

**“Trade Liberalization and Institutional Constraints on Moves to Protectionism:  
Multilateralism vs. Regionalism.”**

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**Abstract**

In this paper, two key questions are asked: why has the GATT/WTO worked in terms of multilateral tariff reduction and promotion of global trade, and to what extent will it act as a constraint on economic nationalism? To answer these two questions, three themes are laid out in the paper: first, the seminal economic model rationalizing the economic logic of the GATT/WTO is assessed; second, the perceived relevance of the GATT/WTO in a world of increasing regionalism is discussed; and third, the robustness of the GATT/WTO legal framework and dispute resolution mechanism is evaluated. The key conclusion of the paper is that the underlying economic logic of the GATT/WTO is still relevant, but that enforcement of the cooperative agreement will likely be placed under significant strain with threat of increased protection, and even a potential trade war.

**JEL Codes:** F13, Q17

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## **Introduction**

Since the high-point of global protection following US implementation of the Smoot-Hawley Tariff Act of 1930, successive rounds of trade negotiations under the auspices of the General Agreement on Tariffs and Trade (GATT) have resulted in substantial reductions in manufacturing tariffs by developed countries (Bhagwati, 1991; Irwin, 1995; Bagwell and Staiger, 2002; and Rose, 2004), as well as commitments in the Uruguay Round of GATT to cut agricultural tariffs and place constraints on support for domestic agriculture (Anderson, 1994). Available empirical evidence suggests that the GATT and its successor, the World Trade Organization (WTO), have had a significant impact on trade volumes in both the manufacturing and agricultural sectors (Subramanian and Wei, 2007; Grant and Boys, 2012). At the same time, there has been significant growth in the number of regional trade agreements (RTAs), especially since the 1990s (WTO, 2011), with a growing emphasis on deep economic integration (labor, environmental, and investment rules) beyond simple tariff-cutting (Baldwin, 2016).

However, two recent political events present a significant challenge to the global trading system: the referendum setting in motion the process for the UK to leave the European Union (EU) (Brexit), and the election of Donald Trump as US President on a platform of economic nationalism. President Trump's platform included pushing back against the multilateral trading system and the WTO, renegotiating the North American Free Trade Agreement (NAFTA), not ratifying the Trans-Pacific Partnership (TPP), and the threat to adopt tough trade policies against China. These events should also be seen in the context of an environment that is increasingly unfavorable to deeper global economic integration: public pushback on negotiation of the Trans-Atlantic Trade and Investment Partnership (TTIP) and TPP despite their expected net economic benefits (Felbermayr *et al.*, 2015; Petri and Plummer, 2016), failure to complete negotiations in the Doha Round of the

WTO (Baldwin, 2016); and evidence for a slowdown in global trade growth post-2012 relative to both historical performance and to economic growth (IMF, 2016).

In this paper, two key questions are asked: how has the GATT/WTO achieved multilateral tariff reduction and promoted of global trade, and to what extent will it act as a constraint on economic nationalism? To answer these two questions, the paper is divided into four sections: first, the seminal economic model rationalizing the economic logic of the GATT/WTO is outlined; second, the approach to trade policy of the current administration is set in the context of this model; third, the perceived relevance of the GATT/WTO in a world of increasing regionalism is discussed; and third, the robustness of the GATT/WTO legal framework and dispute resolution mechanism is evaluated. The key conclusion of the paper is that the underlying economic logic of the GATT/WTO is still relevant, but that enforcement of the cooperative agreement will likely be placed under significant strain with threat of increased protection, and even a potential trade war.

## **Background to and Economic Logic of GATT/WTO**

### *Success of GATT/WTO*

By some simple metrics, the GATT, and its successor the WTO, has been a very successful institution of international governance. GATT/WTO has established a rules-based system for world trade based on a set of principles enshrined in the GATT Articles, along with a dispute settlement system, that have been universally accepted and respected by its members (Baldwin, 2016). Membership has grown from the 23 countries that signed the GATT in 1947 to 164 countries today. WTO members account for more than 95 percent of both global trade and GDP (Williams, 2008). Over the 70 years of its existence, there have been eight rounds of trade negotiations, resulting in average industrial tariffs being reduced to less than 4 percent, although

it should be noted that there is quite a bit of heterogeneity in the level of bound tariffs across both countries and industries (Baldwin, 2016; Bagwell, Bown, and Staiger, 2016).

There have been several empirical studies that have explored the relationship between membership of the GATT/WTO and countries' trade flows. The initial finding by Rose (2004) came as something of a shock to trade economists and policy analysts: membership of the GATT/WTO was not correlated with increased trade flows as compared to non-member countries. Not surprisingly this generated a body of research seeking to overturn Rose's (2004) result, including, *inter alia*, Subramanian and Wei (2007), Tomz, Goldstein and Rivers (2007), and Baldwin (2010). Subramanian and Wei (2007) provide the most robust response to Rose's (2004) findings, their econometric analysis being much more consistent with theoretical treatment of GATT/WTO. Specifically, they argue that the impact of a country's membership of GATT/WTO will depend on three dimensions: first, what a country does with its membership; second, with which other countries a country negotiates; and, third, which products are covered in trade negotiations. Their econometric results are consistent with these predictions: industrial countries that participated in reciprocal trade negotiations enjoy a significant increase in trade, bilateral trade is greater when both countries engage in tariff reduction as compared to when only one country does, and sectors such as agriculture that were not covered by trade negotiations exhibit little or no increases in trade. It should be noted, however, that in subsequent empirical work, Grant and Boys (2011) find that, countries' agricultural trade has been significantly increased by their membership of GATT/WTO.

These results, subsequently confirmed by Chang and Lee (2011) and Eicher and Henn (2011), have been interpreted in the context of developing countries receiving special and differential treatment (SDT) under GATT/WTO rules (Bagwell and Staiger, 2014). Specifically, developing-

country members of GATT/WTO have been exempted from its reciprocity norm, i.e., developing countries get a “free pass” on any tariff cuts negotiated between industrialized countries through the most favored nation (MFN) rule by not being expected to cut their own tariffs. The motivation for SDT is ostensibly that developing countries would be able to gain greater access to developed country markets under MFN. However, Bagwell and Staiger (2014) argue that, by not lowering their own tariffs, developing country resources are retained in inefficient import competing sectors. In a simple general equilibrium setting, this acts as a tax on their export competing sectors, i.e., in trade negotiations, “...what you get is what you give...” (Bagwell and Staiger, 2014, p. 99) Therefore, the conclusion to be drawn from the extant empirical research is that membership of GATT/WTO can be characterized as the outcome of a cooperative game that is Pareto-superior in some sense for its members, and particularly those that engage in reciprocal tariff-cutting.

#### *Economic Logic of GATT/WTO*

Orthodox trade theory suggests that a small country will unilaterally cut its tariffs, the gains from trade through specialization and exchange subsequently maximizing national income. This is not necessarily the case if a country is large enough to influence its terms-of-trade, or if public policy is influenced by government preferences other than maximization of national income. In other words, economic analysis of GATT/WTO is about seeking a logical explanation for why a country would seek to be part of such a trade agreement, despite these unilateral incentives to raise tariffs. We might also ask, if it is Pareto-improving to be part of a cooperative agreement, why would a member undermine that agreement or leave it altogether?

In order to answer the first question, the bare bones of the seminal approach to modeling GATT/WTO is now described, the reader interested in more technical details being directed to the considerable body of work by Kyle Bagwell and Robert Staiger, e.g., Bagwell and Staiger (1999,

2002, 2010, 2014), and Bagwell, Bown and Staiger (2016). Using their notation, the workhorse model for their approach is a simple two-good two-country general equilibrium model, where the home country has a comparative advantage in producing good  $y$ , and the foreign country has a comparative advantage in producing good  $x$ . Local relative prices are  $p \equiv p_x / p_y$  and  $p^* \equiv p_x^* / p_y^*$  in the home and foreign country respectively, while world prices are  $p^w \equiv p_x^* / p_y$ , and in the absence of tariffs  $p \equiv p^w \equiv p^*$ . If home and foreign tariffs are  $\tau$  and  $\tau^*$  respectively, market-clearing local and world prices can be written as,  $p = p(\tau, \tilde{p}^w)$ ,  $p^* = p^*(\tau^*, \tilde{p}^w)$ , and  $\tilde{p}^w(\tau, \tau^*)$ , the following conditions being assumed,  $dp/d\tau > 0 > dp^*/d\tau^*$  and  $\partial \tilde{p}^w / \partial \tau < 0 < \partial \tilde{p}^w / \partial \tau^*$ , i.e., each country's tariff drives a wedge between local and world relative prices, giving protection to their import-competing sector, but at the same time each country is large enough to be able to improve their terms-of-trade through a tariff. The welfare functions of the home and foreign governments are defined in terms of relative prices,  $W(p, \tilde{p}^w)$  and  $W^*(p^*, \tilde{p}^w)$  respectively. Given that local prices determine the level and distribution of factor incomes in each country, various government preferences discussed in the political economy literature can be captured, including national income maximization (Johnson, 1953; Mayer, 1981), and political lobbying models (Grossman and Helpman, 1994; 1995). It is also assumed that holding its local relative price fixed, both home and foreign governments value an improvement in their terms-of-trade,  $W_{\tilde{p}^w}(p, \tilde{p}^w) < 0 < W_{\tilde{p}^w}^*(p^*, \tilde{p}^w)$ .

If there is no trade agreement, the home and foreign countries play out a Nash equilibrium in tariffs, the first-order conditions defining optimal tariffs being:

$$\begin{aligned} W_p + \lambda W_{\tilde{p}^w} &= 0, \\ W_{p^*}^* + \lambda^* W_{\tilde{p}^w}^* &= 0, \end{aligned} \tag{1}$$

where  $\lambda = [(\partial \tilde{p}^w / \partial \tau) / (dp / d\tau)] < 0$ , and  $\lambda^* = [(\partial \tilde{p}^w / \partial \tau^*) / (dp^* / d\tau^*)] < 0$ . The expressions in (1) reflect the balance that each government strikes with respect to the local and world relative price effects of their tariff choices. In terms of local relative price changes, there is a trade-off between the political benefits of redistribution to factors employed in the import-competing sector and any deadweight losses to domestic consumers. With respect to world relative price changes, the improvement in one country's terms-of-trade necessarily results in a worsening of the other country's terms-of-trade, i.e., each country shifts some of the costs of their protection onto the other country.

Essentially, it is the cost-shifting externality that results in Nash equilibrium tariffs being inefficient. Given that,  $W_p < 0 < W_{p^*}^*$ , each government would like to lower their respective tariffs in order to reduce the domestic distortion and generate more trade, but if done unilaterally they suffer a worsening of their terms-of-trade, given  $\lambda W_{\tilde{p}^w} > 0 > \lambda^* W_{\tilde{p}^w}^*$ . Bagwell and Staiger's (1999) insight is to argue that, if the terms-of-trade externality can be neutralized, it will be Pareto-improving for both countries to lower their tariffs. In other words, suppose that neither country's government cared about terms-of-trade effects,  $W_p \equiv 0$  and  $W_{p^*}^* \equiv 0$ , from (1), optimal tariffs will be set to satisfy domestic political objectives, i.e.,  $W_p = 0$  and  $W_{p^*}^* = 0$ . These tariffs are termed "politically-optimal tariffs", which would either be zero if each government seeks to maximize national income through free trade, or they would be positive in order to satisfy domestic political-lobbying constraints, but importantly, they are lower than Nash equilibrium tariffs. Therefore, if countries enter into a trade agreement, they will seek mutual reductions in tariffs changes that will generate a Pareto improvement, with equilibrium tariffs being located on the efficiency locus.

Necessarily, “politically-optimal” tariffs satisfy this condition, but they are only one of several tariff combinations on the efficiency locus.

Given this model structure, Bagwell and Staiger (1999) argue that application of the principle of reciprocity in GATT/WTO does result in welfare-improving tariff reductions. Specifically, reciprocity means that for either country to offer a tariff concession, it requires a tariff concession from the other country such that the world relative prices remains unchanged, i.e., terms-of-trade effects are ruled out. Tariff-cutting continues until one of two conditions is satisfied: one country’s government achieves its preferred local price before the other, i.e.,  $W_p = 0, W_{p^*}^* \neq 0$  or  $W_p \neq 0, W_{p^*}^* = 0$ ; politically optimal tariffs” are achieved, i.e.,  $W_p = 0$  and  $W_{p^*}^* = 0$ . Of course, the idea that trade negotiators are concerned with the technicality of terms-of-trade effects is likely unrealistic, but as Bagwell and Staiger (2010) point out, this concept can be expressed in terms of market access. A tariff, while creating a terms-of-trade benefit for the importing country, also results in a loss of market share for the exporting country. In other words from a practical standpoint, trade negotiations are about mutual concessions on market access.<sup>11</sup>

Reciprocity also helps explain the idea behind “withdrawal of equivalent concessions” as part of the dispute settlement mechanism of GATT/WTO. Standard game theory would suggest that both home and foreign countries have an incentive to deviate from the low-tariff equilibrium that results from a trade agreement. Consequently, in a repeated Prisoners’ Dilemma, a credible punishment threat is reversion to the Nash tariff equilibrium. In practice, the rules of GATT/WTO seek to maintain the balance of concessions and avoid the use of punitive actions (Staiger, 1995; Zissimos, 2007). Essentially, if the home country were to deviate from the agreement by raising

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<sup>1</sup> There is a growing body of empirical evidence supporting the terms-of-trade theory of trade agreements, e.g., Broda, Limão, and Weinstein (2008), Bagwell and Staiger (2011), Bown and Crowley (2013), and Dhingra (2014).

its bound tariff, this would imply a loss of previously negotiated market access for the foreign country. Assuming that this action is not “abusive”, under GATT/WTO rules, the exporting country is allowed to withdraw an amount of market access equivalent to what the home country has withdrawn – by implication, there will be no change in either country’s international terms-of-trade. However, if the home deviates in an “abusive” manner, reversion to the Nash equilibrium is possible. In other words, the objective of GATT/WTO rules is to ensure that retaliation by one country against the unilateral action of another is proportionate, thereby minimizing the chance of a trade war.

As well as reciprocity, the principle of non-discrimination in GATT/WTO also requires that tariffs be applied on an MFN basis, i.e., in the simple model, if the home and foreign country agree to lower their tariffs, those tariff cuts should be extended to any other country that is a member of GATT/WTO. Importantly, MFN in combination with reciprocity can minimize the risk of third-country spillovers (Bagwell and Staiger, 2010). Suppose the home country exports good  $y$  to two foreign countries, and imports good  $x$  from both countries, and it chooses to enter into reciprocal tariff reduction with foreign country 1, but each offers their respective tariff cuts to foreign country 2 under MFN. The end result is that given foreign country 2 keeps its tariff fixed, negotiations between the home and foreign country 1 under MFN ensure that there is a single world relative price that remains unchanged, i.e., foreign country 2 experiences no change in its export volume. It should be noted though, that without reciprocal tariff cuts by the home and foreign country 1, the world relative price will change, thereby affecting foreign country 2’s export trade volume – in other words, MFN on its own is not sufficient to prevent concession erosion.<sup>2</sup>

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<sup>2</sup> Empirical evidence supporting the reciprocity and non-discrimination principles in GATT/WTO negotiations can be found in Bown (2004), and Limão (2006, 2007).

## Economic Nationalism in the Context of GATT/WTO

Is it possible to rationalize the trade policy approach of the current US administration in the context of this large body of theoretical and empirical evidence on the GATT/WTO? If the existing tariff equilibrium is on the efficiency frontier, and has until now been politically optimal, there are no obvious gains to economic welfare to unilaterally raising tariffs, i.e., it should be renegotiation-proof (Bagwell and Staiger, 1999). However, it is possible that the existing tariff equilibrium, while on the efficiency frontier, is no longer politically optimal, and is, therefore, not renegotiation proof. Given sufficient domestic political changes within the United States, it might be optimal for the Administration to withdraw some tariff concessions under GATT Article XXVII, after which the affected country(ies) would be permitted to withdraw equivalent concessions.

These two arguments are described in figure 1. Given home US and foreign country tariffs,  $\tau$  and  $\tau^*$ ,  $EE$  is the efficiency locus,  $PO$  and  $R$  describing two specific efficient tariff combinations. The relevant iso-world-price loci,  $p_w^{PO}$  and  $p_w^R$ , run through these two tariff combinations, i.e., neither country's terms-of-trade vary along these loci. Finally, the loci along which tariffs result in  $W_p = 0$  and  $W_{p^*}^* = 0$  are shown for the US and foreign country respectively. These loci only intersect at the politically optimal point  $PO$  where there is a multiple tangency between the iso-welfare contours  $W$  and  $W^*$  and the iso-world price locus  $p_w^{PO}$ . If the US economy has actually reached this point after successive rounds of trade negotiations, it cannot be Pareto-improving for it to raise its tariffs unilaterally, i.e., it is renegotiation proof.

Suppose instead, the US economy starts at a point such as  $R$ , the locus  $W_p$  (not shown) being sufficiently close to  $R$  such that at the margin, there is no incentive to withdraw any tariff concessions. Suppose instead that the current US administration has different political objectives

to those held by the previous administration, the locus being  $W_p'$ . This puts pressure on the US to withdraw some tariff concessions, the foreign country responding by withdrawing equivalent concessions in such a way as to preserve the world price ratio at  $R'$  where the US now maximizes welfare. Under these circumstances, there may be a rationale for the US to withdraw tariff concessions, but its willingness to do so is constrained by the retaliation allowed to the foreign country by the GATT/WTO rules.

The key to this argument is that the preferences of the current administration have shifted enough in favor of renegotiating previous tariff concessions in the GATT/WTO. Why would they choose to do this? First, one could appeal to a political lobbying model such as Grossman and Helpman (1995) to argue that the US is seeking to increase the tariff applied to the import-competing sector due to less weight being attached to average social welfare, i.e., the deadweight costs imposed on individual voters are not weighed as heavily in the policymaker's decision calculus. Also, in a political lobbying model where loss aversion on the part of owners of specific factors in the import competing sector matters (Freund and Özden, 2008), it may be that the world price has fallen below the reference price, and so an increase in the US tariff is sought.

However, this argument is difficult to reconcile with empirical research by Fajgelbaum and Khandelwal (2016), who find that that the burden of increased protection is likely to fall disproportionately on individuals at the lower end of the income distribution, many of whom likely voted for Donald Trump. In addition, if the US import-competing industry has been long in decline, by the logic of Freund and Özden (2008), the level of protection should be declining not increasing, as sensitivity to losses diminishes, an argument they support empirically with reference to the US steel industry. Interestingly, President Trump did authorize an investigation under the Trade Expansion Act of 1962, Section 232 into whether steel imports are a threat to US national

security, and in particular whether excess capacity in the Chinese steel sector has resulted in their dumping steel on the world market. Keynes and Bown (2017a) suggest that the premise for such an investigation misses the point for several reasons: first, the decline in employment in the US steel industry happened long before China became a significant player in the world market; second, the bulk of US steel imports come from Canada; and, third, China is proactively seeking to reduce its production capacity. Keynes and Bown (2017a) conclude that China is not willing to continue reducing capacity if President Trump unilaterally implement tariffs in order to look tough.

A second possibility is that the US seeks to rebalance trade with countries with whom it has a bilateral trade deficit, the objective being to negotiate “more reciprocal” tariffs with such countries. For example, the current administration seems to believe that reciprocity should result in uniform reciprocal tariff rates, i.e., if the US has a tariff rate of 2.5 percent on automobiles, then China should also have a 2.5 percent tariff on automobiles (Bown, Staiger and Sykes, 2017). However, this view does not appear to recognize the exact nature of reciprocity in GATT/WTO which incorporates the notion of “first-difference” reciprocity, i.e., “...tariff cuts are to proceed via bargaining that reflects a balance of perceived advantage at the margin rather than by...perceived full equality of market access and reverse market access (or what in modern American parlance, is pithily described as ‘level playing field’...)” (Bhagwati, 1988, p.36).

Third, it is possible that the current administration does not fully appreciate the GATT/WTO “latecomers” problem. While developing countries such as Brazil, India and China might like to offer tariff cuts in the GATT/WTO, developed countries such as the US do not have much to offer in new rounds of reciprocal tariff-cutting, i.e., there is essentially “globalization fatigue” (Bagwell and Staiger, 2014). Bown, Staiger and Sykes (2017) argue that the way to approach this problem, is not through “leveling the playing field”, i.e., unilaterally threatening to raise tariffs if developing

countries such as China do not lower their tariffs, but instead seek a new reciprocal trade bargain within the GATT/WTO. Bagwell and Staiger (2014) address this issue in terms of how to “make room” for the developing countries at the GATT/WTO table. Specifically, they argue that the traditional reciprocal exchange of market access through tariff concessions will have to be replaced with an approach that involves developed countries lowering/eliminating their agricultural export sector subsidies, thereby improving the terms-of-trade of developing country agricultural exporters, in exchange for which developing countries reduce their tariffs on imports of manufactures.

The overall conclusion to be drawn is that the current administration’s objective function differs from those of previous administrations. While previous administrations participated in decades of successful rounds of multilateral tariff cuts, the current administration is following a path of economic nationalism and pushing back with threats of not playing by the accepted rules of international governance. The approach of the current administration is to address what they see as “unfair trade practices” by following unilateral policies, renegotiating or withdrawing from trade agreements, and threatening to apply import protection (Handley and Limão, 2017). Essentially, President Trump believes that his approach to bargaining will be much more likely to get a “better deal” for the US (Bown, Staiger and Sykes, 2017). In other words, rather than being the win-win of reciprocal and multilateral exchange of market access as a resolution to an inefficient Nash tariff equilibrium, it would seem that trade agreements are instead perceived as a zero-sum game, where until now, the US has typically lost, and its trading partners have won.

This view of trade agreements certainly appears to characterize the current administration’s attitudes towards dispute settlement within GATT/WTO. The US has been blocking the appointment of two judges to the WTO’s Appellate Body, and plans to block the appointment of

a third when the current incumbent steps down this December (Keynes and Bown, 2017b). The administration is attempting to hold the WTO hostage, because they feel that in the WTO's dispute settlement process, the US is being denied the benefits it signed up for. Specifically, US Trade Representative Robert Lighthizer is of the view that these benefits included the right to impose anti-dumping duties, and the fact that the US has lost a significant number of cases involving anti-dumping actions, means that the judges are denying the US its benefits (Wroughton, 2017).

The administration's attitude to dispute settlement in the GATT/WTO is also mirrored in its renegotiation stance over dispute settlement in NAFTA. Specifically, NAFTA's Chapter 19 is designed to resolve disputes over anti-dumping and the use of countervailing duties, based on an arbitration panel picked by the US, Canada and Mexico (*The Economist*, 2017). Chapter 19 has its origins in the Canadian-US Free Trade Agreement (CUSFTA) signed in 1988 when Canada sought to restrain the US from using trade remedies such as anti-dumping duties against Canadian exports. Essentially the current administration wants to scrap Chapter 19 so that there are no restrictions on its use of trade remedies (Keynes and Bown, 2017c).

### **The Role of Regional Trade Agreements**

At the same time that the current administration has expressed skepticism about multilateral trade agreements, they have demonstrated an interest in negotiating smaller, especially bilateral, trade deals (Porter 2017). One notable example is the ongoing effort to renegotiate NAFTA, which involves only the US, Canada, and Mexico. Although the administration has expressed a willingness to walk away from NAFTA if they are not satisfied with the process (Gillespie, 2017), the negotiations continue. This stands in stark contrast to the administration's withdrawal from the TPP in January of 2017 without any attempt to renegotiate the deal.

The administration's decision to renegotiate NAFTA but not the TPP is puzzling when we compare the content of the TPP with the administration's NAFTA renegotiating objectives. Both include, increases in market access for American goods. Both also include so-called "deep integration" measures, also known as "WTO-extra" provisions. These commitments extend beyond the areas covered by the GATT/WTO. They typically target the harmonization of domestic regulatory standards, including labor and environmental standards as well as protections for foreign investors and intellectual property. These have become the target of trade negotiations as firms increasingly rely on "offshoring" some parts of their production processes to other countries in order to reduce costs. Today, approximately 40 percent of the value of exports is derived from imports, and trade in intermediate goods represents over half of all merchandise trade (Lamy 2014). "Deep integration" would help firms avoid the costs of dealing with inconsistent regulatory standards across multiple countries.

One way to interpret President Trump's skepticism toward the WTO and (begrudging) embrace of NAFTA is simply as an extension of the global trend away from multilateralism and toward Regional Trade Agreements (RTAs). Although President Trump's particular brand of regionalism may be more accurately described as bilateralism. This may reflect a bias identified in Bhagwati (1994) as the tendency of US politicians to "...mistakenly identify multilateralism with America's postwar altruism" (p. 29). Movement toward RTAs might be seen as an attempt to act in the US's own best interests. Whether this engagement with RTAs will ultimately lead to progress on multilateral trade agreements is still an open question.

### *The Rise of Regionalism*

The first major RTA in the post-war period was the formation of the European Economic Community (EEC) in 1958, followed quickly by the establishment of the European Free Trade

Area in 1960 (Bhagwati, 1994). Attempts were made through the 1960s and 1970s to launch additional RTAs, especially in the developing world, but they were not successful. The next wave of regionalism came in the 1980s and 90s. The EEC transformed into the European Community (EC) as part of its transformation into a single, unified market. The EC (now the EU) and the US both began negotiating regional and bilateral trade agreements with partners around the world (WTO, 2011). Developing countries in Asia, Latin America, and Africa also launched ambitious efforts to build common regional markets. The third wave of regionalism began after the conclusion of the Uruguay Round of GATT negotiations in 1994 and continues today. As of 2017, the WTO has been notified of 445 RTAs still in force among its members (WTO Secretariat, 2017). These RTAs coalesced around regional trading “blocs” in the Americas, the Euro Area, and Asia (Crawford and Fiorentino, 2005).

Most recently, the major economies of the world have focused on the negotiation of so-called mega-regional trade agreements, such as the TPP and TTIP. These typically involve large groups of countries, many of whom have already negotiated RTAs with each other (Bown, 2017). Compared to previous waves of regionalism, today’s mega-regionals focus more on “deep integration” than tariff reductions. This partly reflects the success of previous multilateral negotiations. Today, 84 percent of trade flows fall under the MFN tariffs negotiated under the WTO (Lamy, 2014). However, the slow pace of the Doha Round of the WTO has caused some to question whether the mega-regionals will act as a substitute for multilateral negotiations, and whether this will ultimately lead to closer global integration (Bagwell, Brown, and Staiger, 2016).

Why the explosion of RTAs? Economists offer several possible explanations. One possibility is that RTAs are more effective than multilateral agreements for promoting “deep integration.” The third wave of regionalism has occurred parallel to the stalled Doha Round. Negotiators may

have found it is easier to conduct complex negotiations around harmonizing domestic regulatory standards if they work in smaller groups (Lamy, 2014; Baldwin, 2016). It might also be easier to build consensus among a small group of “like-minded” negotiators (Bhagwati, 1994).

### *Are RTAs Good for Globalization?*

As RTAs have proliferated and the Doha Round has stalled, economists have turned their attention to the question of whether or not RTAs increase *global* economic welfare. This is related to the question of whether RTAs are “building blocs” or “stumbling blocs” toward multilateral trade deals (Bhagwati, 1994). Ever since Viner (1950), economists have been skeptical of the efficiency implications of RTAs. Although RTAs reduce trade barriers, they are, by definition, discriminatory; they grant concessions to only a select few trade partners. RTAs may reduce global welfare if they lead to trade diversion. This occurs when RTA members import from less-efficient producers inside the agreement rather than the more efficient producers outside the agreement. Discriminatory tariff cuts can also create opportunities for “bilateral opportunism” (Bagwell, Bown, and Staiger, 2016). Bilateral opportunism exists when two parties to an RTA agree to reduce tariffs on each other’s goods, improving their terms of trade at the expense of excluded partner(s). Concerns like these are why the principle of non-discrimination has been central to the GATT/WTO since its inception.

However, as Bhagwati (1994) points out, we must be careful to separate the static and dynamic effects of RTAs when trying to evaluate their impact on global economic welfare. It is possible for the dynamic gains from RTAs to compensate for their static losses, i.e., trade diversion. Of course, the size of the dynamic gains depend on whether RTAs act as “building blocs” or “stumbling blocs” toward multilateral agreements. Aghion, Antràs and Helpman (2007) provide a general theoretical framework to understand trade negotiations with endogenous formation of RTAs. In

their framework, RTAs are part of “sequential” negotiations, which may or may not lead to a multilateral agreement, also known as a “grand coalition.” They show that RTAs will generally act as building blocs toward multilateral agreements as long as these agreements satisfy the property of “grand-coalition (GC) super-additivity.” This means that the benefits of the grand (multilateral) agreement are greater than the sum of the benefits under no agreement, or the sum of the benefits under an RTA excluding at least one partner. When GC super-additivity holds, RTAs will ultimately produce multilateral agreements, regardless of whether the initial RTA imposes externalities on the excluded partner(s).

The property of GC super-additivity holds under standard economic assumptions, e.g., competitive markets and convex production sets, but might break down if trade policy is determined by domestic political forces rather than simply maximizing the aggregate welfare of the country. To understand this, we can draw on Grossman and Helpman (1994) who model trade policy formation as outcome of competition among domestic interest groups. Policymakers maximize a weighted average of aggregate welfare and the welfare (profits) of special interest donors.

Baldwin (2006) shows how this political competition among special interests, both inside and outside the RTA, can lead to a “domino effect” that draws more and more countries into the agreement. If we assume the country starts in political equilibrium, an exogenous shock that expands the RTA will expand exporting sectors in member states relative to import-competing sectors. This translates into a shift in the relative sizes of their political contributions, and a new political movement toward expanding the RTA. If we assume the expansion of the RTA imposes negative externalities on the remaining non-members, i.e., through terms-of-trade effects, this will also strengthen the political forces pushing to join the RTA within non-member countries.

However, this kind of political competition does not guarantee that RTAs will expand to form “grand coalitions.” Aghion, Antràs and Helpman (2007) show that, in the absence of GC super-additivity, an RTA might actually prevent the formation of a multilateral agreement if the RTA imposes *positive* externalities on the excluded partner. In this case, the increased import demand from the newly-expanded RTA increases the price of the excluded country’s exports, and their profits are higher than what would be obtained under a multilateral agreement. Starting from this point, no further expansion of the RTA is likely to occur.

The analysis in Aghion, Antràs and Helpman (2007) also optimistically assumes that the structure of the RTA would allow transfers through side payments among the members of existing RTAs. As pointed out in Bhagwati (1994), payment mechanisms help ensure the expansion of customs unions by transferring a portion of the gains from expanding the RTA to the losers among the existing RTA members. Without these mechanisms, RTAs are more likely to stall.

#### *The Noodle Bowl and other Problems*

Expanding trade through RTAs rather than multilateral agreements also presents its own set of challenges. One is the so-called “noodle bowl” problem. This refers to the web of overlapping RTAs that connect countries in East Asia (Baldwin, 2006). This complexity can create costs for firms and governments of member states. RTAs typically also require complex rules of origin (ROOs). These rules can create distortions similar to the trade diversion scenario described above if they force firms to purchase inputs from inefficient suppliers in order to receive preferential tariff treatment Baldwin (2006).

If RTAs do not ultimately produce multilateral agreements, they may also contribute to a “fracturing” of the global economy into distinct blocs centered on mega-regionals (Lamy, 2014). “Deep integration” is not as simple as cutting tariffs. It is not always welfare improving to reform

a domestic law simply because it is perceived as a barrier to trade. For instance, Pigouvian taxes and subsidies may be first-best policies in some countries. Eliminating them to reduce barriers to trade might not be welfare enhancing (Bown, 2017). Ultimately, it may prove easier to harmonize these policies among regional trade partners rather than developing a single global standard (Lamy, 2014). We have no reason to believe, *a priori*, that regional blocs will converge to the same standard, so these separate standards might develop into mutually incompatible regulatory systems.

### *Future Negotiations*

Will the Trump administration's focus on bilateral and regional trade deals ultimately produce a multilateral agreement? The current administration's willingness to renegotiate NAFTA at least shows that progress can be made toward lowering trade barriers between the US and its partners. However, the current administration's unwillingness to negotiate multilaterally or in mega-regionals such as TPP may ultimately be self-defeating. There is a real danger that RTAs will stop the progress of multilateral negotiations. While the administration may believe it can achieve "a better deal" in bilateral or small regional trade deals, only multilateral negotiations can fully realize the gains from trade.

### **WTO Dispute Settlement and Trade Protectionism**

Although the US political objective function seems to have changed, the institutional features of the WTO have not. The WTO dispute settlement system is considered to be one of the WTO's crowning achievements. It ensures reciprocal and proportionate responses when countries fail to uphold their obligations under the WTO. However, the dispute settlement system cannot be used effectively to deter the rising tide of nationalism as exhibited by some of the policies of the current administration. To understand why this is the case, we must start with a basic understanding of

how the dispute settlement system works to resolve trade disputes. The ultimate goal of the dispute settlement system is to bring a non-conforming measure, law or regulation issued by a WTO member into compliance with the obligations of the WTO as set forth in its agreements. All other types of remedies, such as compensation or retaliation (both further explained below), are seen as temporary measures with the goal of inducing compliance (Chow and Schoenbaum, 2017).

### *WTO Dispute Settlement and Trade Remedies*

To bring an action within the dispute settlement system, the complaining party must show a “nullification or impairment” of a trade benefit in order to assert a viable claim against an offending party. One can view this as a requirement that the complaining party must show an injury cognizable under the WTO. This is the standard that is adopted in the WTO Dispute Settlement Understanding (DSU):

#### General Agreement on Tariffs and Trade Article XXIII Nullification or Impairment

- (1) If any contracting party should consider that any benefit accruing to it directly or indirectly under this Agreement is being nullified or impaired or that the attainment of any objective of the Agreement is being impeded as the result of
  - (a) the failure of another contracting party to carry out its obligations under this Agreement;  
or
  - (b) the application by another contracting party of any measure, whether or not it conflicts with the provisions of this Agreement, or
  - (c) the existence of any other situation,

the contracting party may, with a view to the satisfactory adjustment of the matter make written representations or proposals to the other contracting party or parties which it considers to be concerned. Any contracting party thus approached shall give sympathetic consideration to the representations or proposals made to it.

To begin with, note that under Article XXIII, an action cannot be brought before the WTO Dispute Settlement Body (DSB) until a “nullification or impairment” of a benefit has already occurred. In other words, the WTO dispute settlement system does not contemplate any type of

relief to prevent an injury; in general, the injury must have already occurred before any relief is possible. Contrast this position with a domestic legal system such as that of the US in which it is possible under the right circumstances to obtain injunctive relief to prevent an injury from occurring when such a possibility is imminent. The WTO lacks the power to issue injunctive relief to prevent a harm from occurring; this type of relief is not possible within the WTO and this can be considered one of its shortcomings. The result of this deficiency in the WTO is that the global trading system must have first suffered a trade distortion in the form of a protectionist trade measure before any type of relief can be sought. The relief that is sought must then undergo a set of procedures and a decision-making process that can last several years before a decision is reached.

Now assume that the current administration makes a sudden unilateral and decision to raise tariffs on imports above the agreed upon WTO rate for the imports. The US is implementing a new set of protectionist measures meant to protect local industry from import competition. In this situation, the nation that is subject to the sudden increase in tariffs on its imports can assert the “nullification or impairment” of a trade benefit, i.e. the US decision to impose a higher tariff than the lawful WTO rate. The nullification or impairment is the result of US failure to carry out its obligations under the WTO to apply the WTO tariff rate (GATT Article XXIII(1)(a)). The aggrieved nation can then bring an action within the WTO dispute settlement system subject to the rules of the WTO Dispute Settlement Understanding. Let us further assume that the aggrieved nation wins the WTO case and the WTO issues a decision finding that the US is in violation of its WTO obligations. In this event, the WTO dispute settlement body will “recommend” that that the US bring the offending measure, i.e. the higher tariff, into compliance with its WTO obligation, i.e. that the US lower the tariff rate to the lawful WTO rate. At this point, under the WTO

procedures, the US has a reasonable period of time to comply with the recommendations of the DSB (DSU Article 21.3).

If the US fails to follow the recommendation of the DSB within a reasonable time by removing the offending higher tariff, the aggrieved party can seek compensation from the offending party (DSU Article 22.2). Providing compensation is a voluntary decision on the part of the offending party, the US in this hypothetical. Compensation in this context does not refer to a monetary payment but the granting of additional concessions on the part of the offending party to benefit the aggrieved party. For example, the US could agree to impose zero tariffs instead of the agreed WTO rate on certain imports from the aggrieved party, which would provide a financial benefit or compensation to the aggrieved party. As compensation is a voluntary measure on the part of the offending party, the current administration might refuse to provide compensation. At this point, the aggrieved party can seek authorization from the DSB to impose countermeasures in the form of suspending trade concessions (such as low tariffs on US imports) given to the offending member (DSU Article 22.3). Although the WTO uses the term “countermeasures,” this is really a form of trade retaliation. The aggrieved member can ask for and may receive authorization to impose higher tariffs on imports from the US. Retaliation, like compensation, is viewed by the WTO as a form of political pressure to induce the offending member to bring its non-conformity measure into compliance with its WTO obligations. In other words, retaliation, like compensation, is meant to induce the US to lower its tariffs.

Trade retaliation is viewed as an extreme measure and is rarely invoked, but trade retaliation is problematic and may be the weakest part of the WTO dispute settlement system, at least in relation to powerful states. Trade retaliation may create effective pressure on weaker trading states to comply with the WTO, but trade retaliation creates the possibility that powerful states, such as

the US, will refuse to comply for many years and simply live with retaliation. This policy could mean that in the event of a trade dispute arising from the current administration's imposition of higher tariffs as a protectionist measure, the current administration will ignore any adverse decision of the WTO and simply live with the consequences of any WTO authorized trade sanctions. Living with trade retaliation, while arguably against the spirit of the WTO is in line with its letter. In fact, the current administration might further escalate trade tensions by imposing additional protectionist trade measures as a form of counter retaliation against the aggrieved country.

#### *Foreign Direct Investment and Protectionist Measures*

So far this discussion has focused on protectionist policies involving trade in goods. The WTO has major agreements regulating three of the four channels of trade: the GATT governing the trade in goods, the General Agreement on Trade in Services (GATS) governing the trade in services, and the Agreement on Trade Related Intellectual Property Rights (TRIPS) governing the trade in technology or intellectual property. Any dispute involving any of these channels of trade (goods, services, and technology) can be brought within the WTO dispute settlement system. However, the WTO does not have a major agreement governing trade in foreign direct investment (FDI). The lack of a WTO agreement on investment means that trade disputes involving FDI are not subject to review in the WTO dispute settlement system. Nations can impose protectionist measures on FDI and the WTO is without jurisdiction to rule on the legality of the action or to offer a remedy.

Outside of the WTO, issues involving FDI can be expressly made subject to dispute resolution by an international arbitration body in the case of a bilateral investment treaty (BIT) or a regional trade treaty, such as the TPP. However, in the absence of a BIT or an RTA governing investment,

the issue of discrimination or protectionism in investment trade is subject to domestic law only. For example, in the case of the US and China, the two countries currently do not have a bilateral investment treaty (BIT) and the US has withdrawn from the TPP. This means that issues of protectionism in investment trade are to be decided under US law only. To take a concrete example of FDI, suppose that a Chinese state-owned enterprise seeks to acquire a US company. Under current US law, the transaction would be subject to review by the US Committee on Foreign Investment (CFIUS) under the Foreign Investment and National Security Act (FINSIA), 50 U.S.C. app. § 2170 (2006) to determine whether any national security interests of the US might be compromised by the Chinese acquisition of a US company. Suppose further that the US decides on a pretext to reject the Chinese acquisition and that protectionist reasons underlie the decision. There is no recourse from such a decision within the US legal system and, of course, no recourse under the WTO. The US can exercise protectionist policies in the area of FDI and that foreign nations such as China that do not have a bilateral or regional trade agreement with the US have no legal recourse.

#### *The WTO as an Ineffective Deterrent against Trade Protectionism*

The structure of the WTO dispute settlement system is based upon the good faith of the WTO members, peer pressure, and an overall desire of all WTO members to maintain the viability and credibility of the WTO system. In the event that a powerful country such as the US is determined to take impose protectionist measures that promote its own view of nationalism as opposed to multilateralism as the basis of the modern trading system, there is little that the WTO can do. A powerful country like the US can simply decide to live with any sanctions authorized by the WTO, an option that is permitted under the DSU. The WTO dispute settlement system, as presently organized, will not be able to operate as an effective deterrent to the type of nationalistic policies

that the current administration has announced that it intends to follow. A second major deficiency of the system is that disputes involving FDI are outside the purview of the WTO so that any protectionist measures undertaken by the US will be immune from WTO review. Unless the nation has a bilateral or regional treaty with the US that covers FDI, the nation will be without any legal recourse to challenge protectionist actions of the US in the area of trade in investment.

### **Summary and Conclusions**

The key motivation for this paper is the significant challenge presented to the multilateral and regional trading system by the election of Donald Trump as US President on a platform of economic nationalism. The key takeaway of the paper is that the underlying economic logic of the GATT/WTO is still relevant, but that enforcement of the cooperative agreement will likely be placed under significant strain with threat of increased protection, and even a potential trade war. Given this, the analysis focuses on two key questions: why has the GATT/WTO worked in terms of multilateral tariff reduction and promotion of global trade, and to what extent will it act as a constraint on economic nationalism? In order to answer these two questions, four aspects of the GATT/WTO are analyzed.

First, the economic logic of the GATT/WTO is assessed, the general conclusion being that over eight successive rounds of trade negotiations in the post-war period, it has resulted in a significant reduction in tariffs and increased multilateral trade for many of its members. This has come about through reciprocal and non-discriminatory exchange of market access that has proven successful in resolving a terms-of-trade driven Prisoners' Dilemma.

Second, the approach to trade policy of the current administration is set in the context of this model, the overall conclusion being that it is difficult to rationalize economic nationalism in the context of the traditional model of GATT/WTO. Instead the current administration appears to

view trade agreements as a zero-sum game, and as a consequence is addressing what they see as “unfair trade practices” by following unilateral policies, renegotiating or withdrawing from trade agreements, and threatening to apply import protection.

Third, the perceived relevance of increasing regionalism is discussed. The current administration’s willingness to engage with regional partners to renegotiate NAFTA suggests that progress can be made toward lowering trade barriers between the US and its partners. However, the administration’s unwillingness to negotiate either multilaterally or in mega-regionals such as TPP, along with its view that any trade deal represents a zero-sum game, may ultimately be self-defeating. As a consequence, there is a real danger that RTAs in general will stop the progress of multilateral negotiations, and the potential for undermining NAFTA and other RTAs such as the Korean-US free trade agreement (KORUS), will result in significant preference erosion for the US. Therefore, rather than focus on bilateral deals to gain leverage, the current administration should refocus its efforts on multilateral and mega-regional negotiations to fully realize the gains from trade.

Finally, the robustness of the GATT/WTO legal framework and dispute resolution mechanism is evaluated, the overall conclusion being that the GATT/WTO framework has well-defined enforcement/legal mechanisms in place that can handle specific disputes, but probably would not be able to contain an all-out trade war. The record also suggests that RTA dispute resolution mechanisms are weak at best, and that trade partners have typically sought solutions through the GATT/WTO (Bagwell, Bown, and Staiger, 2016).

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