

Special Brief

Termites in the trade system

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Two different questions must be distinguished in the current political debate on free trade for the United States of America (but they apply equally to any other open economy): Should we have free trade? If we agree that we should, how should we trade freely?

Often, the press announces that the consensus on the desirability of free trade among economists has disappeared; but in each instance, they have been disproven.

Today, the most potent argument is that free trade may increase income and wealth, but that it suppresses workers' wages and even harms the middle class. Nearly all research shows that this claim is also mistaken. My own research demonstrates that trade may even have moderated the fall in wages that labour-saving technical change is producing.

Many are mistaken, though, in thinking that freeing trade through free trade agreements (FTAs) is a good idea. FTAs are better described as preferential trade agreements (PTAs) since they free trade for members only, so they are freeing trade on a discriminatory basis. As I argue in my book, *Termites in the Trading System* (Bhagwati, 2008), FTAs have several crippling downsides that must be recognized.

First, they will often divert trade from cheaper non-member sources to more expensive member sources, doing harm rather than good. Second, the enormous increase in such FTAs, now numbering more than 350 and still growing, has led to a systemic effect, creating what I have called a "spaghetti bowl" of preferences and chaos in the world trading system.

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Third, in one-on-one negotiations between powerful, hegemonic nations, such as the United States, and weaker, smaller FTA partners, several lobbies in the hegemon have imposed demands unrelated to trade on the weaker nations, increasing resentments abroad. In Seoul, there was a street demonstration against the proposed United States-Republic of Korea FTA. These powerful-country lobbies include labour unions seeking to raise labour standards with a view to raising the production costs of rival firms abroad, financiers seeking absence of capital controls and firms wanting ever-stronger patent protection.

There are plenty of reasons to believe that these preferential trade agreements have slowed down our progress on the multilateral freeing of trade, as with the Doha Round of multilateral trade negotiations. The Doha Round's success is essential to strengthening the multilateral trading system, which is beneficial to all.

The American doctrine of inducing multilateral trade liberalization by signing FTAs has, however, proven to be a chimera. Much attention and lobbying has been diverted to inconsequential deals. We need to put a moratorium on FTAs, while treating those already ratified as water under the bridge.

The free traders who are passionate supporters of these FTAs are undermining everything that we have worked for in seeking to produce and strengthen a non-discriminatory trading system. There is no better example of folly wrought by good intentions.

The following are excerpts from *Termites in the Trading System: How Preferential Agreements Undermine Free Trade* (Bhagwati, 2008).

1. PROLIFERATING PREFERENTIAL TRADE AGREEMENTS

“Perhaps the most striking historical flirtation with preferences in trade came from John Maynard Keynes, arguably the 20th century's most influential economist. At the end of World War II, the British were sceptical of non-discrimination as implied by the most favoured nation, or MFN, clause, which would automatically extend to every member country of the proposed trade institution the lowest tariff extended to any member. They also wished to hold on to their imperial preference, which extended British protection to its colonies and dominions. On the other hand, the Americans vigorously supported the MFN clause and favoured non-discrimination in the trading arrangements being contemplated after the conclusion of the war. They were led by Cordell Hull, the Secretary of State between 1933 and 1944 and a recipient of the Nobel Prize for Peace; he believed, not without substance, that free trade would also lead to peace, not just prosperity. Keynes sided with his own, and made the following characteristically flamboyant statement:

“ ‘My strong reaction against the word “discrimination” is the result of my feeling so passionately that our hands must be free ... The word calls up and must call up ... all the old lumber, most-favoured-nation clause and all the rest which was a notorious failure and made such a hash of the old world. We know also that it won’t work. It is the clutch of the dead, or at least the moribund, hand.’

“Yet once they had thought more deeply about the issue, Keynes and other British economists who were engaged in the negotiations with the United States that led to the final agreement in Proposals for Expansion of World Trade and Employment had come to accept the Cordell Hull view that non-discrimination was a key principle that had to prevail in the proposed new regime for international trade. Keynes, who thought that intellectual inflexibility was a mark of inferior minds, then spoke in the House of Lords what are among his most eloquent words:

“ ‘[The proposed policies] aim, above all, at the restoration of multilateral trade ... the basis of the policies before you is against bilateral barter and every kind of discriminatory practice. The separate blocs and all the friction and loss of friendship they must bring with them are expedients to which one may be driven in a hostile world where trade has ceased over wide areas to be cooperative and peaceful and where are forgotten the healthy rules of mutual advantage and equal treatment. But it is surely crazy to prefer that.’

“As it happens, Keynes was reverting to an anti-discrimination view that had begun to make increasing sense to economists during the 1930s. World trade had gradually been shifting to a multilateral non-discriminatory regime by growing acceptance of the MFN principle, under which any member of a trade treaty, later the GATT as well, would receive the same lowest tariff that any other signatory of the treaty would enjoy. But world trade would soon turn disastrously to bilateralism and attendant preferences in trade.

“Read almost any of the splendid accounts of world trade in the 1930s and you will find fulsome and fulminating accounts of how the tit-for-tat protectionism and the competitive depreciations of currency, which were intended to divert limited world demand to one’s own goods to reinflate one’s economy, led to extensive use of quotas, which are necessarily discriminatory. They led also to explicit bilateral treaties aimed at balancing trade flows bilaterally wherever possible.

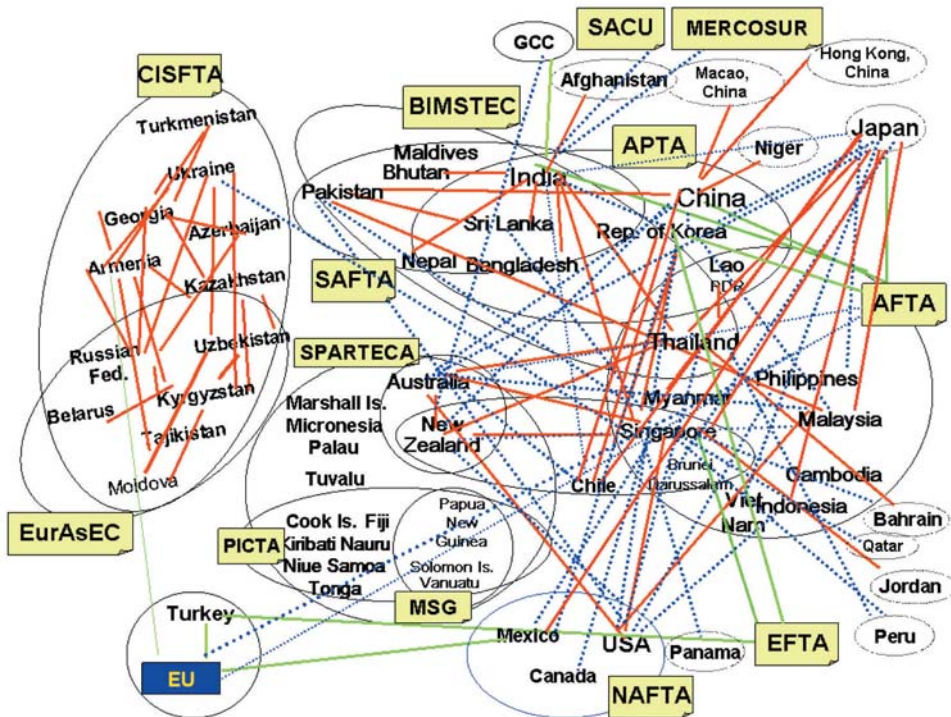
“It was manifest that protectionism, each trading nation acting on its own, had damaged the world trading system: each nation followed what the Cambridge economist Joan Robinson famously called ‘beggar my neighbour policies’ and many were beggared in the end. By contrast, coordinated action, eschewing protection and agreeing to increase world aggregate demand (rather than seeking to divert to oneself a given, insufficient amount of world demand), would have produced a better result.” (Bhagwati, 2008, pp. 1-7)

2. THE PANDEMIC OF PTAs

“There is yet another irony. The interwar proliferation of preferences was a result of an uncoordinated pursuit of protectionism, itself aided by the breakdown of financial stability and macroeconomic equilibrium in the world economy. But the current tide of preferences has been a result of politicians mistakenly, and in an uncoordinated fashion, pursuing free trade agreements because they think (erroneously) that they are pursuing a free trade agenda.

“So today we have a cumulative total of over 350 PTAs reported to the WTO. Even if only active PTAs are counted, the estimated total is still large. By either count, the PTAs are evidently increasing continually.” (Bhagwati, 2008, p. 11) Economies of Asia and the Pacific joined this PTAs bandwagon relatively late during the 1990s, but are now leading the race of signing and negotiating new agreements. This led to a regional tangle of trade rules and regulations which was appropriately named “noodle bowl” (figure 1).

Figure 1. “Noodle bowl” of trade agreements in Asia and the Pacific



Source: Asia-Pacific Trade and Investment Agreements Database, ESCAP, available at www.unescap.org/tid/aptiad.

Note: Not all PTAs are shown.

“Among economists, I was the earliest to warn against PTAs, starting in 1990 when I sensed that we were facing a systemic threat to the principle of non-discrimination in world trade. I was then in a minority of one, even among economists, many of whom thought I was a ‘multilateralist freak’. Arrayed on the other side were truly eminent economists, among them Larry Summers, who became the United States Treasury Secretary, and the remarkable Paul Krugman, my former MIT student and now *New York Times* columnist.

“But now that the proliferation and its many downsides have become evident, and ever more threatening, I daresay that the profession has moved like a herd into my corner. Pascal Lamy, currently the Director-General of the WTO, once remarked that half the economists in the world were now opposed to FTAs. I retorted mischievously that this was an English understatement by a distinguished Frenchman; in fact, nearly all were.

“I discovered that the European Union, which started the pandemic while the United States had grossly aggravated it, applied its MFN tariff to only six countries [or areas]—Australia, New Zealand, Canada, Japan, Taiwan Province of China, and the United States—with all other nations enjoying more favourable tariffs. I asked Pascal Lamy, who was then the European Union Trade Commissioner, Why not call it the LFN (least favoured nation) tariff?

“In short, we now have once again a world marred by discriminatory trade, much as we had in the 1930s.” (Bhagwati, 2008, pp. 11-14) And we know how that turned out. While it will be impossible to halt the formation of PTAs, we can still try to mitigate their adverse effects—going back to the table of multilateral negotiations and trying harder to close the deal, which is to reduce the overall trade barriers in a non-discriminatory fashion and make bilateral exchange of trade preferences less attractive.

REFERENCES

- Bhagwati, J. (2008). *Termites in the Trading System: How Preferential Agreements Undermine Free Trade* (New York, Oxford University Press).