MULTILATERALISM and UNILATERALISM

The constituents of international trade policy

Unilateralism
Multilateralism
Regionalism

I. Multilateralism

The evolution of the GATT/WTO

High protection in the 1930s.

US Trade Agreements Act

The GATT
  Basic principles
  Successive rounds of multilateral negotiations
  Dispute settlement mechanism

The Uruguay Round and the WTO

The stylized facts of multilateralism

I mean the entire GATT-WTO structure, but shall distill it into six stylized facts.
Multilateralism and Regionalism

- **Tariffs** are the instruments of protection.
- The countries of the world *multilaterally* negotiate tariff reductions.
- The negotiated liberalization is *gradual*.
- Negotiated agreements feature *reciprocity*: the mutual exchange of concessions.
- *Nondiscrimination* characterizes trading relations: Each country is a Most Favored Nation (MFN) of every other country.
- Punishments for alleged violations of past agreements have consistently been *commensurate with the violation*, that is, tit-for-tat.

Reducing multilateralism to these stylized facts is deficient in one way. Multilateral liberalization has increasingly shifted from the further reduction of already reduced tariffs to *broadening* liberalization into additional areas, notably agriculture, services, and intellectual property.

Attention has necessarily shifted to government policies other than tariffs. Consideration of these would not alter the following argument, so I abstract from them and pretend that continued multilateral liberalization is only the continued reduction of tariffs.

With initial high protection consisting only of tariffs, most of the stylized facts—multilateral negotiations, gradual liberalization, reciprocity, and MFN—will develop endogenously, if government behavior is dictated by a political support function consistent with how governments claim to behave, and if reasonable substitutes for each country’s exports are produced elsewhere.

II. Regionalism

The Old Regionalism and the New

*Old Regionalism*

An earlier burst of regional integration took place in the late 1950s and 1960s. With the notable exception of western Europe, these initiatives amounted to little and the efforts eventually petered out: it was the GATT rounds of multilateral liberalization that were to have lasting significance.
New Regionalism

Since the late 1980s and early 1990s there has been a surge of regional and bilateral initiatives for economic integration.

Major examples:

- The U.S.–Canada Free Trade Agreement and the subsequent incorporation of Mexico in the NAFTA,
- The accession of Austria, Finland and Sweden into the European Union,
- The Europe Agreements between the European Union and several former communist states of central Europe,
- The Mercosur agreement between Brazil, Argentina, Paraguay and Uruguay for a customs union.

plus dozens more.

How the World Has Changed

The international environment greeting the “new regionalism” differs from that experienced by the old regionalism in three critical ways.

- The multilateral liberalization of trade in manufactured goods among the industrial countries is much more complete now than it was then.
- Scores of economically less advanced countries have abandoned the basically-autarkic, anti-market policies they followed during the days of the old regionalism and are now actively trying to join the multilateral trading system.
- Direct investment, largely a matter of U.S. firms investing in Canada and western Europe in the days of the old regionalism, is now surging, is basically two-way, and, since the late 1980s, is increasingly likely to flow into reforming less advanced economies.

As a result there may well be a qualitative distinction between the old regionalism and the new.

The Vinerian Paradigm: The Theory of the Old Regionalism
Suppose that the countries of the world all initially trade with each other and all have tariffs. Some countries then abolish all tariffs on each other's products but maintain their tariffs on goods from the rest of the world (R), whose commercial policy is unchanged. The elimination of tariffs between the partners is a move toward free trade, which we might expect to generate beneficial trade creation. But now goods from R are subject to tax whereas similar goods from the partners are not. We would expect this price discrimination to generate harmful trade diversion. Thus integration has on balance replaced one distortion (the tariff on partner trade) with another distortion (geographical price discrimination).

Trade creation is presumably beneficial and trade diversion harmful. Which dominates depends upon circumstances; integration may or may not be a good thing. If, before integration, the partners trade mostly with each other, trade creation will likely (but not certainly) dominate, because there is not much trade with W to be diverted. The larger the extent of the integration, the more likely it is to be beneficial: integration of the whole world can involve no trade diversion. But the welfare consequences are inherently indeterminate; this is basic to the Vinerian paradigm.

(Optional Extra: To look at this formally, suppose that countries H and A contemplate integration, with R remaining outside. There are n goods, of which, initially, for country H,

\[ M_A = \text{vector of goods imported only from A} \]
\[ M_R = \text{vector of goods imported only from R} \]
\[ M_B = M_{BA} + M_{BR} = \text{vector of goods imported both from A and from R}. \]

These are all n-vectors, with zeroes in the irrelevant places. The international n-dimensional price vectors for H are \( P_A \) and \( P_R \), and \( P_B \), with \( P = P_A + P_R + P_B \), and \( t_A \) and \( t_R \) are the n-dimensional vectors of H tariffs on imports from A and R respectively. Just as before, we can derive an expression for the effect on H real income of a (small) change in its trade:

\[ dy_H^* = -MdP + [t_A P_A]dM_A + [t_A P_B]dM_{BA} + [t_R P_B]dM_{BR} + [t_R P_R]dM_R]. \]

or,

\[ dy_H^* = -MdP + t_A[P_A dM_A + P_B (dM_{BA} + dM_{BR})] + (t_R - t_A)P_B dM_{BR} + t_R P_R dM_R]. \]

The four terms on the right-hand side can be thought of as, respectively,

Terms of trade effects (internal and external)
Trade creation
Trade diversion
Trade modification.

For simplicity ignore terms of trade effects. Then two results follow immediately from the above.

1 With initial nondiscrimination \((t_A = t_R)\), a small \(dt_A < 0\) (i.e., marginal discrimination) must increase \(H\)'s real income if \(t_R \mathcal{P}_R dM_R \geq 0\) (i.e. \(R\) goods complement \(A\) goods).

2 With initial complete integration \((t_A = 0)\), a small \(dt_A > 0\) (i.e., a marginal retreat from integration) must increase \(H\)'s real income if \(t_R \mathcal{P}_R dM_R \geq 0\) (i.e. \(R\) goods substitute for \(A\) goods).

The above applies to comparative-advantage trade, but analogous possibilities occur with imperfect competition or economies of scale. For example, if integration increases welfare in the partner countries by exposing firms there to intensified competition (competition creation), it may also reduce the competition faced by firms in the rest of the world (competition diversion), producing a possibly negative effect on welfare. Likewise, one can talk about scale creation and scale diversion.

The Ohyama-Kemp-Wan Theorem

Suppose that when the partners integrate they adjust their external tariffs so that they together import and export to \(R\) exactly what they together did before integration. Then there is no net trade diversion, and integration is necessarily beneficial. Thus any group of countries can always integrate and harm no country in the world.

Let
\[ X(P) = \text{the excess supply vector of } R \]
\[ M^H(P) = \text{the excess demand vector of } H \]
\[ M^A(P) = \text{the excess demand vector of } A. \]

Initially, \(M^A + M^H = X(P_0)\). Now, \(A\) and \(H\) form a customs union with the common tariff vector \(t\).

Let
\[ M(P) = M^H(P) + M^A(P) \]

be the joint excess demand vector of the partners.

Let \(P^*\) solve: \(M(P^*) = X(P_0)\). Then, if \(A\) and \(H\) set \(t\) so that \(P^* = P_0(1 + t)\), \(X = X(P_0)\) so that there will be:

No external terms of trade effect
No trade diversion
No trade modification.

So, the formation of a customs union plus internal transfers between members can be Pareto improving.

This suggests the possibility of a regional road to multilateralism: a trading bloc might continue to expand by adding new members until the entire world is included. Such a possibility is of practical relevance only if it is feasible and tempts the partners. Feasibility could be a problem if integration induces strategic behavior by the rest of the world. And the theorem gives no reason why the partners should want to adjust external tariffs to prevent harm to non-partners. Article XXIV of the GATT requires only that external barriers, on average, be no higher after integration than before; this can be consistent with a lot of trade diversion.

The Stylized Facts of the New Regionalism

The following five characteristics do not apply to all current regional initiatives, which are quite diverse, but they do apply to most of the more important ones.

- Contemporary regionalism typically involves one or more small countries linking up with a big country.

In NAFTA, Mexico and Canada are each a small fraction, economically, of the United States; the new members of the EU are tiny relative to the EU itself; the same is true of the central European adherents to the Europe Agreements with the EU; Brazil is likely to play a dominant role in Mercosur, etc.

- Typically the small countries have recently made, or are making, significant unilateral reforms.

This is dramatically true of the Europe Agreements’ central European participants, who had abandoned communism, and of the members of Mercosur and of Mexico. But it also characterizes, to a lesser degree, the small industrial country participants in various regional initiatives. Canada had turned away from Trudeau-style economic nationalism as it negotiated a free trade agreement with the U.S., and the Scandinavian applicants to the EU (except for Norway, which declined to join) had made significant reforms in some sectors (e.g. agriculture).

- A dramatic move to free trade between members is not what it’s all about: The degree of liberalization is typically modest. Thus the Vinerian paradigm is not a natural starting point.

For example, NAFTA actually provides only modest liberalization: US tariffs were already low and NAFTA hedges sensitive sectors in all sorts of ways. Canada and Mexico have done somewhat more, but the most significant measures (largely Mexican) were unilateral and not part of NAFTA. The accession
of new members to the EU is even more glaring: because of their membership in the EA, the trade relations of Austria, Finland and Sweden with the EU are virtually identical to what they would have been had they decided not to join! The Europe Agreements provide for little in the way of concrete liberalization. Even with the more ambitious Mercosur the liberalization involved is small relative to the unilateral liberalizations of the members.

- The liberalization that is achieved is due primarily to concessions by the small countries, not by the large country: The agreements are quite one-sided.

The moderate liberalization achieved in NAFTA is due much more to “concessions” by Mexico and Canada than by the United States. In negotiations over enlargement, the EU has been flexible with regard to financial responsibilities and periods of adjustment, but has always maintained a take–it–or–leave–it attitude regarding the nature and structure of the EU itself. The Europe Agreements involve virtually no “concessions” by the EU: Indeed the EU instituted antidumping measures against some of its new partners even as the initial agreements were coming into effect! In a sense this asymmetry is a direct reflection of how the world has changed since the days of the old regionalism: one reason the small countries get only small tariff advantages is simply that the large countries have small tariffs to begin with.

- Regional arrangements often involve “deep” integration: the partners seldom confine themselves to reducing or eliminating tariff barriers, but also harmonize or adjust diverse assortments of other economic policies.

The EU is a clear and dramatic example of this. The U.S.–Canada agreement and the subsequent NAFTA included a host of economic reform commitments by Canada and by Mexico. Sometimes partners in regional arrangements exempt each other from acts of administered protection (such as antidumping duties), but often they do not (e.g., NAFTA). Sometimes partners are in effect granted rights of appeal denied to non-partners (NAFTA again). Of course, the last three GATT rounds tried, with significant success, to broaden the scope of multilateral arrangements. But a major attraction of the new regionalism seems to be that negotiations with a small number of partners broadens the range of instruments over which negotiation is feasible.

In summary, regional integration often involves reform-minded small countries “purchasing,” with moderate trade concessions, links with a large country that involve “deep” integration but that confer relatively minor trade advantages.
A Theory of the New Regionalism

Reform Facilitation

This approach utilizes the stylized facts that the latter usually involves a big country linking up with one or more small ones that are making significant reforms, and that the degree of liberalization is modest but asymmetrical. The basic argument is as follows.

- The success of multilateralism, during the 1940s-1980s, in reducing barriers to trade in manufactured goods caused the opportunity cost of remaining outside the multilateral to steadily rise.

- As a result, beginning in the late 1980s scores of developing and communist countries embarked on fundamental economic reform, one of the goals of which was to join the multilateral system.

- These countries perceived the ability to attract foreign direct investment as key to successful reform. With so many countries attempting to reform at the same time, competition among them to attract FDI became keen.

- A regional arrangement with a country with a large market is one way to compete for FDI. As a reforming country is competing with more-or-less similar reforming countries, a small advantage could prove decisive. Thus a reforming country might well be willing to concede more to its large-country partner than it receives in return.

- With so many reforming countries attempting to do this, such regional arrangements should proliferate, tending to spread out FDI among the reformers.

Note several features of this approach to regionalism. First, the major role of regionalism is to facilitate reform in the less developed countries. A secondary role (because it is marginal) is to stimulate investment. Second, the relation between multilateralism and regionalism is benign. Regionalism is the consequence of multilateral success, not failure, and it in turn strengthens rather than undermines the basis for a commitment to the multilateral order. Third, I used the terms “investment creation” and “investment diversion” to acknowledge an apparent parallel to the Vinerian paradigm. But trade diversion is the major negative influence there, whereas investment diversion is strongly positive here, as the force behind the major benefit of regionalism.

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[Optional extra: A formal treatment]

The model
The model is comprised of $N$ identical industrial countries, each endowed with $H$ units of human capital, $L$ skilled labor and $U$ unskilled labor, and of $M$ identical less developed countries. Each developed country can produce one good, $x$, using human capital and skilled labor, and one service, $z$ requiring skilled labor and unskilled labor. Goods are tradeable but services are non-traded; the goods produced by the respective countries are imperfect substitutes for each other.

*Production.* Production of each good is in two stages, with one stage, using only human capital, necessarily performed at home. The other stage, using only skilled labor, can be performed anywhere; that is, the home firm can employ labor located in any country (foreign direct investment) to perform this stage. If this stage is conducted abroad, the resulting unfinished goods must be exported from the foreign subsidiary. If $b$ denotes the level of operations of this stage, final output is given by:

$$x = f(H, b)$$  \hspace{1cm} (1)

where $f$ is a conventional neoclassical production function, $H$ denotes the stock of human capital, and where

$$b = kL_b$$  \hspace{1cm} (2)

with $L_b$ the skilled labor allocated to stage $b$. I assume that $k = \sum_{i=1}^{N} L_{b_i}$, $k_i > 0$ with and with $L_{b_i}$ denoting the skilled labor allocated to stage $b_i$ of the good of country $i$. The $b$–stage features increasing returns to scale that depend upon the size of global $b$–stage activity for all $N$ goods and that are external to the individual firm. I assume that goods are produced in perfectly competitive markets.

Production of the non-traded service, $z$, is by competitive firms operating under constant returns to scale and utilizing the total stock $U$ of unskilled labor and the amount $L_z$ of skilled labor. Thus

$$L = L_b + L_z.$$  \hspace{1cm} (3)

*Protection in the industrial world.* I assume that each developed country levies an ad valorem tariff, $t$, on the imports of each foreign good (and it also levies a tariff $t_b$ on its own $b$–stage production, if that stage is performed abroad). I assume all developed countries are identical, and I shall confine attention to symmetric equilibria, so $t$ will be the same for all countries and all goods.
Commercial policy in each industrial country is determined by a political process in which unskilled labor attempts to secure rents. Instead of modeling this explicitly I simply assume that the political process operates as if the country were maximizing a social welfare function that trades off labor’s wage against aggregate welfare:

\[ V = r w + (1 - r) u \]  

(4)

where \( w \) equals the marginal product of unskilled labor in producing services. The parameter \( r \) reflects the influence of unskilled labor over the political process.

The less developed countries. Each less developed country implements a commercial policy which is also the outcome of a political process, again not modeled explicitly, in which special interests attempt to secure rents. Because I am concerned with the possibility of fundamental economic reform, not with marginal changes in protection, I assume that the government must choose between just two possible policies: autarky or reform. With autarky, the special interests secure their rents. But if the social welfare benefit \( R \) of reform is expected to be sufficiently great, the government will attempt reform; let \( r^* \) denote the minimum the expected value of \( R \) must attain for the government to be tempted by reform. The parameter \( r^* \) thus reflects the influence of special interests over the political process.

The benefit of reform depends of course on the benefit of participating in the multilateral system, and this in turn depends on \( k \). So I assume that \( R \) is an increasing function of \( k \): \( R = R(k) \). The less developed country will be tempted to undertake reform if and only if the global economy is sufficiently productive that \( \rho R(k) \geq r^* \), where \( \rho \) equals the probability that reform will succeed. The goal of reform is to modernize the country’s economic structure and to bring it into the multilateral system. To capture this idea, I simply assume that reform is successful if and only if the country does in fact attract foreign direct investment (not permitted in autarky).

A developed-country firm that undertakes direct investment in a less developed country employs labor there and pays for it with exports of its own finished good. I assume that the goods produced by developed countries have not been adapted for use by the less developed, who therefore regard them as perfect substitutes for each other. Less developed countries also benefit because their own nontraded sectors (not modeled here) benefit via spillovers.

I assume that the less developed countries differ from each other in only one way: the propensity \( r^* \) to favor special interests. Let \( M'_s(\rho, k) \) denote the number of less developed countries that, given \( \rho \) and \( k \), would attempt reform. \( M'_s(\rho, k) \) is clearly increasing in each of its arguments.

A symmetric Nash equilibrium in policy: unilateralism. Next, consider an international
equilibrium in which $r$ and all the $r^*$ are sufficiently large that no less developed country attempts reform (i.e., $M^*_s(p, k) = 0$ in equilibrium), and each developed country sets an ad valorem tariff $t$ on imports of each of the $N - 1$ foreign goods at a level that is optimal, given that every other developed country chooses the same $t$ and that the less developed countries all choose autarky. This characterizes unilateralism.

I assume that $N$ is sufficiently large that each country behaves as though its actions have no effect on the world prices of traded goods or on the global $k$. If $P$ denotes the relative price, in terms of home services, of each of the $N - 1$ foreign goods, this small-country assumption is that the home government proceeds as though $k$ and $P/p$ are exogenous. Then a choice of $t$ determines both $p$ and $L_b$ via equilibrium conditions. The effect on the government’s objective of a change in $t$ is

$$\frac{dV}{dt} = r \frac{dw}{dt} + (1 - r) \frac{du}{dt}.$$  

that, with terms of trade effects and external scale effects both absent, the effect of a tariff change on utility is simply the change in import volume multiplied by $tp$, the excess of the social value of a marginal import over its social cost. Thus $
\frac{dV}{dt} > 0$ if $t = 0$: The government will always wish to institute some protection because, with $t$ initially zero, protection will produce a first-order increase in the wage of unskilled labor with no first-order effect on utility. The optimum (unilateral) tariff, as a function of $L_b$ and $p$, is given by $\frac{dV}{dt} = 0$. The symmetric noncooperative equilibrium simultaneously determines $L_b, p$ and $t$.

**Multilateralism**

Assume the following sequence of moves.

- Initially, the developed countries are in a unilateral equilibrium and the less developed countries have each chosen autarky.
- Next, the developed countries, without participation by the less developed, negotiate a multilateral equilibrium (described below) and implement it.
- Then, the less developed countries observe $t''$ and the multilateral equilibrium value of $k$ and individually decide whether to reform or not, taking $t''$ and $k$ as given. The reform efforts are made, they succeed and/or fail, and a new international equilibrium emerges, with $t$ still fixed at $t''$ but $k$ determined endogenously.
Suppose now that the developed countries undertake multilateral trade liberalization. In the resulting multilateral equilibrium, each developed country adopts the policy that is optimal, if all other developed countries adopt the same policy, given the policies adopted by the less developed countries. That is, the developed countries jointly choose a common $t$, denoted $t^m$. The less developed countries do not participate in the multilateral process and continue to choose policies of autarky. It should not be surprising that, subject to a technical condition, moving from a unilateral equilibrium to such a multilateral one produces a lower common tariff, larger $b$–stage production of each good (with, therefore, enhanced scale effects), and higher welfare for each developed country.

Note several distinctive features of this approach to multilateralism. First, no country attempts to manipulate the terms of trade to its advantage, reflecting a belief that such attempts have just not been important in practice. [For an alternative view, see Bagwell and Staiger (1996).] This implies a critical role for special interests: countries would otherwise adopt free trade unilaterally.

Second, national concern for social welfare provides countries an incentive to enter into multilateral arrangements.

Third, the purpose of multilateralism here is to internalize an externality: The development of a multilateral trading system confers benefits of technological spillovers, external economies of scale, and so forth, on all participants. Jointly setting their commercial policies allows countries collectively to address this.

Fourth, the theory assumes, unlike much recent literature, that individual countries credibly commit themselves to the multilateral policy even though, ex post, each government will not be doing the best it can—according to its own objective function—given the policies of the other governments.

Implications of multilateralism for the less developed countries. Multilateralism lowers the tariff, and this will increase $L_M$, causing $k$ to rise. Since $R(k)$ is increasing in $k$, $R$ also increases:

Multilateralism increases the temptation for the less developed countries to reform. To consider the case in which $R$ rises enough so that some countries embark on reform, make the following assumption:

$$R(k^U) < r^*_1 < R(k^M),$$

(A1)

where $k^U$ and $k^M$ respectively denote the value of $k$ in the unilateral and multilateral equilibria, and $r^*_1$ denotes the smallest $r^*$, i.e., that of the country most receptive to reform. Then all less developed countries choose autarky in the unilateral equilibrium, and some attempt reform in the multilateral equilibrium if $\rho$ is sufficiently high.
A reform attempt will succeed if and only if some developed-country firms undertake direct investment there, so turn to this question next. Direct investment will introduce trade in \( b \)-stage products: imports of \( b \) into the developed countries are subject to protection at the rate \( t_r \). I assume that each developed country sets \( t_r \) to optimize some criterion, given the multilateral equilibrium.

**International equilibrium.** Let \( M'_r \) denote the number of less developed countries that attempt reform and \( M_r \) the number that succeed. The developed countries will wish to undertake direct investment in the reforming less developed countries if wages are sufficiently low there, which I assume. Let \( m \) denote the total employment of skilled labor by the foreign subsidiaries of each developed country. Market clearing conditions will determine the equilibrium value of \( m \), but this model does not determine how the total direct investment \( Nm \) is distributed among the reformers. A symmetric equilibrium would allocate \( Nm \) among all \( M'_r \) in equal amounts \( F = Nm/M'_r \), thus ensuring that \( M_r = M'_r \). But there is no reason to expect this outcome because, from the viewpoint of the investing firms, all less developed countries are identical. So I assume that, when all potential hosts are equivalent, investing firms decide where to invest, among all potential hosts, by some random process.

Let \( L' \) denote the maximum labor available in each less developed country for employment by foreign subsidiaries. Then if \( Nm > (M'_r - 1)L' \), some investment must go to each potential host, so \( \rho = 1 \) and \( M_r = M'_r \). But otherwise distributions of \( Nm \) that leave some potential hosts without foreign subsidiaries do exist. With the location of direct investment determined at random,

\[
\rho(M'_r, m) = \varphi \left( \frac{Nm}{(M'_r - 1)L'} \right), \quad (5)
\]

where \( \varphi \) reflects the random process by which investment is allocated. Assume that \( \varphi = 0 \) if \( m = 0 \), \( \varphi = 1 \) if \( Nm > (M'_r - 1)L' \), and \( \varphi' > 0 \) otherwise. Clearly \( \rho \) is decreasing in \( M'_r \) and increasing in \( m \) whenever its argument is less than unity.

Equilibrium conditions determine \( k \) and \( m \), and \( M'_r = M'_r(\rho, k) \) and (46) then simultaneously determine \( \rho \) and \( M'_r \), and thus \( M_r = \rho M'_r \) as well. Since \( \rho \) and \( M'_r \) are positively related in \( M'_r = M'_r(\rho, k) \) and negatively related in (46), the solution is unique. Thus a switch from unilateralism to multilateralism induces some \( M_r \) less developed countries to reform successfully, some \( (M'_r - M_r) \) to attempt reform and fail, and some to wish to reform but to refrain from trying because of the fear of failure. The condition for this is the following.
With \textbf{multilateralism and no investment}: $f^*_L(\mathcal{H}, kL^*_b) > \alpha(1 + t^*_b)$;

\begin{equation}
\text{(A2)}
\end{equation}

With \textbf{multilateralism and investment}: $Nm < (M^*_R - 1)L^*.$

\textbf{Regionalism}

Now introduce the possibility of regional arrangements between developed countries and less developed countries. Such arrangements can be initiated after the developed countries switch from the unilateral equilibrium to the multilateral one, and while the less developed countries are considering whether to reform or not. Define a regional agreement to be:

\textit{An agreement between one developed country and one less developed country in which:}

\begin{itemize}
  \item The less developed country commits—
  \begin{itemize}
    \item To attempt reform,
    \item To levy a tariff of $t^*_b$ on imports of goods from all developed countries other than those of its partner, whose goods will not be subject to duty;
  \end{itemize}

  \item The developed country commits—
  \begin{itemize}
    \item To make a marginal reduction, $dt^*_b < 0$, in the duty applicable to $b$–stage output imported from its partner country.
  \end{itemize}
\end{itemize}

A less developed country which attempts reform without entering into a regional initiative sets $t^*_b = 0$ without discrimination. Thus a country may choose between two roads to reform: unilateral, nondiscriminatory free trade, or bilateral preferential trade.

\textbf{A regional initiative.} Will any such regional arrangements be negotiated? Suppose that the developed countries have moved from a unilateral to a multilateral equilibrium and that (A1) and (A2) hold. Then some less developed countries will want to attempt reform, but $\rho < 1$. Consider how a regional arrangement would affect such a country.

Such an arrangement would commit the country to undertaking reform. The trade preference implies that all imports will come from the partner country, so that $t^*_b$ will be prohibitive—regardless of its positive level, but this is of no consequence since the less developed country regards all goods as perfect substitutes. But the preferential reduction in $t^*_b$, though only marginal, is much more significant. From the point of view of firms considering direct investment to produce $b$–stage output for the partner country’s good, all less developed countries choosing reform are completely equivalent, except for this marginal preference. Thus it attracts all such investment. This ensures the reform will succeed: $\rho$ becomes unity when the country signs the regional arrangement because of the “investment diversion” it implies.

There will also be “investment creation:” a preferential reduction in $t^*_b$ will increase $m$ and cause a
smaller fall in $L$, so that $k$ increases, with the international spillovers this implies. These effects will not be large—the changes are marginal—but the direction is unambiguous.

Now consider the effect on a potential developed country partner. Such a country obtains a secure less developed country market for its good, but this is of no real consequence: in equilibrium its export of goods to all less developed countries must equal the wage bill paid by its foreign subsidiaries, regional arrangement or not. The developed country benefits from investment creation. This has a favorable effect on social welfare, but the marginal change in $t$, will have a zero first order effect on the government's objective function, since $t$ has been assumed to have been optimally set. The principle gain to the government is merely the assurance that it will not find itself facing a tariff of $t'$—and thus higher production costs for its good—in the event that all reforming less developed countries conclude regional arrangements with other developed countries. Thus the government of a developed country may see little to gain from a regional arrangement. But it has nothing at all to lose, and its potential partner has much to gain. Thus it is reasonable to expect that, if necessary, a side payment by the latter would produce such an agreement. So I assume that a developed country would agree to a regional arrangement. And other developed countries should not object, because the only effect on them will be the rise in $k$.

But the regional arrangement will not be uniformly benign. Other less developed countries desiring reform will suffer. Suppose one less developed country, that would undertake reform anyway, enters into a regional arrangement. Then the direct investment producing $b$-stage output for that country's partner will all be diverted there. Thus the numerator of the argument of $\varphi$ in equation (46) falls by $m$; the denominator is unaffected since the less developed country with the regional arrangement still remains a potential host for other direct investment. Therefore each value of $M'$ now corresponds to a lower value of $\rho$ in equation (46) than before: the function shifts down. Accordingly, both $\rho$ and $M'$ are lower than without the arrangement. Regionalism produces “reform destruction” by causing fewer countries to attempt reform and lowering the proportion of those who succeed.

Suppose instead that the less developed country would not have attempted reform at all in the absence of the regional arrangement,. This can be termed “reform creation,” and tends to nullify the fall in $M'$ but further accentuate that in $\rho$. Thus the probability of success falls even more than before, but the number of countries attempting reform may either rise or fall, depending on the balance between reform creation and reform destruction.

**Regional equilibrium.** The above describes a single regional arrangement. But all developed countries would accept such an arrangement, and all less developed countries that attempt reform will want one. So consider the international equilibrium that would emerge when all countries are allowed freely to enter into such arrangements.

I have defined a regional arrangement as one between a single developed country and a single less
developed country. But one country might enter into several arrangements with different partners, thus, in effect, generating larger groupings. Then, regardless of the relative number of developed and less developed countries, all can potentially participate in some arrangement. But there are some constraints.

The first is that, if many less developed countries enter into arrangements with a single developed country, each arrangement may no longer guarantee the success of each reform effort. Although the arrangements will divert investment from nonparticipants to participants, there is no guarantee that it will be distributed among all participants. Suppose that \( M_{rr} \) less developed countries establish regional arrangements with one developed country. For these arrangements to guarantee the success of each country’s reform effort, it is necessary that \( m > (M_{rr} - 1)L^* \). A less developed country will never enter into a regional agreement that violates this condition if an agreement with some other developed country would not violate it. Thus regional groupings would emerge to satisfy the requirement, if possible. The number of less developed countries that would wish to undertake reform if they could be certain of its success is \( M_{k}^*(1, k) \). Then the condition that guarantees that it is possible to accommodate all less developed countries that wish with regional arrangements that guarantee successful reform is the following.

\[
N\left(\frac{m}{L^*} + 1\right) > M_{k}^*(1, k).
\]  

(A3)

A second question is whether a country already in one regional arrangement would be willing to enter another as well. Consider first a developed country. If its partner is not large enough to supply fully its need for \( b \)-stage goods from abroad, this country will want another partner. But with an interior solution, the developed country has nothing to gain from a second arrangement. It has nothing to lose either, and its potential partner has much to gain. Thus it is again reasonable to expect that a side payment by the latter would produce such an agreement, so I assume that developed countries would agree to enter multiple arrangements.

Would a less developed country be willing to enter additional arrangements? These would attract more investment, but, with successful reform already guaranteed by one arrangement, this is no benefit. The country has nothing to gain, but nothing to lose either. The developed country, on the other hand, now has much to gain. With all less developed countries linked to developed countries through regional arrangements, the developed country without such a link will find its exports of goods required to pay for the labor employed in its foreign subsidiaries subject to the tariff of \( t^r \), even though it must pay the same wage as everyone else. Since one party has much to gain and the other nothing to lose, I again assume that such an arrangement would be negotiated.

The regional equilibrium should now be apparent. With (A3), all developed countries, and all less developed countries that wish to reform if \( \rho = 1 \), will enter regional arrangements that guarantee the
success of all the reform efforts. Reform destruction will not occur, but reform creation will.]

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Reform Commitment and Credibility

While attracting foreign direct investment is crucial to the success of reform, so is sustained commitment by the reforming regime and its successors. Regional arrangements are useful here, and, to the extent that the reform attempt is due to the success of the multilateral system, so are the regional arrangements. The stylized facts important here are: reform-minded small countries linking up with a larger country in an arrangement featuring deeper integration.

The basic idea is to use the regional arrangement as an external commitment to reform that will bind the government to the reform measures in the future. Multilateral negotiations are of little use for this purpose since they would not embody detailed reform measures by individual countries and because they provide no enforcement mechanism should a country backslide. Regional arrangements can address both problems.

Because such arrangements allow for deeper integration, they can contain obligations to undertake specific measures central to the reform effort. This is quite clearly illustrated by the free trade agreement between Canada and the U.S. and by the subsequent NAFTA. The fact that the agreement is with a big country (often the dominant trading partner) adds a credible enforcement mechanism.

The previous discussion of the relation between the success of a reform effort and the ability to attract direct investment is also relevant here. In practice, the credibility of the commitment of the government to its announced reform can in fact be very important in attracting direct investment and, in that way, ensuring the success of the reform. Even a regional arrangement with only modest preferences for the small country establishes an external commitment to reform that (weakly) binds future governments, thereby making the future preservation of reform (slightly) more credible. This in turn makes the country more attractive for direct investment, relative to similar countries without such commitments. Thus the ability of a regional arrangement to bind the government to reform can be important for the success of that reform even when it confers only modest direct benefits.