

Chapter 1

Introduction

This book is a collection of individual essays. Yet they all have a common theme: trade liberalization and preferential trade agreements (PTAs). Trade liberalization is arguably the major issue of the conduct of commercial policy. And, as a component of it, the relationship between universal, multilateral trade liberalization and the conclusion of PTAs — that is, a process of liberalization that discriminates between trading partners — has been a focus of analysis and debate in recent years. This book is thus designed as a contribution to the understanding of several salient elements of these issues. It is a search for answers to significant questions, which have not been raised and explored before; an attempt to clarify and elaborate upon others which, although they have been discussed (sometimes extensively) in the literature, have not been settled; and an analysis trying to provide bridges for moving from generalities to the comprehension of concrete instances and developments.

A few themes keep recurring in the analyses of the separate essays. One revolves around issues of stages in the process of liberalization. Another is the *impact* of both trade liberalization and preferences. Still another is the role of *size* of economies in liberalization and in the conclusion of preferential agreements. Similarly, the role of *proximity* of economies in the conduct of trade policy. And, probably most prominent, the possibility of *assessing* the desirability and outcome of policies.

Chapter 2 raises a fundamental question for the outcome of opening up economies to movements of both goods and factors between them: which of the two will actually move? It analyzes the *ex-ante* expectation, given the circumstances of the economies, discusses the issue of how, in fact, to assess the outcome of opening up, and suggests an illustration through the analysis of a concrete recent case.

Chapter 3 addresses four issues, which are commonly faced when trade liberalization is introduced in stages, rather than at one stroke. One is the significance, and meaning, of the existence of “tariff redundancy.” Another is the preferred method of gradually collapsing an existing system of tariffs. A third one is the treatment of tariffs on intermediate inputs in the process. Finally, the chapter provides an analysis of the implications of the industrial structure of an activity (that is, the degree of competitiveness in it) for the order of the activity in the implementation of liberalization.

Chapter 4 examines the desirability of a PTA, not in the “second-best” framework — as is the practice in the customs-union theory, when preferences are compared with no liberalization at all — but as a “first-best” question, namely, how should a PTA be compared with *free* trade? The former is obviously inferior (given a conventional set of assumptions); but what is the impact of various economic attributes on the extent of such inferiority?

Chapter 5 turns to the significance of the size of an economy for the desirability of a partner for a preferential agreement. The conventional wisdom has been that “large is beautiful”: the larger an economy the more promising it should look, *ceteris paribus*, as a potential partner. This premise has been disputed in recent years, and the chapter’s analysis suggests the circumstances under which one presumption or another should be adopted.

Chapter 6 again focuses on the size of economies, addressing a much wider range of issues. It first specifies the attributes that distinguish small from large economies, and examines whether these attributes should lead to faster or slower growth of small economies, and whether indeed observed growth rates differ in small economies as compared with large ones. Then, coming to the major themes of this book, the analysis turns to the issue of trade liberalization, asking whether small economies benefit more or less than others from freer trade, and whether the introduction of liberalization should be easier or, on the contrary, more difficult in a small economy. Similarly, it inquires whether the desirability of preferential agreements between small countries is different at one or both ends of the partnership, given the attributes of such economies, than it is for agreements concluded between large countries.

Chapter 7 addresses an issue of PTA analysis which has been brought up recently, and to which little analysis has been applied, namely, in considering the promise of a PTA, does it matter whether the home country’s current trade with the potential partner is due to any significant

extent to “history” rather than (or in addition to) present circumstances by which trade flows would otherwise be determined? The analysis of the chapter provides a positive answer to this question. Moreover, it shows that the possibility that the past participates in forming the present ascribes significance to the *order* in which the two trade policies considered here — universal trade liberalization vs a PTA — are introduced.

Chapter 8 is devoted to an issue whose importance may have been realized, but which has been subjected to only little investigations, namely, beyond (generally recognized and often studied) the impact of trade liberalization on the *size* of trade — leading to its expansion — does the policy have also a substantial impact on the *structure* of trade? Using a variety of elements to define the nature of a structural change and employing several indices to measure these elements, the weight of the evidence suggests that liberalization does indeed affect the structure of trade — both exports and, probably to a lesser extent, imports — in a given pattern. This conclusion carries implications about issues such as the impact of liberalization on dependence on the outside world, on the country’s terms of trade, on the structure of employment, or on the derived level of welfare.

Chapter 9, as well as the two chapters that follow it, turns to issues of *assessment* of a PTA. How should the promise of a contemplated, concrete PTA be judged? Much of the analyses of the earlier chapters, such as the examination of the role played by size of the economies, or by their past trade relationships, is obviously meant to contribute to the ability to make such *ex-ante* assessments. However, in this chapter, a general review of the relevant criteria is provided. And — based on it, and probably of more importance — a set of tools of measurement is suggested for this task.

Chapter 10, then, following in the footsteps of its predecessor, proceeds to illustrate the usefulness of such tools by applying them to a concrete case: the promise of PTAs concluded within Latin America — a region that has contributed a major share of the world’s experiments with PTAs in recent decades, and in which further PTAs are continuously being contemplated.

Chapter 11, on the other hand, addresses the issue of an *ex-post* assessment of the conclusion of a PTA. It tries to determine whether, and to what extent, the PTA changes the geographic pattern of the home country’s trade; specifically, the extent of the bias in the expansion of the country’s trade toward its PTA partners. The chapter develops, again, a set of indices whose use is likely to contribute to such assessment. And, as in the earlier *ex-ante* analysis, it then provides an application to a concrete, recent

case — the PTA among five countries in Latin America that is known as the Andean Pact.

The last three chapters of the volume are all related to the likelihood of a country being a “natural trade partner”, and, specifically, to the role played by geographical proximity of countries. Chapter 12 addresses two issues. First, whether proximity of economies should be expected to make a preferential agreement between them more promising — an issue which in recent years has been hotly debated. Second — an issue to which less attention has been paid — whether a general nondiscriminatory liberalization should be expected to expand trade between neighbors more (or less) than between distant partners. This analysis is important, among other things, for distinguishing between the impact of preferential agreements and that of overall trade liberalization.

Chapter 13 looks more closely and specifically at the impact of distance on trade. It points out that estimates of the relationship between the two, normally derived from “gravity model” equations, consistently indicate a very strong influence of distance on the size of trade flows: an increase in the former contracts the latter by the same proportion, or even more (that is, the elasticity of trade on distance is unity or above). However, the size of international transportation costs is normally very low, as a proportion of the price of the good, and the increase in these costs with distance, involving only a minor change in the price of the good, could not possibly explain a large reduction in the trade flow. Hence, “distance” must involve, and represent, attributes other than transportation costs, which are not directly observed and which presumably have a stronger impact than that of a change of transportation costs.

Finally, Chapter 14 addresses the issue of “natural” trade partnership through the investigation of intra-regional trade relationships within each of nine regional groupings in the world — including, altogether, most of the countries which might be classified into such groupings. The findings indicate that in each and every region, intra-regional trade is indeed much more intensive than trade of the region’s members with outsiders, and, similarly, that complete absence of trade with any member of a region is practically nonexistent; whereas it may be common in relationships with potential partners outside the region. Trade is particularly intensive between contiguous countries. In most regional groupings, an overwhelming weight is found for a “center” country — a weight far exceeding its general role as a heavy trader. Trade of each member of the region with this “center” is the essence of intra-regional trading; whereas trade flows among the

“periphery” countries are minor. This hub and spokes pattern is mostly explained by the center’s attributes as a more developed economy than its periphery partners, offering a particularly broad range of goods to satisfy the demands of its partners.

The methodology of the essays in this book is eclectic. Parts of the analysis are pure theory — often conducted through diagrammatic representation. Beyond this, an important analytic goal is the development of tools for measurement and assessment. Empirical studies constitute another major component of the analysis. While there are different analytic elements, a common thread is shared by these essays: all consist of steps designed to lead from theory to policy. This process requires the transformation of theory to assessment through the development of appropriate tools, and a demonstration of the validity and usefulness of the latter by illustration through empirical studies. The fundamental character of this collection of essays is thus the use of theory to enhance the ability to carry out assessment and, in this manner, to contribute to the improvement of trade policy.