*, and the measures called for by the rules are temporary rather than permanent.

I intend to argue that the policy tools of the new protectionism are best seen as embodiments of general principles of unilateralism, rather than as instruments to be examined one by one. I shall describe the instruments themselves and then argue about what these general principles are.

Four Instruments of Unilateralism

• *Voluntary export restraints* (VERs). These instruments are extralegal in that they fall outside both national laws and international agreements; as a result of the Uruguay Round, they are becoming even more extralegal.

The other three instruments are known collectively as "administered protection." They are both provided for in the national law of many countries and sanctioned by the WTO, the members of which are required to abide by certain principles in their administration. These instruments are:

• *Antidumping duties.* Dumping refers to pricing for export below the cost of production or below the price for comparable domestic sales. Antidumping laws provide for a two-pronged investigation when such behavior is alleged: determination of the dumping margin, if any, and determination of material injury to domestic import-competing firms. If both determinations are positive, a temporary duty equal to the dumping margin is imposed on the relevant good imported from the country whose firms have been found to have dumped. Note that the national interest plays no role in this procedure and that, in the United States, the president has no discretion to decline to impose the duty. These laws thus define certain behavior as objectionable and force import prices up when it occurs. Whether or not the behavior *should* be regarded as objectionable is apparently beside the point; the laws delineate a set of circumstances under which import-competing interests may obtain temporary protection.

• *Countervailing duties.* These duties apply to imports that have been subsidized for export by the exporting country. Their administration is similar to that of antidumping laws.

• *Safeguard provisions.* These provisions give temporary protection for domestic industries harmed by an increase in imports. Once again, a material-injury test is applied. But in this case, in the United States, the president has discretion to decline to impose a duty. More generally, duties that are imposed should be nondiscriminatory, and they should not increase protection overall; duties should be reduced (again, in a nondiscriminatory way) on goods that are important exports of the exporting countries most affected by the safeguard measures.

Antidumping and countervailing-duty laws brand certain practices as objectionable, and the presence of these practices may allow a country to impose temporary protection *in addition to* trade barriers already in place. Safeguard provisions, by contrast, are nonpunitive measures intended to allow countries temporarily to *readjust* the existing structure of protection to limit perceived internal pain.

By limiting consideration to the above four instruments, I exclude a number of other tools. The most prominent of these are, no doubt, those that are intended to be used aggressively for export expansion, such as Super 301 in the United States. Such instruments are more characteristic of the United States than of other countries. More important, I want to limit the scope of this discussion by confining unilateralism to import protection. My topic is very broad, and without some such limits, all hope of coherence would be lost.

Changing Instrument Use

The way the above four instruments are employed has changed dramatically in several ways, and these changes often illustrate an interplay between multilateralism and unilateralism. First, use of these instruments has greatly increased since the 1960s. With the freedom to conduct traditional tariff policy progressively constrained by multilateral agreements, protectionist pressures have increasingly found outlets in the new protectionism.

Second, with use of the instruments becoming more pervasive, multilateral agreements have been broadening in attempts to encompass unilateral actions. The Tokyo Round established voluntary codes for the conduct of administered protection. These were made mandatory for WTO members by the Uruguay Round, which also attacked VERs, attempting to phase out existing restraints and to curtail future use. But the code for safeguards has been liberalized, and countries are now allowed, under certain circumstances, to use safeguards more in the way that VERs have been used. The final outcome of all this is far from clear.

Third, countries have continually made changes to their laws governing administered protection. Although some changes have been made to adhere to the codes of conduct, the changes have generally had the effect of reducing discretion in their application and making protection a more likely outcome. The United States moved administration of its antidumping law from the Treasury Department to the Commerce Department for just this reason.

Fourth, as the use of administered protection has grown, the mix among the instruments used has changed dramatically, with the number of escape-clause cases declining absolutely, as well as relatively, and the number of countervailing-duty and (especially) antidumping cases exploding.

This persistent change in instrument use, and the prospect of continued change in the future, suggests the possible strategy of searching for a common denominator of underlying principles of unilateralism. If such a common denominator exists and is sufficiently significant, analysis can be directed toward the principles themselves, rather than toward the specific instruments that embody them. Such an analysis might then be expected to remain relevant even as the mix of instruments actually employed continues to change. I argue that such a common denominator does, indeed, exist.

Principles of Unilateralism

Five principles characterize—more or less—the trade restrictions produced by the various instruments of unilateralism:

- Foreign exporters are *compensated*. The restrictions are voluntary, in large part, for exporting as well as importing nations.

A distinctive feature of *VERs* is that the rents generated by the restriction of trade accrue to the exporting nations, which actually administer the quotas. Usually, the quotas are administered in such a way that the exporting firms themselves capture the rents and are thereby compensated, at least in part, for the lost export sales. Also, in oligopolistic markets, total profit may increase further, because of the restraint placed on some firms, thereby enhancing the (reduced) share accruing to exporters (Harris, 1985; Krishna, 1989). On balance, the exporting firms may or may not be better off than if there had been no restraints, but they receive significant compensation in any event. Safeguards explicitly require that exporters be compensated, but the compensation is to the exporting *country* rather than to the exporting *firms*.

With antidumping and countervailing duties, the assertion of significant compensation seems implausible, maybe ridiculous. These instruments use tariffs, after all, and the targets of antidumping actions spend large sums defending themselves. But the compensation does, in fact, exist, and this can be appreciated after a closer look at the way in which these instruments are actually used. About one-third of U.S. antidumping petitions, for example, result in duties; another third are rejected; and the remaining third are withdrawn. Of those that are withdrawn, many are withdrawn after a settlement has been negotiated (with or without government involvement) between the domestic and foreign firms. This typically involves an undertaking by the foreign firms to raise prices or to restrict exports. Thomas Prusa (1992) reports that withdrawn petitions appear to restrict trade almost as much, on average, as petitions resulting in the imposition of duties, implying that negotiated settlements are, on average, more restrictive than antidumping duties. When such undertakings are made, the exporters receive the rents, just as they do with VERs.

If a petition results in an antidumping duty, instead, the effect is higher export prices, not tariff revenue. Any tariffs collected are rebated when it is determined, *ex post*, that the goods were not in fact dumped.[2] The exporter, realizing that the price in the importing

[2] But in the United States at least, the importer will incur additional liability if it is determined that the goods were in fact dumped by more than the duty. This implies that

country is going to rise by the amount of the dumping margin, no matter what he or she does, raises the export price by that amount. The purpose of an antidumping law is not to impose temporarily a conventional tariff but to force exporters to raise prices. Just as with VERs, the exporters usually get the rents.[3] In addition, an antidumping duty usually applies to similar products from all firms in the industry in the country of the dumping firm, not just the latter. Thus, just as with a VER, an antidumping duty collectively constrains the behavior of exporters from a specific country. And it, too, possesses the potential to raise oligopolistic profit in an industry and to confer a net benefit on exporters.

Even if both home and foreign firms wish exporters to be collectively constrained, the mere existence of an antidumping law means that the home firms will use it, if they can, to bolster their bargaining position in negotiations with the foreign firms and that the foreign firms will resist, not necessarily to prevent export restrictions, but to prevent their own bargaining position from being weakened in those negotiations. The vigor of their defense is therefore not a good indicator of potential harm to defendants.

I do not mean to suggest that the instruments of unilateralism actually benefit the foreign firms against which they are employed, or even that they leave the latter more or less indifferent. This is possible (Hillman, 1990), but the first general principle of unilateralism is simply that the countries that are denied market access receive significant, if only partial, compensation.

This is a curious phenomenon. If unilateralism were practiced in a vacuum, it would make no sense at all. Even a government that is nothing more than a captive of import-competing special interests will not want to hand over tariff revenue to foreigners. Even a government totally indifferent to improvements in the terms of trade will have no motive to strive for their deterioration. But this is exactly what governments do, routinely, in the conduct of unilateralism. Their behavior can be understood only in the context of a multilateral liberalization that is perceived as beneficial. When market access is denied, compensation is

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it is riskier to buy goods from a country against which there is an outstanding dumping determination than from some other source at the same price.

[3] Usually, but not always. Sometimes the duty is large enough to reduce imports drastically, or to eliminate them altogether, so that the higher price is little consolation to exporters. Sometimes (particularly in Europe) administration hinders the ability of the exporter to capture the price rise.

extended to reduce the chance of provoking a confrontation that could threaten the multilateral order. Unilateralism is what it is because of successful multilateralism.[4]

- The restrictions are in response to *established* import positions that have harmed import-competing interests.

Voluntary export restraints are almost always a response to a large, established import presence (usually recently established or enlarged), not to the prospect that such a presence may come about. Usually, there is, instead, the prospect that the import presence will quickly grow much larger still in the absence of an agreement to prevent such growth. Administered protection possesses exactly the same property. This is ensured by the material-injury test: it is not credible to conclude that imports are the cause if the import position is insignificant. Moreover, there is often the prospect of immediate additional import growth if nothing is done. In determining whether material injury exists by reason of imports, authorities often employ a "trends" approach. They examine rates of change of purportedly relevant variables, such as the volume of imports, the ratio of imports to domestic consumption, and employment and capacity utilization in the domestic industry. All this suggests that antidumping procedures are used to prevent significant increases in already significant import positions.

There are several plausible explanations. First, being able to point to an existing and growing large volume of imports makes it easier to enlist the sympathy of fellow citizens for restrictions. Second, there must be a significant import-competing interest adversely affected by the imports to provide the source of the political pressure to restrict trade. Third, and most important, if foreign firms are to receive significant compensation by means of trade rents for the restrictions imposed on them, they need to be left with a large enough market share to generate those rents. Thus, this second principle of unilateralism is closely connected with the first.

- The instruments provide *temporary* (at least, in original intent) trade restrictions.

These temporary trade restrictions accomplish two things. Temporary protective acts pose less of an ostensible threat to multilateral liberalization than would permanent increases in protection. In this sense, this feature reinforces the previous two. In addition, these instruments

[4] It is true that antidumping and countervailing-duty laws existed long before the GATT, but their use became significant only after multilateral liberalization had become significant.

are used in pursuit of specific targets in response to particular interest groups; because the protective measures they provide are temporary, they can easily be adjusted until the target is reached.

One reason that these measures are temporary is that they are also porous. Restricted exporters adjust the nature of their products, the location of production, and so forth, to evade restrictions. The longer a restriction is in place and remains unchanged, the greater the opportunity for exporters to use such maneuvers.

- The restrictions are *discriminatory*.

In different industries, VERs have sometimes been employed between many exporters and an importer (steel), between many importers and an exporter (automobiles), or among many exporters and importers in a comprehensive framework (textiles and apparel). But the individual VERs are bilateral and, thus, inherently discriminatory. This is an important way in which VERs violate the spirit of the GATT and WTO.

Antidumping and countervailing-duty laws are WTO-consistent (if in accord with the respective codes of conduct) but also inherently discriminatory, because they usually provide for duties against the products of specific countries. Safeguards, alone among the four instruments, are nondiscriminatory. It is therefore significant that their use has greatly declined relative to that of the other three instruments and that, in the future, it will sometimes be permissible to employ them in a discriminatory manner. One of the less prominent controversies during the Uruguay Round negotiations concerned a proposal to allow safeguards in general to be used in a discriminatory way. In the end, this proposal was not adopted.

The discriminatory nature of unilateralism implies that an analysis of it should consider four distinct groups of firms: *import competitors*, which are the intended beneficiaries of acts of unilateralism; *restrained exporters*, which may be harmed but usually receive significant compensation; *unrestrained exporters (from third countries)*, which can usually be expected to benefit from an application of unilateralism and so not to put pressure on their governments to protest; and *import competitors (in third countries)* not part of the arrangement, and which, in industries with significant economies of scale, may be harmed, because restrained exporters, to keep production up and costs down, would be expected to export more to countries where they are not restrained in order to keep production up and costs down. In practice, however, the response of such firms has almost always been to press for protection of their own, rather than to protest the original unilateral act. This suggests that at least some agents do, in fact, see a system of unilateralism, and not merely a collection of unrelated measures. Absent from my list are consumers and other domestic groups that have interests counter to those of the import-competing firms. To the extent that these matter, there will be less unilateral protection from the start.

- Unusually compelling in this context is *tariff-quota equivalence*.

Voluntary export restraints are explicitly quantitative, but, for administered protection, this may be a bit hard to accept: these laws do, after all, stipulate when and how to impose *tariffs*. Nevertheless, three points are noteworthy: First, the outcome of an antidumping action is quite often an undertaking by the accused party to restrict exports—that is, a VER. Second, as argued above, the rents generated by trade restrictions resulting from antidumping actions, for example, almost always accrue to the exporting country, rather than to the importing country. Third, tariff-quota equivalence is a likely occurrence. Tariff-quota equivalence is a proposition in the theory of international trade asserting that any equilibrium that can be supported by a tariff policy can also be supported by an appropriate quota policy and vice versa. A large (and largely redundant) literature makes the obvious point that tariffs and quotas are very often not equivalent in fact. If an equilibrium is disturbed, the resulting response will generally depend on whether a tariff or a quota is in place. Thus, if a policy must be implemented before all circumstances are known (which will always be true), it matters which tool is used. This is especially true of once-and-for-all changes in protection, so the emphasis on the tariff as the tool is an important principle of multilateralism. But unilateralism is one theater (perhaps the only theater) in which tariff-quota equivalence really matters. Each of the instruments seeks to attain a particular market outcome and does so by imposing a restriction that can be readjusted frequently. It therefore matters little whether the restriction is quantitative or not. The real distinction between the instruments is in the circumstances under which they can be used.

To summarize, unilateralism embodies five principles:

- Foreign exporters are *compensated*. The restrictions are largely voluntary for both exporting and importing nations.
- The restrictions are in response to *established* import positions that have harmed import-competing interests.
- The instruments provide *temporary* trade restrictions.
- The restrictions are *discriminatory*.
- *Tariff-quota equivalence* is strong.

Unilateralism is, thus, a set of rules allowing import-competing interests to obtain protection (under varying degrees of uncertainty) that is conferred according to the above five principles. The remainder of this essay identifies unilateralism with the consistent application of these principles over time. I shall no longer consider the actual (changing) mix of instruments used to implement them.

4 Regionalism

Of the three constituents of the international commercial system, regionalism has had, over the past half-century, perhaps the most curious history. Many regional initiatives began in the 1950s and 1960s (the "old regionalism"), but they accomplished little, except in Western Europe. The relation of this European integration to multilateral liberalization was usually regarded as benign, largely because of the success of the Kennedy Round. Two quiet decades followed. Then, in the late 1980s, a new bout of regional integration (the "new regionalism") began, which still continues today.

Because the international economic environment of the 1990s differs dramatically from that of the 1950s and 1960s, the characteristics of the new regionalism differ from those of the old. I identify the new regionalism with five principles. Although these principles cannot hope to give either an exhaustive or a universal description of the new regionalism (which includes over three dozen diverse arrangements), together they paint a picture that is simple enough to be useful and not too unrealistic to be relevant. My presentation will be terse, because I have discussed this before (see footnote 1).

- One or more *small* countries link up with a *large* country or entity, for example, with the United States in the North American Free Trade Agreement (NAFTA), with Brazil in Mercosur, or with the European Union (EU).

- The small countries undertake *significant economic reforms* prior to, or simultaneously with, the regional integration. The major economic event of our age is the wholesale abandonment of communism and of relentless import substitution by scores of countries of the East and the South. Most of these countries have at least tried to enter into regional arrangements, and the small industrial countries establishing regional links have usually, like the new members of the EU, preceded entry with meaningful sectoral reforms.

- The degree of liberalization is *moderate*. This is necessarily so in comparison with the old regionalism, because trade barriers are significantly lower now than they were in the 1950s and 1960s. But also, the new arrangements by no means eliminate all internal barriers.

• The agreements are *asymmetric*. The small countries make significantly more concessions than the large countries make. That the United States and the EU should wish to flex their muscles is no cause for surprise, but why are their small partners so anxious to cooperate?

• The partners do not confine themselves to reducing or eliminating tariff barriers; they also harmonize or adjust diverse assortments of other economic policies (*deep* integration).

Regionalism is inherently discriminatory and so is at odds with one of the principles of multilateralism. However, Article XXIV of the GATT explicitly allows free-trade areas and customs unions that substantially abolish all internal trade barriers and, on average, do not raise external barriers. A WTO panel investigates whether a proposed regional initiative is in compliance. The outcome has so far always been nonconfrontational (at least, with regard to the WTO panel). Although important internal barriers remain, the WTO panel declines to find the proposed agreement in violation of Article XXIV. The integrating countries, for their part, contrive to make sure that the remaining barriers are not so outrageous that the panel must choose between confrontation and making a travesty of Article XXIV. For such an outcome to be consistent with the principle that liberalization is moderate, initial trade barriers cannot be too great. Thus, the principles of regionalism, like those of unilateralism, reflect the presence of multilateralism.

5 The Arena

Now that I have reduced each of the constituents of the international commercial system to a few basic principles, I need an arena in which they can interact. To keep such a wide-ranging circus manageable, the arena, too, must be minimalist. I therefore present a simple abstract description of a world economy that will evolve over time in response to the interactions among multilateralism, unilateralism, and regionalism.

The Participants

Imagine a world with two sets of countries, *inside* countries and *outside* countries. Initially, each outside country has a policy of autarky. The inside countries trade with each other but have high tariff barriers. Some of the inside countries have a comparative advantage in A-type goods and some in B-type goods. Production of each good entails an early stage and a late stage. Each firm must conduct the late stage in its home country but may, if it wishes, establish a foreign subsidiary to perform the early stage. Technology is improving at a rate determined by the amount of labor allocated, worldwide, to the comparative-advantage sectors of the trading countries, but technological advance is uneven. Each improvement is discovered and initially utilized only by the technology *leaders*, a randomly determined subset of inside countries, and each improvement occurs first in a randomly determined set of sectors. After an interval, knowledge of the new technology diffuses to all trading countries.

Each outside country has the choice of two policy regimes. Under *autarky*, no inward foreign direct investment or trade is allowed; the country is self sufficient, producing for its own consumption with a primitive technology. The country cannot adopt the technological advances experienced by the inside countries. Under *successful reform*, trade is liberalized, foreign direct investment is allowed, and some labor is employed by the foreign subsidiaries of inside-country firms for early-stage production. Technology spillovers from these subsidiaries enable the country to use contemporary technology. An attempted reform succeeds if and only if the outside country attracts foreign direct investment. The payoff to successful reform thus depends on the gap between an outside country's primitive technology and the state of contemporary technology in the inside countries. Outside countries will abandon autarky for reform if the expected payoff is sufficiently high, but they differ among themselves about the payoff level required to induce a reform attempt and, therefore, in their willingness to pursue such an attempt.

Trade liberalization by the inside countries will generate static gains, from the exchange of *A* goods for *B* goods, and dynamic gains, as the reallocation of resources toward countries' comparative-advantage sectors accelerates the pace of technological advance. The governments of the inside countries realize all this, but they face short-term political-economy constraints (see Hillman, 1982, for more detail on a closely related model). In the short run, resources are immobile between the export and import-competing sectors. This immobility establishes competing special interests, and each government determines its policy by weighing one interest against the other. A government is willing to harm the import-competing interest in order to obtain a greater benefit for exporters, but it is not willing to infuriate any group by harming it too much. Any liberalization will thus be only partial. Risk-averse governments will be even more reluctant to allow large liberalizations, because they do not know beforehand which sectors and countries will be the technological leaders.

The availability of short-term trade credit means that governments do not perceive, over the short term, the budget constraint that the value of exports should equal the value of imports. Thus, they want to expand exports as much as possible and imports as little as possible, and they do not regard these as two aspects of a single outcome. This predisposes the inside-country governments to prefer trade negotiation to unilateral action; tariffs will be reduced by a government when other governments reciprocate. Each government takes the view that it is exchanging access to its domestic market for foreign importers in return for access to foreign markets for its domestic exporters (see Hillman and Moser, 1996).

The Course of Events

Suppose a succession of periods. At the beginning of each period, the tariff rates of the inside countries, the level of international technology, and the level (unchanging) of primitive outside technology are all inherited from the past. The following sequence of events then takes place within each period:

First, resources are allocated among sectors within each country. The allocations become specific for the rest of the period, so the owners of resources base their decisions about where to locate on their forecasts of what will happen during the rest of the period (but not beyond).

Second, the governments of all inside countries, and of those outside countries that have successfully reformed (initially none), negotiate tariff reductions.

Third, those outside countries that have not yet reformed (initially all) decide whether to attempt to do so. At least in the initial period, all decide against reform.

Fourth, the identity of the technological leaders is determined, with the level of technological advance that they experience depending on the resources allocated to comparative-advantage sectors.

Fifth, the tariff reductions are permanently implemented and trade is realized.

At the end of the period, the technological innovations introduced by the technological leaders become available to all trading countries for the following period. The negotiated tariffs become the initial tariffs for the next period.

All agents are forward looking within each period. Labor is willing to allocate itself to the import-competing sector, because it knows its presence there will constrain the government in its negotiations. The government knows that the consequences of its acts will be determined in part by the still-unknown pattern of subsequent technological advance. For simplicity, no one looks forward across periods: labor knows that it will be unconstrained at the start of the next period (or replaced by new labor), and the government, although it may care about what level of protection it bequeaths to its successor, behaves as though it will be the government no longer.

I intend this framework, in the initial period, to be a highly stylized representation of the international economy of half a century ago. The length of a period should be thought of as roughly corresponding to the time between the start of one GATT round and the start of the next. I do not impose structures corresponding to unilateralism, multilateralism, or regionalism. Instead, I try to determine what structures might be expected to evolve endogenously in such a framework.

6 How It Works

At last my stage is set. Before plunging ahead, however, I summarize, for purposes of comparison, what I believe to be the most widely held views about some elements of the international commercial system.

The Conventional View

The conventional view is that nondiscrimination (MFN) is desirable because it causes bilateral agreements to have multilateral consequences. But nondiscrimination also involves a *free-rider* problem: Country 1 will be tempted to refrain from offering concessions in the hope of benefiting, without cost, from the concessions Countries 2 and 3 extend to each other. The free-rider problem can be expected to become more severe as the number of countries increases, so that multilateral agreements among a large number of countries are difficult to secure.

Administered protection and VERs are unambiguously harmful, but if unilateralism is a necessary evil, it should be exercised subject to MFN wherever possible. This will minimize the inconsistency with a liberal multilateral order and will, perhaps, make countries more reluctant to practice unilateral protection.

The new regionalism is a response to the increasing difficulty of achieving multilateral agreements. In addition to the possibility of traditional trade diversion, these arrangements will impede further multilateral progress and, indeed, will threaten the continued existence of past liberalization.

This curt summary of the conventional view is necessarily a caricature, with all details, qualifications, and elaborations ruthlessly stripped away. But it will do as a point of comparison. It will become apparent below that I believe the conventional view to be fundamentally misguided.

Multilateralism and Nondiscrimination

Our outside countries are in autarky and satisfied to be there. The inside countries are trading with each other, but subject to high tariff barriers, and their governments know they can do better. Each government is willing to concede some market access, harming import-competing interests, in exchange for foreign-market access that will benefit export interests. Because of comparative advantage, the static gains will outweigh the losses. With many governments acting in this manner, the global reallocation toward comparative advantages will accelerate the pace of technological advance, conferring dynamic gains. All inside governments know this, and they are free to negotiate with each other bilaterally, multilaterally, or in whatever manner they choose. What will happen? Without MFN, absolutely nothing.

Suppose that Country 1, with a comparative advantage in *A* goods, has received an offer from the government of Country 2, which has a comparative advantage in *B* goods, for a reciprocal reduction of 20 percent in the tariffs levied on each other's goods. And suppose that the government of Country 1 believes that the implied exchange of market access will be a net benefit. But if Country 2's offer is not accompanied by an offer of MFN status, Country 1 will not regard the offer as meaningful, because Country 1 will be fully aware that Country 2 will have every incentive subsequently to offer, even before the ink is dry, a reciprocal concession of, say, 21 percent, to some other country (Country 3) that has a comparative advantage in *A* goods. Such a subsequent agreement would enable Country 2 to obtain access to the market of Country 3 by simply diverting to Country 3 the access it had previously granted to Country 1, leaving Country 1 with nothing to show for the access it has conceded. The threat of such *concession diversion* will confront any country producing goods for which reasonably close substitutes exist elsewhere and contemplating any sort of trade agreement (whether bilateral or multilateral) that does not provide for completely free trade. Without MFN, substantive trade negotiations are simply impossible; this has nothing to do with multilateralism.[5]

[5] For contrasting treatments of the role of MFN in multilateral tariff bargaining, see Caplin and Krishna (1988) and Ludema (1991).

This is the reason why MFN was a feature of all the dozens of bilateral agreements reached by the United States under the authority of the Reciprocal Trade Agreements Act, before the GATT even existed. It is why MFN was common in bilateral European agreements before World War I. And it is why the United States, when it followed a policy of high protection and had little interest in negotiated tariff reductions, was content to use a bastardized "conditional" MFN offering partners little real assurance of freedom from concession diversion.

Suppose, then, that our inside countries commence negotiations, that the negotiations are bilateral, and that they all embody MFN, as they must. The negotiations are concluded, the agreements are implemented, and trade commences. Then the next period begins, resources are reallocated within each country, and the inside countries are ready for a new round of negotiations to reduce trade barriers further. Eventually, free-rider problems are going to matter. The conventional view is right about this, although for the wrong reason.

The first time a country negotiates a bilateral trade agreement, the inclusion of MFN status is costless as well as necessary. Inclusion remains costless as long as subsequent bilateral negotiations do not seek to reduce tariffs below the level reached in the initial agreement. Once a negotiation seeks to reduce the tariffs further, however, the total market access a country must concede to the world will be some multiple of the access it offers to concede to its negotiating partner, and that multiple will be larger the greater the number of agreements the country has already reached. In addition, the more agreements its negotiating partner has reached, the less the value to the country of any given offer of market access from that partner. Note that what matters is not the number of *countries*, but the number of *agreements* already entered into by any pair of potential negotiators. The distinction is important because the number of countries does not grow over time, but the number of agreements does. Eventually, this number will reach a saturation point: there will no longer exist any pair of countries for which a mutually beneficial reciprocal tariff reduction is possible. At this point, further negotiations will of necessity be multilateral.

It is true, as the conventional view stresses, that such negotiations will be constrained by the temptation of countries to free ride. But the more fundamental point is that the use of MFN eventually makes multilateralism inevitable.

Negotiations must become multilateral, but they need not be global. Negotiations at some subglobal level might in fact mitigate the free-rider problem, but any subglobal level will have its own saturation point. I am not yet ready to consider the role of regionalism in the international commercial system, however, so the argument summarized to this point is that

> if reasonably close substitutes exist for each country's products, trade agreements that do not extend to free trade cannot be negotiated without MFN because of the possibility of concession diversion. Once the number of agreements reaches the saturation point, only multilateral negotiation is feasible. In other words, the GATT did not beget MFN; MFN begat the GATT.

Multilateral Liberalization

In light of the above, assume that the inside countries conduct multilateral negotiations. Each government would, *ex post*, like to renege on the concession it has made, if it could get away with it, but it knows punishment would follow. Negotiated tariff reductions do not offer a country an opportunity to get a significant jump on its partners by acting first. If Country 1 raises its tariff by 5 percent, Countries 2, 3, and so on can follow suit even before Country 1 is able to implement the increase. If Country 2 makes the 5 percent cut it has promised but Country 1 does not follow suit, Country 2 can cancel the reduction virtually at once. It does not make sense to model a negotiated tariff reduction as the start of a repeated game in which deviation today will be punished in the future: deviation today is punished today.[6] Much more compelling is the assumption of a threat of simultaneous tit-for-tat. If Country 1 lowers its tariff 5 percent less than promised, its trading partners will follow suit at once.

Such a threat can support any negotiated tariff reduction that, *ex post*, every country wants to have generally adopted. But it can support no reduction in excess of that which any country regards as optimal. If some government were to find, *ex post*, that it had agreed to a general tariff reduction greater than the reduction it now wants, it would simply implement a smaller reduction, willingly accepting the retaliation that action would cause. Because every government realizes this, such reductions would never be negotiated in the first place. Thus, the outcome of the multilateral negotiation will be the smallest of the various tariff reductions that, if generally adopted, will maximize *ex post* the objective functions of the respective negotiating governments.

[6] It is true that, when James Madison introduced the first U.S. tariff bill in Congress in April 1789, he hoped to have it apply to the spring imports shipped in ignorance of the tariff. But those days are long gone.

Which will this be? The basic problem is that the inside countries must negotiate a tariff reduction before they fully know the economic environment in which the lowered tariffs will apply. When automotive tariffs came down in the 1960s, it was not known that the Japanese industry would become as strong as it did in the late 1970s. In my world, no one knows beforehand which industry will first see the next wave of technological advance and which countries, among those with a comparative advantage in those industrial sectors, will first experience it.

Each country knows that it might find itself in any of three groups: *leaders*, *laggards*, or *followers*. I label as leaders those countries that experience the technological advance, as laggards, those countries that have a comparative disadvantage in the goods undergoing advance, and as followers, those countries that have a comparative advantage in the goods undergoing the advance but that do not themselves experience it. Although countries do not know in advance to which group they will belong, they do know that the rate of multilateral tariff reduction will be determined by the group that prefers the smallest multilateral reduction. So I shall examine each group individually.

Leaders are the countries whose exporters are most able to compete. Because they can make the most use of foreign-market access, they will probably be most willing to give up something for it. They do not look like good candidates for the group preferring the smallest common tariff reduction.

Laggards, by contrast, are the countries whose import-competing firms are "taking it on the chin" from the technological leaders. Because governments are assumed to be especially concerned that no special-interest suffers a big loss, these countries must be regarded as candidates for wanting the smallest common reduction. But, at least, they obtain cheaper imports.

Followers do not observe their import-competing sectors suffering because of technological advance, but their exporters are at a disadvantage in competing with the exporters of the leaders. Thus, they value foreign-market access less highly and are presumably less willing to pay for it. This group might also prefer the smallest common reduction.

The bottom line is that I expect the interests of the laggards—whoever they might turn out to be—to determine the common rate of tariff reduction, but it is possible that, at least some of the time, the followers will do so. Thus, the conclusion is that

> multilateral tariff negotiations will result in the common tariff reduction that maximizes *ex post* the objective function of the laggard or the follower governments.

Multilateralism and Unilateralism

Thus far, I have described multilateral negotiations in the absence of unilateralism. The rate of multilateral tariff reduction is limited to the lowest reduction any country would prefer *ex post*. Can anything be done to improve on these unsatisfactory prospects? To explore this question, I now allow inside countries the option of establishing, before the onset of a negotiating round, a rule stipulating circumstances under which protection might be granted to some fraction of beleaguered import-competing interests *after* the completion of negotiations and *after* the revelation of which goods and countries are to be the technological leaders. Because the purpose of such measures is at least partly to preserve an outcome for special interests in the face of unanticipated developments, the measures must be either quantitative or sufficiently nimble in execution that it does not matter whether they are explicitly quantitative or not. Will countries wish to institute such a rule? Would it help?

The countries that turn out to be laggards are the ones that can, *ex post*, apply such a rule, but will they wish to do so if the rule is in place? Clearly, they will not wish to apply the rule if they are confident that doing so will prompt retaliation. This would simply be a rollback of the negotiated tariff reductions that are, as argued above, already no greater than those that any country wants *ex post*. Will the countries that turn out to be leaders retaliate? The effect of such a rollback would be to move the common tariff reduction even farther away from the level the leaders want. Still, if the laggards unilaterally increase protection, the leaders will retaliate, for two reasons. First, the unilateral protection would amount to *concession reneging*: because the leaders will not receive all the market access for which they have bargained, they will not want to grant all the access they have promised. Second, the unilateral protection implies that, at the next round of multilateral negotiations, the laggards will have a higher initial level of protection from which to negotiate: the unilateral action gives them future bargaining chips. The leaders will want to retaliate in order to acquire matching bargaining chips of their own. Thus, if the laggards take unilateral action, the leaders will have every reason to retaliate. Because everyone realizes this, such a rule will be of no value and will be neither instituted nor used, *unless* the rule can be fashioned in such a way as to eliminate the motive for retaliation.

This can be done. To eliminate the bargaining-chip problem, the rule needs to call for *temporary* protection that will automatically expire and so need not be bargained down. To make concession reneging acceptable, the rule must provide *compensation* to the leaders. Allowing them to capture the trade rents generated by the unilateral measures will contribute to such compensation and may be enough. They need not be fully compensated for their loss of market access, just compensated enough so that they are not tempted to forsake the compensation by retaliating. Still, we cannot count on the trade rents alone being enough, so it is important to realize that there will be a second source of compensation as well. To see this, assume for a moment that it is the laggard countries that want the smallest multilateral tariff decrease, so their desires are reflected in the resulting agreement. The ability to grant *ex post* protection, free of retaliation, to some fraction of import-competing interests will increase the common rate of tariff reduction that is optimal for the laggards and, therefore, the negotiated rate of tariff reduction. This is an unambiguous benefit to the leaders, who want a greater common tariff reduction than can be negotiated. For the fraction of goods that receive *ex post* protection, the leaders receive larger trade rents; for the fraction that do not, the leaders receive greater market access.

Now consider the reactions of the followers. These countries end up competing, at a disadvantage, with the leaders in the import markets of the laggards. The rents associated with unilateral protective measures by the laggards are worth much less to the followers, who have not experienced cost reductions, than to the leaders. Also, the followers will gain less from an increase in the negotiated rate of tariff reduction. Prospects are therefore dim that these countries will be compensated enough to forestall retaliation. Furthermore, if the followers, rather than the laggards, prefer the smallest rate of common tariff reduction, the increase in the negotiated rate of reduction, which is the second source of compensation for the leaders, will not occur; indeed, that rate may well decrease. Thus, the entire case for unilateralism will unravel unless the interests of the followers are addressed. For this reason, the unilateral measures must necessarily be *discriminatory*. If the measures apply to the leaders but not to the followers, the followers will have nothing against which to retaliate. The unilateral measures will enhance their ability to compete in the markets of the laggards. The followers will consequently now prefer a greater common rate of tariff reduction. The negotiated tariff reduction will increase, regardless of whether the preferences of the followers or of the laggards are decisive in determining the outcome of the negotiations.

The underlying logic of multilateral liberalization thus implies the emergence of a system of unilateralism embodying exactly those principles that, I have argued, characterize contemporary unilateralism. Multilateralism encourages the introduction of tools of unilateralism that are quantitative, temporary, and discriminatory, and that give compensation to exporters. This introduction accelerates the rate of multilateral tariff reduction and benefits each country, both *ex ante* and *ex post*. The application of unilateralism can be expected to increase over time as tariff barriers fall, resources are increasingly allocated to sectors showing comparative advantage, and the pace of technological advance increases.

Multilateralism and Regionalism

The static gains from trade liberalization accrue to the trading countries themselves, but the dynamic gains also increase the opportunity cost to the outside countries of an autarky policy. Suppose that the liberalization by the inside countries proceeds far enough that some outside countries decide to attempt reform.

These countries believe that, for reform to succeed, they must attract significant foreign direct investment, which is seen as the key to successful entry into the multilateral trading system. Multinational firms are a prime means of technology transfer, and they can supply international contacts and modern commercial methods to countries whose past policies have left them with little of either.[7] There are two potential pitfalls, however. First, if many similar outside countries attempt reform at about the same time, they become competitors in attracting foreign direct investment from the inside countries.[8] That is, a reforming country would need to distinguish itself from its rivals. To the extent that the decision to reform reflects a common situation—the growing opportunity cost of autarky in the face of a developing multilateral system—there is every reason to expect many outside countries to try to reform at about the same time. Second, a major concern of potential investors is that the reforms not be undone in the future. That is, the reformers need to *bind* future regimes to the reforms.

Competition among reforming countries to attract foreign direct investment should be keen. A small national advantage offers the hope of attracting a large amount of foreign direct investment. There are three mutually reinforcing reasons to expect this. First, with similar

[7] See Hillman and Ursprung (1995) for more on the links between trade liberalization, reform, political economy, and foreign investment.

[8] Brainard and Riker (1997) and Riker and Brainard (1997) provide relevant evidence that workers in foreign subsidiaries of multinational firms compete with workers in other subsidiaries located in similar host countries, rather than with workers in dissimilar source countries.

outside countries competing, small advantages can prove decisive. Second, direct investment is "lumpy": a factory must be put in one place. Third, the basic advantages that reforming countries see in direct investment involve externalities, and these externalities render a site more attractive for additional direct investment. Firms in the inside countries are tempted to invest in the potential reformers, to take advantage of the reformers' comparative advantage in early-stage production, but the firms have substantial latitude in deciding where to invest, because there are many reformers with fairly similar economic characteristics. Firms will tend to locate together, however, because of the lumpy nature of direct investment and because there will be positive externalities between foreign subsidiaries.

Under these circumstances, successful reform by an individual country will be uncertain but more probable the greater the aggregate amount of direct investment from the inside countries relative to the number of countries attempting reform, that is, relative to the number of potential targets of that investment. A reforming country's prospects will be improved if it can somehow distinguish itself from its rivals.

Regional arrangements might play a role in this scenario.[9] I define a regional agreement as an agreement between one inside country and one outside country in which the outside country commits to the details of an attempted reform and to giving the goods of its partner preferential treatment, and the inside country commits to making a small reduction in the duty applicable to goods imported from its partner country. Note that this definition reflects the principles of regionalism as one or more small, reforming countries linking up with a large country in an arrangement characterized by asymmetrical concessions and deep integration.

A reforming outside country can now choose between two paths of attempted reform. It can adopt the *nondiscriminatory* route of simply adopting the common tariff of the inside countries and participating in subsequent multilateral negotiations. Alternatively, it can attempt to negotiate a regional arrangement with some inside country (and participate in subsequent multilateral negotiations). Suppose, for simplicity, that each potential reformer regards the products of all inside countries as perfect substitutes. Together with my other assumptions, this removes

[9] Alternative treatments of regionalism, very much different from the discussion that follows, may be found in Krugman (1991), Chichilnisky (1994), Perroni and Whalley (1994), Bhagwati and Panagariya (1996), Bond and Syropoulos (1996), Yi (1996), Bagwell and Staiger (1997a, 1997b), Baldwin (1997), and Freund (1997).

the possibility of negative welfare effects from trade diversion. But this is a pertinent oversimplification. The reform attempt has been motivated by the success of the inside countries in reducing trade barriers, a reduction that makes trade diversion—even if very large in magnitude, as high substitution would suggest—of much less welfare significance.

Consider, first, the effects of such an arrangement on a potential reformer. The trade preference implies that all imports will come from the partner country, because the reforming country regards the goods of all inside countries as perfect substitutes. But such trade diversion does not matter here. The preference granted by the inside-country partner, however, although only marginal, does matter. From the point of view of firms considering direct investment to provide early-stage inputs for the products of the inside-country partner, all reforming countries are equivalent, except for this marginal preference. The outside-country partner thus attracts all of this investment. The *investment diversion* the regional arrangement generates thus ensures that the reform will succeed.

Investment diversion is the reason why reforming countries find regional arrangements attractive, even though they typically receive only "minor" concessions from their partners. The goal is to compete successfully with other *similar* countries for direct investment, not to greatly expand exports to their partners or to attract from them direct investments that would otherwise not be made at all. Such *investment creation* will be modest at best.

But regional arrangements are not the only way outside countries can compete for direct investment. They might also offer subsidies, tax holidays, and the like. This is where the second potential pitfall comes in.

One way—sometimes the only way—to bind future regimes to the reforms is to establish an external commitment. The more likely that backsliding from an external commitment will induce retaliation, the more likely such a commitment is to sustain reform. The more specific the reform measures that are embodied in an external commitment, the more likely that commitment is to sustain reform. The multilateral negotiations that are making participation in the international economy more rewarding also offer reforming outside countries a potential external commitment binding future governments to the reform measures. But multilateral negotiations are of little practical use. They provide no enforcement mechanism should a country backslide, and inside countries would not put the multilateral system at risk merely to punish a single deviant reformer. Even if they wanted to punish transgressors, they are likely to have little formal justification for doing so, because multilateral agreements would not embody detailed reform measures by individual outside countries.

But regional arrangements can address both problems. An agreement with a large country (often the dominant trading partner) adds a credible enforcement mechanism. Because such arrangements allow for deep integration, they can contain obligations to undertake specific measures central to the reform effort. This is clearly illustrated by the Canadian-U.S. free-trade agreement and by NAFTA. The commitment aspect gives regional arrangements a unique role in the competition for direct investment among reforming outside countries.

An individual regional arrangement will not be uniformly beneficial, however. Other reforming countries will suffer. Suppose an outside country that would try reform anyway enters into a regional arrangement. Direct investment producing early-stage goods for that country's partner will all be diverted to that country, and the country will still remain a potential host for other direct investment. Less direct investment therefore remains for other reforming countries, reducing their prospects for success and perhaps deterring some of them from even trying reform. Regionalism can produce *reform destruction*, causing fewer countries to attempt reform and lowering the proportion of those that succeed. The country involved in the regional arrangement, however, may not itself have attempted reform (*reform creation*) in the absence of such an arrangement, so the number of reforming countries may either rise or fall, depending on the balance between reform creation and reform destruction.

It would be a mistake, however, to consider only the effects of an isolated regional arrangement when regional arrangements are, in fact, becoming ubiquitous. So, consider the general equilibrium that will emerge if all countries are allowed freely to negotiate regional arrangements, including the possibility of a single country's entering into multiple relationships.

If several reformers establish regional arrangements with a single inside country, the value of the arrangements to these reformers will be eroded—because direct investment may well cluster mainly in some subset of them all. For this reason, the reforming countries will spread themselves out in their choices of partners. If there are at least as many inside countries as potential reformers, each of the latter can find a partner that will guarantee the success of its reform effort. This may or may not be true if there are fewer inside countries, depending upon the amount of direct investment forthcoming. Nevertheless, the ability to enter freely into regional arrangements will maximize the extent and the probability of successful reform and, by doing so, also maximize the number of countries that are induced to attempt reform.

The global interest calls for successful reform to be as widespread as possible. This will maximize the multilateral trading system, accentuating both the benefits (static and dynamic) that it generates and the number of nations that receive those benefits. But this global externality will be ignored by multinational firms, which, in the absence of regional arrangements, will have clustered their foreign investments together. A single regional arrangement may be either good or bad by itself, but this regional general equilibrium will, in effect, internalize the global externality and produce an outcome unambiguously superior to that which can be achieved without regionalism. Reforming outside countries will establish regional arrangements with inside countries to compete among themselves for direct investment. This competition has the effect of internalizing a key externality, maximizing the extent of successful reform.

Multilateralism, Unilateralism, and Regionalism

The proliferation of regional arrangements maximizes the extent of successful reform. This increases the size of the multilateral system and therefore the gains resulting from past liberalization, and it also implies that subsequent liberalization will produce larger gains, both static and dynamic, than it would have produced without the reforms. Without unilateralism, however, regionalism will slow down multilateral progress, not accelerate it. This happens because the addition of the outside countries to the multilateral order increases the diversity within this order and so almost certainly reduces the lowest rate of common tariff reduction acceptable *ex post*. In any case, because this lowest rate cannot possibly rise, the advent of regionalism intensifies the critical importance of unilateralism for multilateralism.

The implication of regionalism for the relation between multilateralism and unilateralism is obvious, but the relation between unilateralism and regionalism itself is inherently ambiguous. This is because, on the one hand, unilateralism may be necessary to induce the partners to come to a regional agreement, and, on the other hand, unilateralism may itself be what the regional arrangement is all about. Which of these considerations dominates depends on circumstances. Thus, in some regional arrangements, such as the EU, unilateralism may be only *external*, that is, directed solely at outsiders; in others, such as the Europe Agreements between the EU and Central European countries, it may be *internal* as well. The NAFTA provides an interesting blend. Canada and Mexico remain subject to U.S. unilateralism, but they have channels of appeal not available to outsiders. Internal unilateralism was almost certainly necessary for U.S. adherence. The appeals procedures are relatively modest advantages, but, for reasons argued above, such modest advantages can be of considerable importance for the partners.

> Unilateralism is necessary if regionalism is not to slow down the pace of subsequent multilateral reform.

7 Conclusions

I have argued that the ways in which the nations of the world together conduct trade policies can usefully be viewed as a coherent international commercial system possessing three components. The argument consists of (1) the reduction of each component to a few basic principles, (2) a simple abstract framework for analysis, and (3) a discussion about the way in which the components relate to each other. The essential elements of these relationships are as follows.

- In a world in which reasonably close substitutes for each country's products can be found elsewhere, reciprocal trade negotiations of any sort—that do not intend to go all the way to free trade—require any agreements to provide for MFN status.
- As trade agreements featuring MFN accumulate, additional negotiations will eventually have to be multilateral.
- The pace of multilaterally negotiated tariff reduction is limited to the smallest reduction any country might want *ex post*.
- This pace can be accelerated by the introduction of unilateralism allowing for temporary, quantitative, discriminatory protection that compensates restricted exporters.
- Successful multilateralism increases the temptation for countries with antitrade policies to reform and seek to enter the multilateral system. Regionalism facilitates this entry and, by internalizing a key externality, maximizes the extent of its success.
- By increasing the diversity within the multilateral order, regionalism causes unilateralism to become even more important for further multilateral progress.

Even though it took me the better part of a decade to get here, the argument summarized above now strikes me as both elementary and obvious. Yet, key parts of it are dramatically at odds with what I have caricatured as "the conventional view," with what policy-oriented economists say, and with what formal models imply. The most insightful (to my knowledge) formal treatment of many of the issues addressed above is provided by Kyle Bagwell and Robert Staiger (1996, 1998). They reach conclusions diametrically at odds, in many ways, with my own. We cannot both be right (but we can both be wrong).

I see two possible reasons for our differences, and they are not mutually exclusive. First, I just might have it all wrong. Second, the difference in conclusions may reflect, at least in part, a difference in methodology. Instead of analyzing in isolation each component of what I call the international commercial system, or treating one component as exogenous and asking what its implications are for some other component, I have stressed an interplay among the three. I maintain that it is a mistake to address basic trade-policy issues—Is MFN desirable? Should VERs be phased out? Should safeguards no longer be nondiscriminatory? Should new regional arrangements be discouraged?—without a picture of the overall system and in ignorance of the reasons why the measures under consideration exist at all.

But enough of all that. I close with two of the tough questions. My answers will be subjective, not inevitable consequences of the above.

- Should economists welcome individual acts of unilateralism, recognizing the benefits unilateralism has for multilateral liberalization?

No. We should fight them tooth and nail. The ultimate brake on liberalization, in my view, is the reluctance of governments to allow liberalization that harms someone, as all liberalization must.[10] Individuals realize this and act accordingly. *A willingness to protect generates the need to protect.* Even though unilateralism is a boon for multilateralism, individual protectionist acts should be consistently resisted. Institutional changes to reduce the willingness to protect are presumptively desirable, so Bhagwati's (1988) discussion of trade-adjustment assistance is pertinent.[11] But attempts to eliminate unilateralist tools, or to make them nondiscriminatory, are pointless at best and harmful at worst.

- Is the new regionalism a good thing?

Yes. But it requires a new vigilance. Regionalism is where the action is, so regionalism is where protectionist efforts will be directed. The signs of those efforts are everywhere.

[10] Much of the gains-from-trade literature notwithstanding.

[11] K. C. Fung and Robert Staiger (1996) provide an alternative perspective on trade-adjustment assistance, but one that is still appropriately concerned with liberalization.

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