Executive Summary of
Beyond Economics:
The political gains from trade agreements

Marcelo Olarreaga
University of Geneva

The current round of multilateral trade negotiations in the World Trade Organization seem to has stalled. Observers and researchers have noted that part of the reason is that the economic gains to be made from the current round of negotiations are relatively low after the previous eight rounds of GATT and WTO negotiations. But these claims are made based on economic gains from trade liberalization through their impact on import and export flows.

Our starting point in this research project is that political gains from trade agreements, associated with problems of credibility, signalling, and insurance can have a very significant economic value that has been neglected by current studies and analysis. The objective of this project is to examine the importance of these political gains from trade agreements.

The economics literature on trade agreements mainly focuses on trade creation and trade diversion: how much has trade increased or decreased with the rest-of-the-word after signing the agreement. The estimates from these traditional gains from trade are generally rather modest. Thus, the basic research question of this research project is whether the political gains can outweigh the gains from the more traditional effects of trade agreements. And if yes, where are they more likely to be larger (developing versus developed countries, natural resource rich countries versus labour abundant countries, etc...).

The quantification of these political gains from trade is not only interesting from an academic perspective, but it is of crucial importance for trade negotiators, which are having trouble finding incentives to conclude the current round of multilateral trade negotiations in the WTO. Political gains may outweigh the small economic gains.

The research project has produced three papers which are attached. The first paper will be submitted to an academic journal at the end of this calendar year after having presented it at several conferences and seminars (details are provided below). The second paper has been published in an edited volume by Kym Anderson at Cambridge University Press, and the third paper is forthcoming in World Economy.

Weak Governments and Trade Agreements

The first paper is titled "Weak Governments and Trade Agreements" and is co-authored by Jean-Louis Arcand (Graduate Institute), Marcelo Olarreaga (University of Geneva) and Laura Zoratto (Graduate Institute and University of Geneva). The paper starts by examining how trade agreements can be used to solve government's time-inconsistency problems. Like Ulysses asking to be tied to the mast to resist the temptations offered by the sirens,

governments may want to use trade agreements to tie their hands when facing pressure groups, to avoid opting for policies which are optimal ex-post, but not ex-ante. Indeed by adjusting their behaviour ex-post government, lose credibility and create incentives for economic agents (firms, investors, etc) to act strategically ex-ante, which potentially creates large economic inefficiencies. Trade agreements can play for governments the same role as Ulysses' mast, by limiting the scope of government's responses ex-post.

The paper first explores the rationale played by credibility issues in explaining trade agreements. Based on the important earlier theoretical literature[1], we found that weak governments which have a low bargaining weight when facing lobbies are more likely to sign trade agreements for credibility reasons. The reason is that if governments have a strong bargaining weight they do not really need a trade agreement to commit to their optimal policy. We also found that governments that give a weight to social welfare in their objective function that is neither too small nor too large relative to lobbies' political contributions are more likely to sign for credibility reasons. To see this, note that if the government gives a small weight to social welfare, then they are probably not going to want to sign a trade agreement as they value very highly political contributions. On the other hand if they give a very high weight to social welfare, they will not need the trade agreement as they are anyway not very responsive to lobbies' demand. And governments that sign trade agreements with relatively larger members are more likely to sign for credibility reasons. This is because self-enforcement of the trade agreement requires that when signing for credibility reasons there must be some important economic cost associated with exiting the agreement.

These three hypotheses are tested using a dataset that contains information on trade agreements signed between 1976 and 2006 for a total of 134 countries. We are interested in the relationship between PTA formation (for countries i and j at time t) and political and economic variables, representing the credibility and market access motivations respectively. The credibility motivation is proxied by the weight government's attribute to social welfare, following Gawande, Krishna and Olarreaga (2009)[2], and the bargaining weight of the government when facing lobbies.[3]

Results suggest that credibility reasons do play an important role in the probability of two countries signing an agreement. On average 20 percent of the variation in bilateral trade agreements can be explained by our credibility variables. As expected trade agreements signed by developing countries with more developed partners tend to have a larger credibility motive in the developing country. North-North trade agreements on the other hand tend to have a smaller credibility motive.

[1]Giovanni Maggi, and Andres Rodriguez-Clare, 1998, "The value of trade agreements in the presence of political pressures", Journal of Political Economy 106(3): 574-601, and Giovanni Maggi and Andres Rodriguez-Clare, 2007, "A political economy theory of trade agreements", American Economic Review.

[2] Kishore Gawande, Pravin Krishna and Marcelo Olarreaga (2009), What governments maximize and why: a view from trade, International Organization 63(3), 491-532.

[3] The bargaining weight is not observed but is derived using bargaining theory, and then using external data to test its validity. For example the theoretically derived bargaining weight correlates quite well with indices of government concentration (i.e., the herfindhal concentration index of political parties participating in the government), suggesting that more concentrated governments tend to have a higher bargaining weight when facing lobbies.

We then test whether agreements that are signed for credibility reasons tend to be more or less trade-creating. Or put otherwise, are countries seeking to use trade agreements as a commitment device more likely to sign agreements with partners that will lead to more trade creation? In a traditional gravity setup where we control for all types of trade agreements, we found that agreements signed for credibility reasons are more likely to be trade creating, suggesting that agreements that are not necessarily signed for market access reasons may end up leading to larger volumes of trade than purely market access driven trade agreements.

The paper has been presented at several seminar and conferences, including Universidade de Minho, Braga (January 2010), Keynote speech at Cesifo, Munich (Feburary 2010), CERDI, Clermont-Ferrand (April 2010), Geneva Trade and Development Workshop at the WTO (June 2010), Warwick Conference on Trade Costs (June 2010), and Sorbonne, Paris (September 2010). It will be presented at seminars at the London School of Economics, and Oxford University in October 2010 by Marcelo Olarreaga, and at the Latin American Economic Association Meetings in Medellin, Colombia in November 2010. The paper will be submitted for publication to an academic journal by the end of the calendar year.

Does Regionalism Reduce the Volatility of Trade Policy?

The second paper titled “Does Regionalism Reduce the Volatility of Trade Policy?” is written by Olivier Cadot (UNIL), Marcelo Olarreaga (UNIGE) and Jeanne Tschopp (UNIL). The economic analysis of Regional Trade Agreements (RTAs) has largely focused so far on how they affect the *level* of trade distortions. On that count, the verdict is still out: whereas early political economists held a dim view of their benefits (e.g. Grossman and Helpman 1995 showed that politically feasible RTAs were the most trade-diverting). However, institutional arrangements like RTAs can equally importantly affect the volatility of trade policy, and that aspect has been largely overlooked (with a few notable exceptions discussed below). We explore empirically here whether RTAs have reduced the volatility of barriers to agricultural trade, using a new database on agricultural distortions
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The issue of whether regionalism has dampened agricultural trade-policy volatility is an important one. Volatility in food prices is more likely to trigger riots than volatility in the price of, say, shirts or home appliances. If changes in the level of border measures were used only to insulate domestic markets against terms-of-trade volatility, they could be justified on insurance grounds. But they are also likely to have an " autonomous" , discretionary component driven by the vagaries of local political processes. This discretionary policy volatility is likely to be welfare-reducing, as welfare distortions rise with the square of the wedge between domestic and world prices. It may also harm investment and growth if it creates an atmosphere of policy uncertainty. If RTAs have the effect of reducing it through a commitment effect (whether based on rules-vs-discretion or strategic delegation), this is an important " non-traditional" argument in their favor.

Our empirical strategy consists of using a new panel database on agricultural distortions (Anderson and Valenzuela 2008), which gives, at the product level, the ad-valorem equivalent of the wedge between domestic and world prices (what they call the Nominal Rate of Assistance or NRA) for 70 countries over half a century. For each product, we define

volatility as the absolute value of the first difference in the NRA and take the simple average across all goods. This yields a gross measure of policy volatility for each country-year pair (our unit of observation), which we subsequently purge of the influence of world-price volatility calculated the same way to retain only the discretionary component that is orthogonal to world-price volatility. This also means that our measure of volatility is "multilateral" rather than bilateral: for each country, we measure the effect of membership in RTAs and the WTO's agricultural agreement on the volatility of an indicator of trade policy that lumps together all MFN and preferential border measures. This is important, because our measure picks up not only the effect of an RTA on the stability of the bilateral trade regime, but also on an aggregate of each member country's trade regimes vis-à-vis all its partners. Put differently, we measure whether membership in NAFTA reduces the volatility of Mexican trade policy not just vis-à-vis the U.S. and Canada but also vis-à-vis Japan, by encouraging the susbtitution of rules for discretion in all areas of trade policy.

We also instrument our basic treatment variable (membership in RTAs), using the theoretical literature on determinants of trade agreements as a guide in the selection of potential instruments. Motives that we consider as potential instruments for signing trade agreements include the internalization of terms of trade externalities, market access insurance, solving time-inconsistency problems in trade policy decisions, and the provision of public goods (Limao 2007).

We found that RTAs are robustly associated with a decrease in agricultural trade-policy volatility across a variety of specifications. But we find that the effect of WTO membership is less precisely estimated, sometimes being insignificant. Thus, as far as we can tell from our empirical experiment, in this particular instance the multilateral trading system and regional agreements work in the same direction, but the disciplines of the latter seem more readily identifiable than those of the former.

Earlier versions of the paper were presented in several seminars and conference including the World Bank's Agricultural Trade Policy Conference in November 2008 in Washington, DC, and the WTO's Geneva Trade and Development Workshop in April 2009. The paper has been published in Kym Anderson (2010), The Political Economy of Agricultural Price Distortions, Cambridge University Press.
(http://www.cambridge.org/catalogue/catalogue.asp?isbn=9780521763233)

Smoke in the (Tariff) Water

The third paper was inspired by the debate regarding the protectionist response to the current economic crisis, and the role played by trade institutions such as the World Trade Organization in limiting the protectionist response. "Smoke in the (Tariff) Water" is written by Liliana Foletti (UNIGE), Marco Fugazza (UNCTAD), Alessandro Nicita (UNCTAD) and Marcelo Olarreaga (UNIGE).

During the great depression protectionism spread rapidly. By 1933 world trade was only a third of what it was in 1929. Part of this slump had to do with the decline in economic activity, but several studies estimate the contribution of protectionist forces somewhere

between 25 to 50 percent of the total decline in world trade. The protectionist response started in the United States with the Smoot-Hawley Tariff Act passed in June 1930, which raised tariffs by 23 percent. Many countries retaliate, and the world average effective tariff (the ratio of the value of import duties and import value) increased from 9 percent in 1929 to 20 percent by 1933, with values as high as 30 percent in Germany and the UK.

Several authors have warned of a similar –albeit more timid- trend developing as the current crisis deepens. Moreover, this time protectionism may be taking murkier forms making monitoring more difficult. An important difference, however, between what happened during the great depression and today is the existence of the World Trade Organization. Through its numerous agreements the WTO imposes some discipline on the protectionist response of member countries. Some may argue that the WTO has been weakened by its failure to conclude the Doha Round it started in November 2001. However, it is still mighty strong compared to what was available in 1930. At the time, the only international commitment to which 1028 US based economists could refer to when asking president Hoover to veto the Smoot-Hawley Act was a 1927 League of Nations resolution announcing that "the time has come to put an end to an increase in tariffs and to move in the opposite direction''.

The objective of this paper is twofold. First, we assess the extent to which countries can respond to the crisis by increasing their tariffs without violating their WTO obligations. Second, we study the tariff response of countries which have been subject to economic crisis in the recent past.

Results suggest that the amount of policy space left by WTO legal tariff bindings allows for an increase in MFN tariffs similar to what we observed during the great depression and this after controlling for the smoke in the tariff water, i.e., bindings above prohibitive levels (that we call water vapor), and widespread regional trade agreements (that we call dammed water). When looking at recent economic crisis, it appears that this large policy space has been used only moderately by countries facing economic crisis. Large countries tend to increase their tariffs more than small countries when facing a crisis. Countries tend to increase their MFN applied tariffs also when neighboring countries face a crisis. However, this tendency is limited if the crisis also affects the country itself. Increases in intermediate goods' tariffs tend to be smaller than increases in final goods tariffs as one would expect in a world with a growing share of trade in intermediate goods. Nevertheless, the overall increase in MFN tariffs remains modest; suggesting that all these running water did not help float strong protectionist forces during past economic crisis.

This paper was presented the World Bank's conference on Protectionism during the Crisis in Brussels (May 2009). The paper is forthcoming in The World Economy. (http://www.blackwellpublishing.com/journal.asp?ref=0378-5920)

The original research plan accepted by SNIS referred to two of these three research projects (the first two). However, due to fruitful collaboration with UNCTAD, and a strong interest in the extent to which trade agreements could help limit the protectionist response, the third paper was undertaken and will be published in the coming months.

The results of this project suggest that non-traditional gains from trade agreements can potentially be much more important than the more traditional trade creating and diverting effects on which economists have focused most of their research effort. These papers should be seen as a first step and we are planning to continue this line of research at the University of Geneva in collaboration with the WTO and UNCTAD.