(Final)

Chapter 1: **Introduction: The Unilateral Freeing of Trade <u>Versus</u> Reciprocity***

by

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NOTE: This is the text of the Introduction to Bhagwati(ed.), <u>Going Alone: The Case for relaxed Reciprocity in Freeing Trade</u>, MIT Press: Cambridge, Spring 2002.

We came to the conclusion that the less we attempted to persuade foreigners to adopt our trade principles, the better; for we discovered so much suspicion of the motives of England, that it was lending an argument to the protectionists abroad to incite the popular feeling against free-traders, by enabling them to say, " See what these men are wanting to do; they are partisans of England and they are seeking to prostitute our industries at the feet of that perfidious nation…" To take away this pretense, we avowed our total indifference whether other nations became free-traders or not; but we should abolish Protection for our own selves, and leave other countries to take whatever course they liked best.

Richard Cobden[1]

God I have loved, but should I ask return
Of God or women the time were come to die.

W.B.Yeats[2]

If, on hearing your call, no one comes,
Then, go thou alone.

Rabindranath Tagore[3]

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[1] Quoted in J.A. Hobson, "Richard Cobden ---The International Man, New York: Holt, 1919; page 41. Cobden was, of course, the great crusader for the repeal of the Corn Laws. His portrait, along with that of John Bright, hangs in London's celebrated Reform Club --- though Prime Minister Robert Peel's does not since he was, beyond the repeal of the Corn Laws, was not a " reformer" . As Martin Wolf of the Financial Times, a brilliant and indefatigable proponent of freer trade, and I were recently having coffee with these two men looking down from the walls at us, I remarked to Wolf about the delightful coincidence of two of the greatest free traders of the 20th century sitting under the portraits of two of the greatest free traders of the 19th !

[2] From " Tara's Hills".

1: Introduction

The analysis of free trade divides into two distinct areas:

- whether the freeing of trade is good: and, if so,
- which are the ways, and among them the better ways, to get to freer trade.

The research under the project that has led to this volume belongs to the latter class of questions. The major ways to free trade can be set out as:

- the unilateral liberalization of trade (or what I call here "going alone" or simply "unilateralism");
- the reciprocal liberalization of trade (or what might simply be called "reciprocity") in a multilateral framework such as Multilateral Trade Negotiations under GATT auspices;
- the reciprocal liberalization of trade under plurilateral or bilateral auspices such as Preferential Trade Agreements typically in the form of Free Trade Areas and Customs Unions; and
- the unilateral reduction of <u>others'</u> (not one's own, as under conventional "unilateralism") trade barriers under the threats of sanctions, as in the use of Section 301 provisions of US trade legislation (a method that I have called[4], and others now call "aggressive unilateralism").

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[3] From this Indian Nobel Laureate's celebrated song.
[4] Cf. Bhagwati and Hugh Patrick (eds), <u>Aggressive Unilateralism</u>, Michigan University Press: Ann Arbor, 1990; and Bhagwati, <u>The World Trading System at Risk</u>, Princeton University Press: Princeton, 1981.

Aggressive unilateralism was used only by the US (though there was discussion in the European Union about deploying such an instrument, imitating the US even as the European Commission was agitating against its use by the US). It is really an instrument that can be deployed only by the very powerful nations and then again only against the weak nations. In US experience, little was won by the US from the EU or from Japan: even the threatened use of the 301 instrument against Japan in the celebrated and high- profile US- Japan auto dispute led to an ill-disguised loss for the US.[5] Besides, it has now faded from the scene, with the use of Section 301 to extract unilaterally-demanded trade concessions from others virtually declared by the WTO Dispute Settlement Mechanism as WTO- illegal if undertaken.[6]

The real contest, in both theory and policy, is therefore between unilateralism and reciprocity when it comes to choosing between these methods of freeing trade. The "conventional wisdom" on the question is that economists, the free traders, favor unilateralism whereas policy makers and politicians, the "mercantilists", favor reciprocity. As always, such stereotypical contrasts have something going for them but are, in reality, too simplistic.

Thus, it is simply not true that economists have viewed reciprocity in freeing trade as necessarily mercantilist, in the sense that if you lower your trade barriers only in exchange for others lowering theirs, you behave as if freeing your own trade is making a "concession". As it happens, and this is what I argue systematically below, there is a very good case to be made for

[5] See my expose of the reality of US loss in contrast to the propaganda by the USTR of a US victory, in Bhagwati, "The U.S.-Japan Car Dispute: A Monumental Mistake" ,International Affairs, Vol.72 (2), 1996, reprinted as Chapter 21 in my collected public policy essays, A Stream of Windows: Unsettling Reflections on Trade, Immigration and Democracy, MIT Press: Cambridge, 1998.
[6] This case involved the European Union as the plaintiff and the United States, of course, as the defendant. Technically, the United States won the ruling because 301 was not declared intrinsically WTO-illegal but only if used.

reciprocity; and I myself set it forth as long ago as 1990 when I argued that[7]:

"While this [reciprocity] approach is considered 'mercantilist' by those who prefer unilateral trade liberalization by oneself, the pairing of mutual concessions has a fourfold advantage:

i) if I can get you to also liberalize while I liberalize myself, I gain twice over;
ii) if there are second-best macroeconomic considerations such as short-run balance of payments difficulties from trade liberalization, the mutuality of liberalization should generally diminish them;
iii) mutuality of concessions suggests fairness and makes adjustment to trade liberalization politically more acceptable by the domestic losers from the change; and
iv) foreign concessions to one's exporters create new interests that can counterbalance the interests that oppose one's own trade liberalization."

Equally, whereas reciprocity has become endemic in Washington today, and this is not surprising in a country which since the 1930s has been populated in varying degrees by what I and Douglas Irwin have called "Reciprocitarians"[8], and whereas prominence in the media often goes to reciprocal reduction of trade barriers through Multilateral Trade Negotiations[9] or via Preferential Trade Agreements such as NAFTA, a great deal of often-unflagged unilateral trade liberalization has also occurred in recent decades (as indeed documented in this volume). Indeed, the first dramatic case of

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For all practical purposes, it was therefore the European Union that had won the decision and therefore it decided not to appeal it. The Panel reported on 22 December 1999; see WTO/DS152/R, especially paragraph 8.1.

[7] Bhagwati and Patrick, op.cit., Chapter 1 by Bhagwati, page 15. The first of these four arguments was then developed formally in Bhagwati, ""The Choice between Reciprocity and Unilateral Freeing of Trade" , April 1997, mimeographed, Columbia University; it forms the basis for the Appendix.

[8] Cf. Bhagwati and Douglas Irwin, "The Return of the Reciprocitarians: U.S.Trade Policy Today" ,The World Economy, Vol.10, pp.109-130.

[9] Because MTNs are marked by reciprocal reductions of trade barriers (though, with important reservations discussed in later sections of this Introduction), my good friends Kyle Bagwell and Robert Staiger, who have done important work of their own recently on reciprocity, call it " GATT-think" , drawing on Paul Krugman. But this is surely inapt. Reciprocity enters the scene with negotiations, whether at the GATT or the WTO or in bilateral or plurilateral trade treaties, and is what Prime Minsiter was renouncing unilaterally repealing England's Corn Laws. So,

trade liberalization, one which can justly be argued to have freed trade hugely for the first time, was the repeal of the Corn Laws in 1846 by the British Prime Minister, Sir Robert Peel, who admitted to having been converted to free trade by the economists of his time: and that was an act of unilateral repeal, totally outside of any reciprocal treaty framework. As I shall state later, Peel actually and articulately drew away from reciprocity as the way of liberalizing British foreign trade.

So, to any serious student of the issues raised by the choice between unilateral and reciprocal freeing of trade, it is obvious that the subject awaits systematic and intensive analysis, both theoretical and empirical. This, in fact, was the agenda of the project whose output is collected in this volume.

This agenda is evidently challenging analytically and relevant to policy. But its immediate motivation was the increasing and obsessive emphasis in Washington on reciprocity in trade negotiations that I just noted. Indeed, Prime Minister Peel and President Clinton seemed to me to be two statesmen standing in contrast: one abandoning reciprocity boldly for unilateralism, the other embracing reciprocity with some passion instead.[10] And, on the face of it, Peel, who towered intellectually above Clinton (who was no slouch himself, indeed was regarded widely as a policy afficionado), seemed to have the better of the argument. Hence the project was set up to see what could be said analytically in favor of unilateralism, a task that would inevitably draw into it virtually as its flip side the question of the merits and demerits of reciprocity as well, while documenting (in different ways, recalled in Section IV below) the enormous extent of unilateral trade liberalization in practice (and, where possible, examining its causes).

[10] Cf. my op-ed, " President Clinton versus Prime Minister Peel: The Obsession with Reciprocity" ,The Financial Times, August 24, 1995 and a more expansive version of the essay in my 1998 essays, A Stream of Windows, op.cit. I should perhaps attribute the passionate embrace of reciprocity to the US Congress and to the US Trade Representative, Ambassador Mickey Kantor. But President Clinton's own embrace of aggressive unilateralism

To anticipate, the central conclusions of the analysis below then are that:

- there is an economic case for reciprocity in freeing trade;
- but where others will not go along with oneself, it makes sense to go with unilateral freeing of trade;
- but this conventional case for unilateralism is incomplete: such unilateral freeing of trade can, and occasionally will, trigger a reciprocal response, implying what I call "sequential reciprocity".

III: Three Basic Propositions on Unilateralism and Reciprocity

Let me now begin by stating the basic economics of unilateralism and of reciprocity in terms of three propositions, developing the underlying arguments with necessary nuances.

Proposition 1: Go Alone if Others do not go with You

The classic statement of the case for going alone if others will not go with you is, of course, by my Cambridge teacher, Joan Robinson. Gifted with a talent for saying things both plainly and wittily --- she is the celebrated author of the phrase "beggar my neighbour" policies that describe Nash-equilibrium behaviour when countries competitively devalue and seek to switch aggregate demand away from each other ---, she famously remarked once that if others throw rocks into their harbour, that is no reason to throw rocks into your own.

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against Japan, even if less inflammatory, was evident in the early years of his first term, and in consequence it affected his choice of staff and infected many others in his administration

This is worth remembering, as it is a lesson that often gets lost in public debates: and the reason is, of course, an obsession with "fairness." Many wrongly think that it is unfair if one's market is open and one's trading rival's is not. This is also a mistake that many make today as they contemplate rich-country protectionism and then claim that therefore it is unfair to ask poor countries to reduce theirs.[11]

In short, we need to remember that if we refuse to reduce our trade barriers just because others do not reduce theirs, we lose from our trading partners' failure to reduce their trade barriers (as they do too) and then we lose twice over from our failure to reduce our own.[12] In many ways, when Prime Minister Robert Peel repealed the Corn Laws unilaterally in 1846 to usher in Free Trade in Britain, he was following this route, having been exasperated with the refusal of continental powers to pursue trade liberalization in the reciprocal framework implied by the then-fashionable bilateral trade treaties.[13]

Proposition 2: If Others go with you, so that there is (simultaneous) Reciprocity, that is still Better

For the same reason, we can argue that if others do liberalize in return for one's trade liberalization, then we gain twice over. This is, of course, broadly true. The formal argumentation for it can be tricky but is readily doable as I demonstrate very briefly below and in greater analytical depth in

[11] Cf. Jagdish Bhagwati and Arvind Panagariya, "Wanted: Jubilee 2010 Against Protectionism", mimeographed, Council on Foreign Relations, February 2001. It has also appeared as an op-ed in The Financial Times, March 30, 2001. UN Secretary General Kofi Annan has also picked up this idea and recommended it to the attention of the assembled NGOs in Brussels recently at the UNCTAD-World Bank meeting on the least developed countries' problems this summer.

[12] We must, of course, add the usual riders when there is national monopoly power in trade. Thus, unilateral trade liberalization is beneficial only if the optimal tariff is zero (i.e. there is no national monopoly power in trade) or when the reduction in barriers is from a level above the optimal tariff and does not go so far below the optimal tariff as to actually bring a welfare loss. Similar qualifications are necessary when firm-level imperfect competition exists.

[13] As I note later, however, Peel also believed that "sequential" reciprocity would likely follow.

the Appendix which draws, as is necessary in theoretical analyses, on a very precise definition of reciprocity (in contrast to the several different ways in which reciprocity is practiced in reality, as I argue from the project findings in Section V below).

Thus, imagine that we have what, following Kyle Bagwell and Robert Staiger, I call a reciprocal trade liberalization that preserves the external terms of trade where it was in the previous higher-tariff equilibrium. This will necessarily increase the welfare of both countries. Why? Because, with terms of trade unchanged, and with tariffs having declined in both countries, each country will have only production and consumption gains from the reduced tariff. It is then possible to show that, compared to unilateral trade liberalization, such terms-of-trade-preserving reciprocal trade liberalization will be productive of greater gains for each country. This is a neat theorem; it also puts a formal structure on the intuition that reciprocal trade liberalization will lead necessarily to greater gain.

What can we say about bargaining so as to achieve this reciprocity (which may, however, not materialize as Peel believed had happened with earlier efforts to get European countries to go to Free Trade alongside Britain through bilateral treaties)? Evidently, it makes sense and is not "mercantilist", though there is a danger that excessive use of the language of "concessions" in trade bargaining can lead, and has indeed led, to a widespread bureaucratic and political acceptance of the wrong-headed view that import liberalization is expensive rather than gainful and must be offset by concessions for one's exports. This, in turn, has fed the popular protectionist misconception that "trade is good but imports are bad"! Evidently, such a viewpoint does create difficulties for trade liberalization: as George Orwell would have reminded us, language matters. And as we scholars believe, sloppy arguments have a tendency to come back at us: we may win battles that way but may lose the war.

Let me then suggest at least one other way in which reciprocity may be helpful. In a pluralistic system, it may help a government mobilize export-oriented lobbies who would profit from expanding foreign markets to countervail the import-competing lobbies that profit instead from reducing trade. True, as trade economists well understand, one's reduced protection itself creates incentives for exporters: protectionism implies a bias against exports. But one may be forgiven for assuming, quite correctly, that this benefit is not easily perceived by the exporters who would benefit (indirectly) from such a change. What reciprocal trade liberalization does is to add to, in a perfectly direct and hence salient fashion, the incentives of exporters and hence to facilitate, through use of countervailing power, the reduction of one's own trade barriers.[14]

In fact, Irwin's beautifully argued account in Chapter 3 of why reciprocity helped the United States after the Smoot-Hawley disaster to liberalize trade, compared to the earlier decades when the Congress unilaterally decided on tariffs, assigns part of the explanation to precisely this argument.

Proposition 3: If you go Alone, others may liberalize later: Unilateralism then begets "Sequential" Reciprocity

Then, we get to the interesting proposition, that if others do not see the light and wish to go on with their protectionism, we might be able to get them to follow us with a lag. So we get in effect "sequential" reciprocity. This thought is not entirely new: it had occurred to Prime Minister Peel for sure. Indeed, he argued that Britain's example, her success with the unilateral introduction of Free Trade,

[14] The distinction between direct (hence visible and salient) and indirect effects of reforms is extremely important in discussing the political economy of reform. I am afraid this point is not as well understood by political scientists such as Robert Bates whose work on reforms in African agriculture aggregates the two types of reforms to arrive at "net" incentives that typically will signify nothing. Get me a peasant who will passively accept the withdrawal of a subsidy on his fertilizers because a change in the exchange rate will make agriculture more profitable sufficiently to outweigh the loss of subsidy (and that too, based on Bates' or the World Bank's model)!

would get the recalcitrant nations to follow suit.[15] But the matter is best seen more generally, as always, in terms of supply and demand: in this instance, of protection.

The supply of protection can shrink if, as Peel believed, the success of unilateral free trade by a country seduces foreign nations into imitating the reasons for this success. I should add to the usual argument about diffusion through imitation of success the fact that, in the case of sectoral unilateral deregulation and liberalization of trade, there is also the slightly different argument that governments that lag behind also lose out to governments that go ahead in worldwide competition. Thus, Japan may hold on to its protected Japanese market in telecommunications but, in competing with the American firms who have grown to strength in a unilaterally-liberalized home market, they cannot hack it in, say, Brazil, India and China for sales. That then drives home to MITI in Japan the necessity to liberalize too: there is some reason to think that this has been the case in Japan and the European Union, that this "ahead-of-the-curve" model of unilateral liberalization drives the laggards into their own market opening, i.e. to sequential reciprocity.

But the demand for protection may also shrink: a possibility that Peel did not allow for but which I have argued for and some of my students (Dan Coates and Rodney Ludema, and Debashish Mitra and Pravin Krishna) have now modeled ably.[16] This happens essentially through the fact that the expansion of trade (thanks to the unilateral trade liberalization elsewhere) can strengthen the export

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[15] His views have been extensively documented in my 1988 book on Protectionism, op.cit. Also see the article by Douglas Irwin, " Political Economy and Peel's Repeal of the Corn Laws." Economics & Politics (1), 41-59,1989.

[16] See Rodney Ludema and Daniel E. Coates, "At Theory of unilateralism and Reciprocity in Trade Policy." George Town University Working paper: 97-23 (March), 1989, now published in the Journal of Development Economics, 2001. and Pravin Krishna and Debashish Mitra, "A Theory of Unilateralism and Reciprocity in Trade Policy" , Brown University Department of Economics Working Paper: 99/09 (April), 1999. The models used by these authors are quite different but they both demonstrate how the foreign demand for protection can get affected by one's own tariff liberalization.

lobbies relative to the import-competing lobbies: in jargon, the foreign political-economy equilibrium is shifted in favor of those who seek reduced rather than increased protection.

Let me add briefly here that the empirical reality, as captured in several essays in this volume (especially Chapters 6-11), shows extensive resort to unilateral trade liberalization in the last two decades in Eastern Europe, in Latin America (especially Chile), in Asia (especially in Australia, New Zealand and Indonesia, and since 1991 in India as well), and yet earlier in Singapore and Hong Kong. In addition, there is evidence of unilateral liberalization in the highly innovative financial and telecommunications sectors in the United States (see Chapters 12 and 14 for US financial services and for US telecommunications respectively), with some evidence of "sequential" reciprocity by the European Union and Japan (both moving to respond with their own liberalization in light of American example and success at competition when earlier they refused to do so under reciprocity and even Section 301 threats).

IV: The Findings on These Questions

These three propositions, admittedly in more intuitive form, were precisely what I had in mind as requiring systematic and intensive scrutiny, both analytical and empirical, when the project was set up and I invited several prominent scholars to address the pertinent issues. As reflected in the three Parts in which this volume is divided, the project was divided into three segments:

- Part I dealt with historical experience on unilateral trade liberalization and reciprocity. A natural starting point was precisely Prime Minister Peel's pioneering shift to unilateral free trade with the repeal of the Corn Laws in 1846. Astonishingly, you will recall, he had expressed hope for what I have called here "sequential" reciprocity, based on his faith that Britain's success with free trade would induce others to follow the British example. The interesting question historically is: did Peel turn out to be right? John Conybeare, a leading political scientist and historian of such questions, probes this matter in some depth in Chapter 2 and tells us: true, there was indeed trade liberalization in Europe subsequent to the repeal of the Corn Laws; but it is not easy to establish strong Peel-like "sequential reciprocity" links. Clearly, more research is needed; the Conybeare essay is a tantalizing first step.

- As I have already noted in the previous section, Part II considers the experience with unilateral trade liberalization worldwide in recent decades. Of particular note are the external trade liberalizations carried out by Singapore, as demonstrated convincingly by Arvind Panagariya in Chapter 8, and by Australia and New Zealand, the former studied in depth by Ross Garnaut in Chapter 6 and the latter with cogency by Lewis Evans and Martin Richardson in Chapter 7. These are "genuinely" unilateral liberalizations: they were not part of reciprocal negotiations, whether bilateral[17] or multilateral, nor were they a result of conditionality imposed bilaterally or multilaterally, as by the World Bank or the IMF (for, in that case, as I argue below, the quid pro quo exists but lies outside of trade benefits and arises in the form of aid inflows). Patrick Messerlin's essay in Chapter 9 on Central Europe's unilateral trade liberalization also makes for interesting reading since it shows how

[17] Australia and New Zealand did form a Free Trade Area, the first NAFTA, and of course participated in tariff cutting in the GATT Rounds, in addition to the significant unilateral trade liberalization.

countries recoiling from communism, central planning and autarky embraced democracy, markets and openness. The interesting and important case of extensive unilateral trade liberalization by Chile is addressed in Chapter 10 by Sebastian Edwards and Daniel Lederman, and the experience of Latin America more comprehensively is reviewed by Rachel McCulloch in Chapter 11.[18]

[These country experiences had much to do with unilateral trade liberalization but little to do with sequential reciprocity in the sense that the unilaterally liberalizing country hoped that its action would prompt its trading partners would respond subsequently with their own liberalization. But that is not to say that the example of success with trade liberalization did not play a part in the decision of other countries to reduce their own barriers unilaterally instead of persisting in protectionism.][19]

- But unilateral trade liberalization has occurred in certain sectors, such as finance and telecommunications, and has prompted sequential reciprocity in rival countries as well. This has typically happened in the United States where, while the ethos of reciprocity is exceptionally strong, these sectors have been characterized by the reality of "going alone". And others, such as the EU and Japan, which were reluctant laggards and unwilling to indulge in simultaneous reciprocity, have followed suit sequentially, more or less. The US experience has been reviewed for the finance sector by Larry White in Chapter 12 and in

[18] I had originally included Hong Kong in the Project since it is a case of a country that had remained a unilateral free trader for a long time. Unfortunately, the commissioned paper, by a team headed by Kar-yiu Wong, could not be completed in time.

[19] The reasons why countries in the project have unilaterally liberalized are considered in Section VI below.

telecommunications by Cynthia Beltz in Chapter 14. Koichi Hamada in Chapter 13 has examined the Japanese Big Bang in its financial sector from the unilateralist perspective.[20]

This set of contributions takes us significantly down the road to understanding the way in which unilateral trade liberalization has worked historically and in modern times, both at the country and the sectoral level. But we need more work, especially at the sectoral level, examining the US experience more fully and also extending the analysis to Japan, EU and other nations.

But the project illuminated, not just the three major Propositions that I have highlighted as its major findings. It has also been of great value also in taking further our understanding of trade reciprocity itself and also of the underlying factors that led to the unilateral trade liberalizations in practice. I will now consider each in turn.

V: Reciprocity: Conceptual Clarifications

Like most concepts in economics, such as the budget deficit or the unemployment rate, reciprocity in trade liberalization seems simple enough but in fact can mean a multitude of things, each with its uses. This became manifest early in the project. What emerged were insights that led me to think of several typologies.

The basic typology used in a central way in this volume is of course what I have already been dealing with. Reciprocity here divides into "simultaneous" and "sequential". The former is when a nation exchanges a trade barrier reduction for another, as part of its trade bargain. Now, such a "contractual"

[20] Unfortunately, Motoshige Itoh of Tokyo University could not complete a paper on Japanese experience with telecommunications.

reciprocity may involve the return concession accruing down the road so that the simultaneous reciprocity is over time. The essence of simultaneous reciprocity therefore is that it occurs within the bargain, not that it is instantaneous or that the actual exchange of concessions accrues at the same time.

By contrast, what I call "sequential" reciprocity and one that underlies Proposition 3 earlier, is one that occurs, not because it is agreed to by the negotiators, but because it is induced by a unilateral, non-reciprocal act of unilateral trade liberalization.

Then again, one must keep in mind, as I noted in Protectionism (1988, pp.35-36) based on the first Bertil Ohlin Lectures in Stockholm, that reciprocity can be either "full" reciprocity, i.e. where equality of market access (e.g.. matching of tariff rates) is sought, or "first-difference" reciprocity where matching of concessions at the margin is all that is sought. Clearly, most MTN negotiations have amounted, where rough balancing of concessions is sought, to first-difference reciprocity. But, in Free Trade Areas and Customs Unions, as under Article 24 of the GATT or the Enabling Clause, the intention has to be to reach full reciprocity since that is what the acceptance of full dismantling of intra-FTA or intra-CU trade barriers amounts to.

But then there are two other typologies, which must also be kept in view for clarity of analysis of the question of unilateralism in trade liberalization. Thus reciprocity can occur within trade and outside of trade: i.e. the quid pro quo may be the securing of trade concessions for grant of trade concessions or the quid pro quo may be concessions on non-trade dimensions.

The "within trade" reciprocity can be sub-divided into three different types that the project participants variously encountered: (1) where tariff cuts are balanced, the most recent practice of agreeing on zero-tariff sectors being the most extreme example; (2) where (estimated) trade volumes from trade concessions are balanced, a practice that Alice Enders discusses in Chapter 4 as the one that the US negotiators seemed to favour when the GATT architects were discussing reciprocity and a practice whose remnants are to be found in the compensation provisions of the GATT when a tariff concessions is withdrawn[21]; and (3) where reciprocity is sought only very broadly and includes offering concessions that cut across sectors and without quantitative balancing of either cuts in trade barriers or volumes of trade that result therefrom: a practice that Michael Finger, Ulrich Reineke and Adriana Castro testify to in Chapter 5 in describing what happened by way of reciprocity in the Uruguay Round.

The project threw up several instances where countries were apparently freeing trade unilaterally but the quid pro quo was absent only in the form of reverse trade concessions. It obtained instead on non-trade dimensions, so that what looked like genuinely unilateral trade liberalization was actually not. Such "outside of trade" reciprocity divides in turn into quid pro quos that arise in form of aid, as when the IMF or the World Bank, or other multilateral or bilateral funding agencies, provide funds only if trade liberalization is undertaken, and those that arise, as the case of Taiwan studied by Arvind Panagariya in Chapter 8 illustrates well, in the form of bargains that are tantamount to avoiding punishment (on security, aid, trade and other dimensions) rather than securing rewards. Evidently, therefore, one must not deduce that all cases where one sees trade liberalization undertaken outside of a trade reciprocity framework, as in an MTN Round, are automatically genuine cases of unilateral trade liberalization where no quid pro quo is simultaneously extracted or given.

[21] Reciprocity is defined unambiguously in terms of trade volumes only in the context of retaliation. Thus, Enders states that "A specific example of retaliation based on this rule-of-thumb was the EEC's request to the GATT Council in March and April 1988 to authorize the retaliatory withdrawal of equivalent concessions granted to the United States in respect of specific products, following the adoption in 1987 of the panel report on 'United States-Taxes on Petroleum and Certain Imported Substances" (Footnote 58). Besides, typically the trade retaliation practiced under Section 301 of the United States, whether GATT-consistent or not, proceeds by calculating the trade-volume effect of whatever is objected to abroad and an attempt at inflicting a similar damage to the offending country's exports (while choosing products for retaliation on different economic and political considerations, of course).

But a second typology relates to the complexity introduced for reciprocitarians by the fact that any attempt at balancing first-difference reciprocity has to face up to the fact that there are more than two countries. This is the so-called "third-country problem". Bilaterally, one can always try to balance concessions whichever way one seeks to do so, (whether on trade volumes or tariff cuts or broadly across sectors). But what does one do when one has trade, and possibly trade agreements or treaties, with third countries? The reciprocitarians have always had to choose a strategy on how to accommodate bilateral trade reciprocity in the multilateral context. Essentially, this third-country problem has been resolved in both treaty-making and trade-institution-devising arenas in two ways:

- unconditional MFN; and
- conditional MFN,

though, I should include absence of any MFN also as a remote possibility.

(i) Unconditional MFN

Under unconditional MFN, any trade concession made bilaterally must be extended to third countries which then enjoy the right to market access on the most favoured terms extended to any other country. This principle is embodied conventionally in treaties signed with specific third countries which then typically extend such MFN rights reciprocally.

The GATT was built on such reciprocated agreement to extend MFN to all members, with some built-in exceptions such as Article 24 permitting preferential trade agreements under well-defined restrictions and, later, with exceptions provided to developing countries in various ways.

(ii) Conditional MFN

Under conditional MFN, there is no automatic extension of bilateral reduction of tariffs and other trade barriers to third nations. Rather, there is a presumption, and in treaties an obligation, that the concessions will be extended to third nations (signatory to such a treaty) provided they make acceptable reciprocal trade concessions. The General Agreement on Trade in Services (GATS) favors this approach, so that the WTO, unlike GATT which was based on unconditional MFN, is now a blend of both unconditional and conditional MFN since it includes both GATT and GATS. [22]

Now, conditional MFN is clearly a way of ensuring reciprocity between any pair of nations, in whatever way it is defined, since no "unrequited" concessions are made to third nations. No third country gets a "free lunch". A third nation gets only the right to get to the dining table, not the right to sit down and sup. To receive, it must give.

But unconditional MFN leaves open the possibility of "free riders" if one is a reciprocitarian. So, does it not handicap trade liberalization, even though MFN has well-known advantages such as non-discrimination which the great international economists of earlier generations, such as Frank Taussig and Gottfried Haberler of Harvard and Jacob Viner of Princeton recognized and which we now know with renewed appreciation as we see the proliferation of discrimination worldwide through multiplying Free Trade Agreements?[23]

Or, to raise a related question which affects the issues in this volume more directly, how can one work with unconditional MFN and still manage to be a reciprocitarian in trade negotiations? As it happens, there are several ways in which the free-rider problem has been minimized or tolerated in practice, some seen from this volume and others from other research and reflection:

[22] WTO is in fact a tripod, with the third leg being intellectual property protection, alongside GATT and GATS.

- ways have been devised that have reduced unconditional MFN in reality to conditional MFN; or
- free riding has been accepted as legitimate; or
- free riding has been dismissed as unimportant and not worth bothering about; or
- "sequential" reciprocity has been regarded as likely and hence the free rides are assumed to be unlikely to endure; or
- the likelihood of actually getting the potential free riders to pay has been enhanced by suitable institutional innovation (as James Meade, who devised the so-called "multilateral-bilateral" way of conducting the GATT-based Multilateral Trade Negotiations using unconditional MFN, is supposed to have done, as documented by Alice Enders in Chapter 4).

I will address each of these ways now.

(i) If reciprocity with third nations is really desired, unconditional MFN may be reconciled with it by ensuring that the bilateral deals, characterised by attempted pairwise reciprocity, are restricted by and large to products of export interest only to the bilaterally-liberalizing countries. That way, through product-selection bias, third countries could not get a free ride or at least not one that is worth much.

This is what has led the GATT negotiations (see Enders in Chapter 4) to be on a "principal suppliers" basis with the initial liberalizing moves in the MTN confined to those who have a substantial position in a product. Michael Finger has also remarked that the reason why developing countries did

[23] On the drawbacks of these preferential trade agreements, which violate intrinsically the MFN principle vis-à-vis non-members, see the many writings of Arvind Panagariya and myself. For many of the most important contributions,

not make much progress on textiles and agriculture is partly a reflection of the fact that they were free riders who were exempted form reciprocity and hence products of interest to them were bypassed by the rich countries playing actively in successive MTNs. The one time that these subjects moved was in the Uruguay Round; but by then, the developing countries had begun to play with their own concessions.[24]

(ii) But if unconditional MFN was reduced to acting pretty much as did conditional MFN, it would surely be disappointing. In reality, however, that is only part of the story. Other factors have been at play in preserving the true character of unconditional MFN.

Among these is the fact that free riding may be considered legitimate when the free rider cannot pay. Here, I may recall the benign view that economists such as Alfred Marshall of Cambridge University held on the question. They argued, at the turn of the last century, that British free trade should be unilateral, without demanding reciprocity from the developing countries. To quote Marshall: "it would have been foolish for nations with immature industries to adopt England's [free trade] system pure and simple".[25] [Though Marshall, Edgeworth and other leading English economists were indeed skeptical of the advisability and utility of protection, they shared with John Stuart Mill an indulgence towards infant-industry protection, Mill having been the father of this argument.]

Indeed, this type of reasoning was behind also the legitimation of exemption from reciprocity for the poor countries at the GATT, with successive changes provided for the purpose as the postwar

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see Jagdish Bhagwati, Pravin Krishna and Arvind Panagariya (eds), Trade Blocs, MIT Press: Cambridge, Mass, 1998.

[24] This argument is well-known to several trade economists but is lost sight of by some well-meaning but misguided NGOs and, with far less excuse, by some World Bank bureaucrats who keep talking about how "unfair" the world trading system is, in having rich-country protectionism, as if it was a result simply of wickedness by the rich countries! The governments of the poor countries who repeat this claim of "unfairness" are besides unaware that "fairness" in trade is a code word for "justifiable" protectionism in the rich countries, and they do themselves harm by taking over this terminology as an acceptable way of looking at the world trading system.

period unfolded. In fact, developing countries long enjoyed an easy exemption from reciprocity in bargaining, and indeed in the disciplines that GATT members were otherwise subjected to, all amounting to what came to be called Special & Differential (S&D) Treatment. It is only with the Uruguay Round that S&D has come increasingly under the axe.

(iii) But the ignoring of free riding by the developing countries also reflected their insignificance in trade at the time. It was simply not worth making a fuss: the free rider was dwarfish and could get into the bus inconspicuously, taking up little space.

(iv) But one can take a more complex view, one that I have developed myself[26], that sees an enlightened-self-interest strategy in this benign approach to not demanding reciprocal concessions from the insignificant multitude of developing nations. If the developing countries, bent on protectionism, were asked to join in reciprocal reductions of trade barriers, they would have likely abstained from the GATT system (as indeed was the danger as they lined up behind UNCTAD). By indulging them at only a negligible cost in terms of markets foregone, and committing them and the GATT to the view that this free ride would last till they developed and then had to "graduate", the postwar hegemonic power, the United States, could lead trade liberalization efforts and simultaneously build up commitment to the Liberal International Economic Order and to the GATT. This would then serve to help open the developing-country markets under GATT's auspices, through new MTN Rounds, when these markets had become truly important (as they now have).

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[25] Quoted in J.M.Keynes (ed.), Official Papers of Alfred Marshall, Macmillan: London, 1926, p.392.
[26] Cf. Chapter 30 in my collection of public policy essays, A Stream of Windows: Unsettling Reflections on Trade, Immigration and Democracy, Cambridge: MIT Press, 1998.

Unlike in Charles Kindleberger's view of the hegemon being altruistic and setting rules and making institutions as a "public good", much like providing a public service from "leadership" and altruistic motives, the view here is then of what I have called by contrast a "selfish" hegemon. Its short-run policy of apparently selfless altruism leads to bigger long-run gain.

(v) But unconditional MFN liberalization may be considered acceptable to the advocates of conditional MFN if only one could think of institutional ways of minimizing the free rider problem. Here, the institution of the GATT and its MTN Rounds, as envisaged by James Meade (in his preference for the "multilateral-bilateral" approach) from the British side in the negotiations over postwar trade arrangements, became the preferred option. As Alice Enders observes in Chapter 4, "The multilateral character of the negotiations would be secured by the simultaneous engagement of countries in the process of bilateral tariff negotiations [conducted on the principal-supplier and a "selective, product-by-product" approach] in one location."

It is certainly plausible that this "single location and negotiation" approach, underlying the successive MTN Rounds under GATT auspices, has served to reduce the free rider problem while not eliminating it, making unconditional MFN more palatable to the reciprocitarians.

VI: Explaining Unilateral Trade Liberalization: Ideas, Interests and Institutions

So, one can conclude that reciprocity, despite the foregoing analysis of its many meanings and conceptual complexities and the difficulty of working with it in the real world of trade negotiations among multiple countries, has indeed played a role in reducing trade barriers in a nondiscriminatory way, both historically (as evident from Irwin's analysis of the US experience in Chapter 3) and in the modern period (as evident from the experience with the GATT's success with its MTN Rounds).

But the project's main findings relate, as already indicated, to the success of unilateral trade liberalization as well. So, the final question I must address is: what have we learnt about the reasons why unilateral trade liberalization has occurred? In my 1988 book, Protectionism, I introduced the tripartite division of the causes of trade liberalization: ideas, interests and institutions. This has proven to be influential; it can be used here to analyze the causes of unilateral trade liberalization specifically. Indeed, both the Asian analysis by Panagariya, and the New Zealand analysis by Evans and Richardson, use it to advantage in this volume; and Garnaut's analysis of Australia clearly reflects this type of analysis as well.

Ideas: This divides in turn into the role of ideas per se and the role of individuals who brought these ideas to bear on the shift to unilateral trade liberalization.

The idea of unilateral trade liberalization (in the form of Proposition 1 in Section III) is of course quite old. But it was reinforced by policy experience: i.e. by "example" as Prime Minister Peel believed when he repealed England's Corn Laws. Conybeare's investigation does not demonstrate unequivocally that Europe followed England's example, as Peel had assumed it would. But the role of example has certainly worked in modern contexts. This is borne out for countries such as India, studied by Panagariya in Chapter 8, and for Central Europe as it turned from central planning and autarky, studied by Messerlin in Chapter 9.

Equally, the example of one's own failure, not necessarily of others' success but possibly in conjunction with it, surely helped as well. India, Latin America and Central Europe had all tried autarky or its less fearsome variants and had failed. In reforms, nothing succeeds like (past) failure! The reformers rooting for unilateral trade liberalization in these countries and regions had the advantage that there was a wide perception, I would say recognition, that opting out of trade and even DFI had failed. As Galbraith once remarked about Friedman, and I endorse the wit but not the economics, "Milton's misfortune is that his theory has been tried"!

But many papers in this volume highlight the role of individuals, both in strategic governmental and quasi-governmental positions as also among intellectuals and economists who worked long to change public opinion through ceaseless public policy writings, who were critical to the unilateral shift to freer trade. In this context, the chapters by Panagariya, Garnaut, and Evans and Richardson, are the most direct and fascinating while some examples of interest can be obtained also from many of the other chapters in Part II in particular. In fact, remember that Prime Minister Peel in the 1840s was himself one of these key individuals, in the right place at the right time; and the developments in political economy, underlining clearly the convincing arguments for free trade, clearly played a major and self-acknowledged role in Peel's conversion to free trade and then to its unilateral version.[27]

Interests: As for interests, I must also note the role played by Richard Cobden and John Bright, the leaders in the Anti-Corn Law League, and the lobbying interests of the manufacturing classes that wanted cheap corn, in providing the necessary political support for Peel's intellectual-conversion-based decision to repeal the Corn Laws and usher in free trade unilaterally.

[27] I might recall with amusement the time I was on the platform at an APEC Seminar in Auckland, New Zealand and with the country's dynamic Trade Minister, Dr.Lockwood. He spoke passionately in favour of unilateral trade liberalization, decrying reciprocity. He argued that asking for reciprocity was like telling your girlfriend: I won't dop my pants unless you take off yours. I did not wish to contradict a free trader on the stage. But over coffee later, I told

The role of exporting interests in pushing for greater freeing of trade, and as countervailing power to the import-competing interests that wish to close markets instead, is of course well understood and has been written about for almost two decades. The rise of globalized multinationals in keeping up the momentum for trade liberalization has been studied in this context.[28] But this volume produces several vignettes as when the role played by users of foreign inputs, made hugely expensive by protectionist policies, is also argued by Panagariya as a major factor in the eventual business push for more openness in trade in South Asia.

In addition, Panagariya reminds us that the exporting interests in powerful countries abroad can act as levers of openness in countries in politically dependent status. He argues this for Taiwan which had to respond to US lobbying pressures. This was also true of successful US threats under Section 301 against South Korea (with exceptions only where the politics was immensely difficult, as with rice and cars). Such unilateral trade liberalization, however, falls into the category distinguished above as really a form of reciprocity going outside of trade: one's trade liberalization has its <u>quid pro quo</u> in removal of punitive threats or promise of benefits like security.

The role of <u>innovation</u> is also emphasized in the creation of genuinely unilateral, new sectoral liberalization. Larry White's analysis in Chapter 12 of the US financial liberalization, virtually all unilateral, and Cynthia Beltz's story in Chapter 14 of how the US telecommunication market was liberalized, illustrate very well how rapid technical change was the effective driver.

<u>Institutions:</u> Perhaps the most dramatic argument for the role of institutions in driving unilateral trade liberalization comes from the Central European experience in Messerlin's Chapter 9. The

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him: unfortunately, since sex normally requires two parties, and it is not much use dropping your pants if your girl friend does not, any sexual analogy can only work for reciprocity, not for unilateral trade liberalization!

restoration of democracy after decades of Soviet-imposed communism changed the economic game as well. The shift to democracy was accompanied by a shift to economic policies such as freer trade that were associated with non-communist systems.

The shift worked because there was no real politics to contend with at the outset. Borrowing from Mancur Olson's way of looking at this, I might say that there were no pressure groups to oppose or to propose change: more or less, ideas alone mattered. It was not that the end of the Cold War had destroyed old economic lobbies that would oppose change; the Cold War had destroyed a system which had virtually no such lobbies in the political space to begin with!

The other paper in this Volume that is of interest from the viewpoint of the role of institutions is Irwin's Chapter 3. It shows, however, how the Reciprocal Trade Agreements Act (RTAA) that followed the Smoot-Hawley tariff was an institutional change that replaced the earlier unilateralism of tariff setting by the Congress with reciprocity in trade bargaining by the Executive and thereby overcame the bias towards protectionism that the Congress exhibited. So, Irwin applauds the shift to reciprocity, and deplores the earlier unilateralism, because the latter paradoxically served institutionally to undermine, not promote, trade liberalization! A paradox indeed.

VII: Concluding Remarks

But there is much else that the curious and careful reader will find in these thoroughly researched, and much-edited, papers. All I have done is to highlight the major issues, and findings, as I see them.

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[28] I developed this theme in Protectionism, 1988, op.cit.; and the political scientists John Odell and Helen Milner have also written on this theme.

I recommend the smorgasbord. But what the reader will find on the sumptuous table is by no means confined to what I see and like. I urge that she explore. If she does, she ought to be rewarded.

Appendix: Formalizing the Argument for (simultaneous) Reciprocity[29]

Consider the theoretical argument, free from any political- economy argumentation, for unilateral free trade (UFT) and then, in light thereof, the case for reciprocity.

I

Model 1: All Countries are "Small": Unilateral Free Trade (UFT)

Assume that all trading nations are atomistic, so that they cannot influence the prices in world trade. This is the familiar (Samuleson) "small country" assumption. Consider also, that for unexplained reasons, each nation starts from an initial tariff- ridden equilibrium and then asks whether unilateral freeing of trade or a reciprocal one is desirable.[30]

It is immediately evident that unilateral free trade will be the choice of every country. No one country can do anything effective, such as closing its markets, to get others to change their tariffs by way of reciprocity; a policy of reciprocity is simply not feasible given the country's atomistic position. Every country therefore has the incentive to chose UFT in the absence of any leverage on world prices.

Of course, in the worldwide free trade (WFT) equilibrium that must emerge in this model, world efficiency is achieved and the equilibrium is Pareto- efficient. But this does not mean that, compared to its welfare in the initial tariff-ridden equilibrium, every country will become better off (ruling out lump

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[29] This appendix is based on my widely- circulated but unpublished manuscript from five years ago, "The Choice between Reciprocity and Unilateral Freeing of Trade," Columbia University., April 1997. Comments from Richard Brecher, Rodney Ludema, Arvind Panagariya and T.N. Srinivasan at the time were most helpful.

[30] A fully satisfactory analysis should derive the initial tariff equilibrium as well. But I stay here with the conventional assumption that somehow tariffs have been inherited, perhaps imposed by an earlier government, and the present government is free to decide whether free trade is good for it and, if so, also is free to choose the way of getting to it.

sum redistribution between nations, as I do throughout this Appendix). The reason obviously is that the world prices facing a country in the WFT equilibrium may be worse than those faced by it in the initial tariff equilibrium, so that the loss from protection is eliminated but the terms or trade are worse. But this prospect will not mean that this country will not opt for UFT; it remains its best choice (since what it does or does not do cannot affect what others do and these others will choose UFT and hence worsen the the terms of trade for this country anyway). Evidently, there is no argument here for reciprocity of tariff cuts.

II

Model 2: Countries are "Large:" Argument for Reciprocity

But this is no longer so once the trading countries are assumed to be large, i.e. with the power to influence their terms of trade by varying the volume of trade. In this case, a unilateral move towards free trade is not necessarily a welfare-improving policy for a country since its optimal tariff now is positive and a reduction in the tariff barrier below that could be welfare- worsening. Thus, UFT proponents would have to assume that the ability to influence the terms of trade is "negligible" in reality and that it is best to therefore, to proceed under the assumption that the trading countries are "small".

But that is a theoretically unsatisfactory position. If we allow for the "large" country assumption, then we must necessarily admit the possibility that UFT is welfare- worsening and hence is not a policy that will be embraced by the country.[31]

[31] I am not even admitting the further complication of trade retaliation by countries when they are also not "small" .

However, once we admit reciprocity, it is also obvious that the optimal- tariff- generated welfare level for a large country can be improved upon if this county's loss from its own liberalization was more than compensated by increased gains from a suitably large reciprocal liberalization by its trading partners. Recall from the text that this is, in fact, the case that I made in 1990 when I proposed four different reasons leading to reciprocity in preference to UFT, the first being the one that I have just stated and will now argue more rigorously.

But this justification for reciprocity is not really complete since the welfare of the partner countries is not examined. Of course, one may assume that a similar argument in favor of reciprocity can be assumed for them. But we still need to show rigorously that, through suitable reciprocal tariff cuts, every trading country (in a world of "large" countries) can improve its welfare with certainty and hence countries have an incentive to choose reciprocal tariff cuts instead of continuing at the initial tariff - ridden equilibrium.[32] This can be done, as I proceed to do now, demonstrating first the propositions stated earlier regarding the large-country case.

1. The model and Initial Situation: Consider a two- country model throughout (except for a brief analysis of MFN towards the end of this section). Then, in Figure 1, with countries I and II trading with each other, their initial tariff- ridden offer curves I and II intersect at T. Their free- trade offer curves I_F and II_F intersect at F which lies on the worldwide free-trade efficiency locus. T clearly is Pareto- inefficient.

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[32]Of course, remember again that , with any particular tariff- retaliation mechanism specified, such as in the celebrated Johnson-Cournot analysis, a large country could well emerge better off under a tariff-increasing policy than under the reciprocity that I analyze. Cf. Harry G. Johnson, " Optimum Tariffs and Retaliation" , Review of Economic Studies, Vol.21, 1953-54, pp. 142-153. But I disregard this possibility as to what form such retaliation will take once the dynamic of trade wars takes over the situation.

2. Bhagwati's 1990 Argument: Suppose now that country I undertakes unilateral trade liberalization. Then in Figures 2(a) and 2 (b), its offer curves shifts to I^{l} and the equilibrium shifts to T^{l}. Consider then a reciprocal trade liberalization by country II which shifts its offer curve to II^{l} and the trade equilibrium to T^{ll}. In Figure 2 (a), the unilateral tariff reduction by I leads to increased welfare U^{l} since, at T, the country is above its optimal tariff in the initial equilibrium. Then, the reciprocal trade liberalization by II, leading to a shift in II's offer curve to II^{l}, leads to a further increase in I's welfare to U^{ll} (exactly as argued in Bhagwati (1991), quoted above).

In figure 2 (b), the alternative case is illustrated where the unilateral liberalization by country I leads instead to reduced welfare at U^{l}, because the initial tariff at T is below the optimal tariff and a further move away from the optimal tariff is welfare- reducing.[33] In this case, the further reciprocal trade liberalization by country II shifts its offer curve to II^{l} and trade equilibrium to T^{ll}, more than compensating the loss of welfare for country I from U to U^{l} from its own liberalization, and hence to an overall welfare increase for country I to U^{ll} from the initial level U.

3. The Zone of Reciprocal Trade Liberalization making Each Country Better Off: But, as I noted earlier, this is a somewhat unsatisfactory way to deal with the advantage of benefits from reciprocity since the attention is exclusively on the welfare gain of one country. It is possible to strengthen the case for reciprocal trade liberalization, on the other hand, by showing that it can be suitably designed in such a way that each nation benefits from it, without invoking lump sum transfers. To demonstrate this, and to establish the zone within which such trade liberalization will lie, consider Figure 3.

With OI and OII still the tariff- inclusive offer curves of the two countries I and II, the initial tariff-ridden equilibrium is at their intersection at T. Now, however, draw the trade indifference curves U^I and U^{II} through T. As known from Johnson[34], each country's domestic price- ratio line will be tangent to its trade indifference curve through T. Because of the tariff, that price line must be steeper than the world terms of trade or price line WP for country I and flatter than it for country II. Hence, we must necessarily have the trade indifference curves through T define a Zone such as the striped area TQ in Figure 3.

If then country I were to liberalize its trade so that its new offer curve moves through Zone TQ, and if country II reciprocally liberalizes so that its new, shifted offer curve intersects country I's shifted offer curve within Zone TQ, then each country will necessarily have become better off. And, mind you, we have not invoked lump sum transfers.

4. <u>The Terms-of-Trade -Preserving Reciprocal Trade Liberalization within this Zone of Mutual Gain: A Special Case:</u> Consider now the case where we move into Zone TQ but along the path set by the initial terms of trade, WP. For any trade liberalization by I, the shifted offer curve of I will go through TS. Chose then the tariff liberalization that makes the shifted II curve go through the same point, yielding the intersection of the two shifted curves.

It is easy to see why this pattern of reciprocal tariff cuts by I and II is beneficial to both nations. For, with terms of trade constant, the only effect of a tariff cut is to yield production and consumption gains to each country. In a two-country world, therefore, we have an algorithm that tells us how we could ensure a mutually-gainful reciprocal trade liberalization. Let I cuts its tariff: this will worsen its

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[33] Successive moves away from the optimal tariff, in either direction, are monotonically welfare- worsening, except for a multiple- equilibrium possibility in the presence of inferior goods, as noted by me and by Murray Kemp in the late

terms of trade. Let II then liberalize its trade until the original terms of trade are restored. Both I and II will have then improved their welfare.

Of course, at each successive reduced- tariff- equilibrium, we must redraw the Zone TQ with respect to it rather than the original T, and repeat the argument with reference to it. Note that, as is evident from Figure 4 and the depiction there of the free trade equilibrium at F on the worldwide free trade efficiency locus, the terms of trade WP at free trade will generally be different from the WP under the initial tariff-ridden trade equilibrium.[35] So, the end game of our terms-of-trade preserving reciprocal- trade-liberalization algorithm will not be (fully) free trade, except in the case where the two countries are fully symmetric. Free trade (at F) will generally be achievable through reciprocal elimination of all tariffs, with gain for each (compared to T), only with lump sum redistribution among the trading countries.

5. Extension to MFN: The preceding argument applies to more than two countries, with MFN. Just consider the country II's offer curve to be the net offer curve of n different countries, As long as there is no discrimination among them, as MFN would ensure, the argument that everyone would benefit from a reciprocal tariff reduction that preserves the world terms of trade would follow immediately. Of course, with n countries in the game, there will generally be multiple solutions: a number of alternative combinations of tariff cuts among them could be compatible with equilibrium at any point along TS in Figure 4, for instance.

1960s.

[34] Cf. Johnson, 1953-54, ibid.

[35] The efficiency locus consists of all points of tangency between the trade indifference curves of both countries. Within any zone TQ, there must be such tangency points. Therefore, as pointed out to me independently by Brecher and Ludema, a segment of the efficiency locus must lie within TQ.