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Essay on:

The New Regionalism and Policy Interdependence

by

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Theory and Empirical Content

The main purpose of the World Trade Organization (WTO) is to promote non-discriminatory international trade by bringing the rule of law into the system. Although the WTO faces several challenges, the greatest are perhaps regional trade agreements (RTAs). RTAs pose a problem for the WTO because they are an inherently discriminatory way of organizing global trade. In an RTA, one or more countries offer preferential market access by eliminating tariffs for members of the agreement while retaining them for non-members. (Oatley 2016, 36 – 43).

In their article, Baccini and Dür (2011) provide data demonstrating a rapid increase in the number of preferential trade agreements between 1990 (*245 dyads*) and 2007 (*2123 dyads*) (Baccini and Dür, 59). Furthermore, these agreements are not limited to one region, but span the entire globe. They call this development ‘new regionalism’. In short, they argue that the ‘new regionalism’ is driven by competition for market access and is mainly a response to preferential trade agreements of other countries.

Baccini and Dür’s causal mechanism is that trade diversion¹ leads to policy diffusion (i.e. the proliferation of trade agreements). What underlies it is the “*protection-for-exporters argument*” (Baccini and Dür, 59-64), which builds on the assumption that preferential trade policies hurt outsiders through trade diversion, therefore nudging them to set up their own preferential trade agreements or join existing ones.

The argument starts with the assumption that there is competition between exporters and importers. Exporters want better foreign market access while importers want protection of their sector against foreign competition. While both can engage in lobbying, exporters do so far less than importers because they face uncertainty (too little information about the benefits of foreign market access, reliance on willingness of a foreign government, delays: trade negotiations take a long time) about the potential benefits they could gain; in a plurilateral agreement the benefits may even go to a foreign exporter. Exporters will only engage in lobbying when facing losses, since their goal is to gain back the market share they lost due to the preferential trade agreement they were excluded from. In this case there is less uncertainty surrounding successful lobbying.

The government will take the interests of exporters into account because of their ability to influence politics (reduce contributions, switch party support, withhold information and shape public opinion) and enter an agreement with the foreign government(s) where

¹ Here ‘trade diversion’ is used in its simplest form and refers to any trade diverted away from efficient producers as a result of the creation of free-trade areas or customs unions from preferential trade agreements. http://www.economicsonline.co.uk/Global_economics/Trade_creation.html (accessed: 19 March 2018)

the exporters face losses. The size of the protection for exporter's effect depends on the size of the trade diversion; the larger it is, the more active exporters will be and thus the more the excluded government should be willing to sign an agreement.

Baccini and Dür (2011) hypothesize that a reverse logic must be in play for countries to sign an agreement, i.e. *“the more discrimination that countries A and B face in each other's markets, the higher the probability of a preferential trade agreement between them.”* (Baccini and Dür 2011, 63).

Baccini and Dür (2011) perform a quantitative analysis of the proliferation of preferential trade agreements among 167 countries between 1990 and 2007. They use a spatial weight matrix to measure the impact of policy change in a dyad on all other dyads. The dependent variable *policy change* is operationalized by whether a dyad signed an agreement between 1 and 5 years ago (5 years is the maximum since the effect should disappear after some time because exporters are successful in convincing their government or the government or adapt to the new situation). It is also lagged by one year to avoid simultaneity bias which may lead to underestimation of the spatial effect. The authors capture the *potential trade diversion* that B will suffer when A signs a preferential trade agreement with C. This potential is mainly determined by the amount of exports from B to A and the degree of competition between the exports of B with A's new partner(s). Additional spatial weight matrixes are constructed for the two alternative causal mechanisms: 'emulation' (likely among geographically and culturally close countries) and 'security externalities' (mercantilist view that two countries increasing their power through trade may force others to follow suit to retain their position vis-à-vis these countries). Economic, geographical and political control variables that could increase the probability of a dyad signing an agreement are included. This is also vital to avoid overestimating the effect of spatial lags, parallel policy choices and exogenous shocks. The authors use a Cox proportional hazards model to test their hypothesis and the findings are very supportive of their argument. The most important result is that the covariate 'Trade & Competition' is statistically significant at the 1% level. Additionally, three robustness checks are performed. The first supports the five-year cutoff for policy change, the second excludes trade shares since exporters may not care about the size of trade flows but only if they are competing with a 3rd country and the third excludes the log of spatial variables. The results in all are highly robust. Based on the empirical results, the authors find support for their argument that the formation of preferential trade agreements is an interdependent process and seems to be mainly driven by countries responding to the negative externalities of existing agreements.

Strengths and Weaknesses

The most apparent strength of Baccini and Dür's (2011) article lies in its methodology. So far, mainly qualitative studies have plausibly shown that countries respond to discrimination from preferential trade agreements. There has been a lack of quantitative studies and those that do exist suffer from shortcomings.

Baccini and Dür (2011) make two improvements to data and methods. First, they test the protection-for-exporters argument that captures the causal logic of countries responding to trade diversion as directly as possible by modelling the spatial logic at the heart of the theoretical argument. Secondly, they create a new database of trade agreements from 1990 – 2007 containing 167 countries, which is an improvement on the datasets used in previous studies in terms of completeness and inclusion of recent agreements.

Baccini and Dür perform a solid quantitative study with robust models and clear sections on data and operationalization where they explain why they limit their data selection and address the endogeneity problem (i.e. B's exports to A will decrease in the aftermath of A signing an agreement with C, if B's exports compete with Cs'). The authors solve this problem by lagging the trade data by one year to capture competing goods and disaggregating trade flows to the sector level to assess whether countries export the same basket of goods.

However, there are also some weaknesses in their methodology. The abovementioned disaggregation of trade flows only disaggregates trade into 12 sectors, which is too broad. This is a minor weakness, since often trade disputes surrounding competing goods revolve around a few goods, sometimes only one (e.g. the Canada – U.S. softwood lumber dispute² or the 'hormone beef trade war' between the EU and the U.S.³). Therefore, a more fine-grained disaggregation would strengthen the operationalization of 'trade diversion'. Another minor weakness is the authors' failure to interpret two of the surprising empirical findings ('Trade Dispute Third Party' and 'Language' are both negative and statistically significant).

The next weakness of Baccini and Dür (2011) is the lack of internal validity. Although the causal mechanism in Baccini and Dür has high external validity for explaining how

²<http://business.financialpost.com/news/economy/the-granddaddy-of-all-canadian-u-s-trade-disputes-is-about-to-rear-its-ugly-head-again> (accessed: 18 March 2018)

³http://www.economicsonline.co.uk/Global_economics/Trade_creation.html (accessed: 18 March 2018)

trade diversion leads to competition which produces more preferential trade agreements, it cannot tell us why one group outperforms another for influence in this competition.

However, the largest weakness of the study is the narrow focus on the winner and loser approach to trade politics. Baccini and Dür (2011) and Bown and Reynolds (2014) both tell us that trade politics is characterized by conflict between winners and losers, or more specifically between exporters and importers in different countries that are fighting to retain or enlarge their global and domestic market shares. Although this approach highlights the continual struggle for market access between winners and losers of international trade, it essentially assumes that politicians have no independent trade policy objectives. In Baccini and Dür (2011) politicians are framed as entities that appear to be solely concerned with maintaining political office. This assumption is misleading, since politicians are not simply recorders of interest group pressures and have independent trade policy objectives (Oatley 2016). Next, the society-centered approach in Baccini and Dür (2011) does not consider the motivations of noneconomic actors in trade politics. According to Oatley (2016), labor unions, environmental groups and human rights groups have all played a prominent role in shaping the specific content of various trade agreements and the assumption that trade politics is driven solely by economic interest groups tells us nothing about the role of these noneconomic actors. In the past this may have been acceptable given their small role, however the influence of such groups has been growing and therefore they should be included in future models of trade. Finally, Dorussen and Ward (2010) have shown in their research that trade networks have a pacifying effect and that stronger direct and indirect trade linkages increase the security of a state. Oatley (2016) suggests that some smaller countries enter into preferential trade agreements in order to increase their bargaining power at the WTO. This research is relevant here because it demonstrates that security concerns and leverage could also play a role in the signing of preferential trade agreements.

In conclusion, there is a range of variables which are not present in Baccini and Dür's causal mechanism which could explain the proliferation of preferential trade agreements. Therefore, the causal mechanism should be restructured, retested, and complemented with process-tracing case studies before it can be taken at full face value.

Further Research

Baccini and Dür provide an excellent starting point for further research and there are several points that have already been hinted at in the section above. First are database issues such as the expansion of Baccini and Dür's database (which only covers dyads up until and including 2007), as well as the creation of a database which disaggregates exports into more fine-grained sectors.

The second and more important issue for future research in the areas of RTAs is causality. Baccini and Dür (2011) only present some of the reasons why countries enter into preferential trade agreements. The rapid proliferation of RTAs is due to numerous factors. For example, Oatley (2016) notes that after the collapse of the Soviet Union, countries from the former Soviet Bloc and the EU concluded many RTAs throughout the 1990s. Additionally, changes in developing countries trade policies led to more RTAs throughout the 1980s and 1990s. It appears that the most laborious and essential task in RTA research is to determine what drives the agreements in a case by case manner. Baccini and Dür's model is consistent because exporters have the same goal (to maximize income through higher market shares) no matter what country they are in. However, the goals and influence of noneconomic actors (civil society, interest groups and politicians) are less stable and have higher variation across countries and time than the economic interests of exporters. Therefore, qualitative process-tracing methods seem more suitable to the task of determining the true cause of why preferential trade agreements are signed. However, I still believe that econometric models are important and that more research is necessary to construct, conceptualize and operationalize a new theory which can incorporate a larger variety of societal and state actors into new models.

Further research could also be related to the level of discrimination in the international trade system. With so many new RTAs it would be interesting to determine which countries and which goods face the most discrimination.

Lastly, due to the rapid proliferation of RTAs, an interesting question that arises is if this movement away from multilateralism toward bilateral and regional arrangements is only a trend or if we are heading towards a new status quo. This is related to the institutional capacity of the WTO. How has decision-making paralysis at the WTO impacted the spread of RTAs?

Globalization has given the WTO many new challenges to deal with and a large question is whether they will be able to modernize effectively and maintain a common decision-

making process that can produce policy outcomes, while dealing with a growing membership and vocal critics from NGOs.

In conclusion, future research should move in the direction of examining the instrumental use of trade agreements from a variety of different perspectives in order provide a more complete causal mechanism.

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