

Revisiting The 1930s

*A pandemic of preferential
trade agreements is
undermining free trade.*

As we contemplate the proliferation of Preferential Trade Agreements taking place even prior to the current global financial crisis, it is useful to recall that the preferences in trade that they embody (with trade being freer for member countries than for non-member countries) are not entirely new. Indeed, at other critical times in history, they have been embraced with almost equal passion and have also attracted a strange, if fleeting, approbation from some of the finest minds among economists.

KEYNES DURING WORLD WAR II

Perhaps the most striking historical flirtation with preferences in trade came from the twentieth century's arguably most influential economist, John Maynard Keynes. At the end of the Second

World War, the British were skeptical of non-discrimination as implied by the MFN (most-favored nation) 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 her colonies and dominions. On the other hand, the Americans, led by Cordell Hull, the Secretary of State from 1933 to 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—vigorously opposed it and favored non-discrimination in the trading arrangements being contemplated after the conclusion of the War. Keynes sided with his own, and made the characteristically flamboyant statement:

“My strong reaction against the word ‘discrimination’ is the result of my feeling so passionately that our hands must be free...[T]he word calls up and

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Termites
in the
Trading System

How Preferential Agreements
Undermine Free Trade

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must call up... all the old lumber, most-favored-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 engaged in the negotiations with the United States that led to the final agreement in Proposals for Expansion of World Trade and Employment came to accept Cordell Hull's view that nondiscrimination 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."

THE 1930S DESCENT OF WORLD TRADE
INTO PREFERENCES

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 earlier 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.

Prophet of Trade

"P referential trade agreements are evidently increasing continually. I was the earliest economist warning against them, beginning in 1990 when I sensed that we were facing a systemic threat to the principle of non-discrimination in world trade. I must confess that 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 U.S. Treasury Secretary, and the remarkable **Paul Krugman**, my MIT student and recent Nobel laureate. But now that the proliferation has become evident, and ever more threatening, and its many downsides have become evident, I daresay that the profession has moved like a herd into my corner."

—J. Bhagwati



Jagdish Bhagwati



Larry Summers



Paul Krugman

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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, that were intended to divert limited world demand to one's own goods to reflate one's economy, had led to extensive use of quotas (that necessarily are discriminatory unless auctioned off) and to explicit bilateral treaties aimed at balancing trade flows bilaterally wherever possible.

British commercial policy had begun gloriously with Prime Minister Peel's unilateral embrace of free trade in 1846 and had survived attempts at changing it to protectionism and bilateralism once Britain had seen the emergence of Germany and the United States as a challenge to her trade hegemony. But it would be buried in the 1930s under the bilateral rubble. Thus, consider what the most accomplished analyst of the period, Heinz Arndt, had to say, in his Chatham House study, *The Economic Lessons of the Nineteen-Thirties*, about the decimation of non-discriminatory free trade in Great Britain:

"One significant aspect of British commercial policy during the 1930s which stands out ... was its general trend... towards increased state intervention and quantitative control. In this respect the adoption of protection was relatively unimportant... The real breach ... lay in the supersession of the free play of market forces by State control and diversion of foreign trade from its 'natural' channels which was apparent in much of British commercial policy... by 1938 nearly half her total trade with foreign (non-Empire) countries was conducted under bilateral trade, payments or clearing agreements."

It was manifest that protectionism, each trading nation acting on its own, had damaged the world trading system: each nation followed what Cambridge economist Joan Robinson famously called "beggar my neighbor 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.

GATT: RESTORING PRIMACY TO NON-DISCRIMINATORY FREE TRADE

The 1930s experience, and reflection on the descent of the world economy into bilateralism under policies of competitive tariff escalations and currency depreciations, provided the backdrop against which the architects of the postwar trading system were thinking of the design of the new postwar trade architecture. However, the International Trade Organization that was proposed as the "third" institution to go with the Bretton Woods institutions, the World Bank and the International Monetary Fund, was not even submitted for ratification to the U.S. Senate. In consequence, the General Agreement on Tariffs and Trade, which had been negotiated and signed in the interim with a view to its being incorporated within the broader ITO, became the *de facto* institution that would govern trade after 1948.

GATT was designed to make uncoordinated free-for-all actions on raising trade barriers difficult, through "rules" and "bindings" that would govern and discourage a lapse into competitive raising of trade barriers. Equally, it sought to resurrect multilateralism and assign a central role in it (via its key Article 1) to the restoration of the primacy of the MFN clause that would ensure non-discrimination, an approach that the British finally accepted under American leadership (as exemplified by Keynes's conversion).

As it happens, the associated MFN-based multilateral reductions in trade barriers through Multilateral Trade Negotiations worked wonders, reducing the trade barriers in manufactures in the rich countries to negligible levels today after seven successive multilateral negotiations. The MTNs were known in common parlance as Rounds, prompting the witticism during the Uruguay Round that many unfamiliar with trade negotiations thought that this was a new Latin American dance. The primacy of MFN in the GATT's rules meant that any exceptions to MFN were explicitly provided for.

Unfortunately, such an exception was made via Article 24 for free trade agreements and customs unions. Why? Because it seems from the historical record that few envisioned this exception would be used except under rare circumstances, because it was thought that having to go the whole way towards virtually free trade and extending it to nearly all commodities would discourage resorting to Article 24. It has been wittily remarked that this was like prohibiting lovemaking through promiscuity and sanctioning it only if the wedding bands were tied, a more demanding commitment.

Ironically, this option would be exercised by numerous GATT, and now WTO (which has absorbed GATT since 1995), members and even the disciplines imposed by Article 24 are now no longer necessary, under a new Enabling Clause, if the preferential trade arrangement is exclusively among "developing country" members.

I asked Pascal Lamy, who was then

the EU Trade Commissioner,

"Why not call it then the LFN

(the Least-Favored-Nation) tariff?"

THE PANDEMIC OF PTAS

In yet another irony, where the inter-war 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, the current tide of preferences has been a result of politicians mistakenly, and in an uncoordinated fashion again, pursuing free trade agreements because they think erroneously that they are pursuing a free trade agenda. Worse, that could emerge as a response to the current protectionist pressures, well-intended, but self-defeating in the end.

So today we have a cumulative total of over 350 preferential trade agreements notified to the WTO. On the other hand, if only active preferential trade agreements are counted, the estimated totals are naturally smaller though still large. By either count, the preferential trade agreements are evidently increasing continually.

I was the earliest economist warning against them, beginning in 1990 when I sensed that we were facing a systemic threat to the principle of non-discrimination in world trade. I must confess that 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 U.S. Treasury Secretary, and the remarkable Paul Krugman, my MIT student and recent Nobel laureate.

But now that the proliferation has become evident, and ever more threatening, and its many downsides have become evident, 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

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retorted mischievously that this was an English understatement by a distinguished Frenchman: nearly all were.

But the politicians have almost all moved to the other corner. Faced with their imperviousness to reason, I thought I would try ridicule, the favored weapon of satirists and cartoonists. I noticed that there were proposals afoot to

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organize FTAs around oceans like the Pacific (PAFTA being what it was then called, and FTAAP, the Free Trade Agreement of Asia and the Pacific, now), and then the Atlantic (this being the North Atlantic Free Trade Area, the real McCoy NAFTA which actually had been embraced by many Atlanticists including Senator Jacob Javits but had not come to pass, as against the lesser FTAs that have worked out and masquerade under that very acronym: the North American Free Trade Agreement among the United States, Canada, and Mexico, and the New Zealand-Australian Free Trade Agreement). So, I took out my daughter’s map of the world with rivers, bays, and lakes and, in an article titled mischievously “The Watering of Trade,” I made up a couple of funny FTAs built around such bodies of water. Imagine my surprise when I found that, by the time the article was published, these FTAs were already being discussed.

Then again, when I discovered that the European Union which started the pandemic while the United States had grossly aggravated it, had its MFN tariff applicable to only six countries today—Australia, New Zealand, Canada, Japan, Taiwan, and the United States—with all other nations enjoying more favorable tariffs, I asked Pascal Lamy, who was then the EU Trade Commissioner, “Why not call it then the LFN (the Least-Favored-Nation) tariff?” In short, we now have once again a world marred by discriminatory trade, much as we had in the 1930s from which all sensible men and women had recoiled. ◆