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14 Multilateral or bilateral trade deals? Lessons from history

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> *The Trump Administration believes in free and fair trade, and we are looking forward to developing deeper trading relationships with international partners who share that belief. But, going forward, we will tend to focus on bilateral negotiations. (USTR, 2017)*

> *The United States must address the challenges to economic growth and employment that may arise from large and chronic trade deficits and the unfair and discriminatory trade practices of some of our trading partners. (White House, 2017)*

President Donald Trump has railed against trade deals, and especially multi-country trade agreements.[2] His stated intent is for his administration to focus on bilateralism and bilateral trade imbalances.

This approach does raise questions about trade agreement design. Why negotiate trade agreements multilaterally as opposed to bilaterally? What are the benefits of an approach that features the most-favoured-nation (MFN) rule of nondiscrimination instead of bilateral trade preferences?

1 Thanks to Douglas Irwin for useful discussions. All remaining errors are our own.

2 In a televised interview with NBC's Chuck Todd, Trump indicated "It doesn't matter. Then we're going to renegotiate or we're going to pull out. These trade deals are a disaster, Chuck. World Trade Organization is a disaster." (NBC, 2016)

Many themes in Trump's stated approach are not new; they resonate with US trade policy debates of the 1930s. The parallels are instructive for understanding the economic logic behind the current trading system and how lessons from historical experience have shaped it.

The economic environment and the trading system of the early 1930s

The First World War of 1914-1918 left a devastated global economy. Recovery began to take hold in the 1920s, but the US stock market crash of 1929 was a major setback, and the world ultimately fell into the Great Depression. The United States made matters worse in 1930 by responding to the economic crisis with its now infamous Smoot-Hawley tariffs.

Some countries – like Canada, Spain, Italy and Switzerland – retaliated directly by raising tariffs or imposing quantitative restrictions against US exports. Other partners – like the United Kingdom – retaliated indirectly by reducing trade barriers on a selective, discriminatory basis to favoured trading partners. The UK's imperial preferences deepened trade blocs from which the United States was excluded.[3]

US exporters faced discrimination in foreign markets through a complex web of policies. As it was described later, world trade in the 1930s was

> *regulated by quotas, exchange controls, clearing agreements and barter deals, which relegated the customs tariff, the normal instrument of trade control, to a minor role. It became evident during the [Second World War] that the restrictions on trade would grow even more onerous unless a resolute attempt were made to restore to Europe and the world a one market economy. (GATT 1949, p. 6)*

3 For discussions, see Irwin *et al*. (2008, pp. 5-8) and Irwin (2012, pp. 13-34).

The 1934 Reciprocal Trade Agreements Act

By 1934, President Roosevelt and Congress had developed a new approach to US trade policy through the Reciprocal Trade Agreements Act (RTAA). Cutting US tariffs would be undertaken by negotiating reductions in trade barriers abroad, in order to achieve reciprocal *changes* in market access. This idea of reciprocity marked a major shift in US trade policy, away from the unilateralism of earlier periods and toward the negotiation of tariff agreements that would entail symmetric obligations for the partner countries. Jagdish Bhagwati characterised what this symmetry did – and, importantly, what it *did not* – imply as

> …first-difference reciprocity – *that is, tariff cuts are to proceed via bargaining that reflects a balance of perceived advantages at the margin rather than via negotiations that result in a perceived full equality of market access and reverse market access (or what, in modern American parlance, is pithily described as a 'level playing field'). (Bhagwati 1988, p. 36)*

Equally important was the decision the Roosevelt administration would make to afford nondiscriminatory treatment through an 'unconditional MFN clause'. This clause would assure partners that any tariff cuts that the United States agreed to in later negotiations with other countries would be automatically extended back to them as well. And under reciprocity, the United States would demand the same unconditional MFN treatment from its bargaining partners.

This important decision followed a battle over who would lead US trade policy negotiations under the RTAA. The struggle arose between Secretary of State Cordell Hull and George N. Peek, a special assistant to the President on trade policy.[4]

4 See the discussion in Tasca (1938, pp. 86-90). Peek's position was also supported by Secretary of Agriculture H. A. Wallace, and is similar to views articulated by the Bannon, Navarro, Ross, and Lighthizer camp in the Trump administration (Donnan and Sevastopulo 2017).

Peek's positions on bilateral negotiations and bilateral trade imbalances echo those taken by some Trump administration officials today:

> *[Peek] was an adherent of high tariffs in line with the historical American tariff policy. With this as the starting point he then advanced a program of trade bargaining on a strictly substantively bilateral basis with pure barter deals a vital part. Implied here was the abandonment of the unconditional [MFN] clause in American commercial treaties. (Tasca 1938, p. 90)*

But Cordell Hull eventually won the administration's internal clash for control over Roosevelt's trade diplomacy in the 1930s. Hull was a strong advocate for unconditional MFN in US negotiations.[5] He was particularly concerned about the impact of imperial preferences, where tariffs had been selectively reduced in important US export markets – like the United Kingdom and Canada – but where US companies and farmers faced decimation because they were left out. The United States pursued unconditional MFN to put an end to the discrimination facing US exporters in the 1930s.

Pre-1934 experience with bilateral negotiations coupled with 'conditional' MFN

The history of trade agreements that had attempted to proceed without unconditional MFN also showcases its virtues.[6] Under the alternative 'conditional' MFN approach, a country does not automatically extend newly negotiated tariff cuts to partners with which it has negotiated a prior deal. The idea is that a new, lower tariff would be extended to earlier partners only if they offer satisfactory additional trade concessions in exchange.

5 To be clear, the United States had shifted toward the unconditional MFN approach by 1923 - William Culbertson of the Tariff Commission was the main instigator. Hull's contribution in the 1930s was to implement unconditional MFN in reciprocal tariff negotiations.

6 See Bagwell and Staiger (2010a) for a more detailed discussion of these issues. Formal models that showcase these issues include Bagwell and Staiger (2005, 2010b).

While this may sound reasonable, the European experience with trade agreements omitting unconditional MFN had proven unsustainable. As Wallace (1933, p. 629) notes:

> *After the [First] World War, France experimented with the idea of abandoning the [unconditional] most-favored-nation clause…By 1927 France was again driven back to the granting of most-favored-nation treatment, either de jure or de facto… When a country, by exclusive tariff bargains, institutes discriminations against third countries, then the greater these discriminations the greater will be the pressure against that country for their removal. In each successive negotiation it finds that the firmest demand of the other country is for equality of treatment, present and future, guarded by a most-favored-nation clause or its equivalent.*

Because of the fear that future deals with others would result in the erosion of concessions offered in the current deal, negotiations relying on conditional MFN were less likely to come to any deal whatsoever, and thus ended up a waste of time. Tasca (1938, p. 105) reports that of the 625 trade agreements negotiated globally between 1870 and 1934, only 48 had a conditional MFN clause. And in many of those, unconditional MFN became the *de facto* practice.

Nevertheless, understanding the full benefits of MFN is complicated. As Wallace (1933, p. 629) described – like today – 1930s critics of unconditional MFN too often also focused on just one side of the ledger:

> *One of the reasons why the most-favored-nation clause has been under fire in Europe is that manufacturers have tabulated the reductions of duty incidentally extended to third countries, but exporting interests have not been equally diligent in calling attention to the reductions in foreign tariffs to which their exports have become incidentally entitled in the same manner.*

The US experience since the RTAA

Between 1934 and 1947, the United States negotiated 29 separate bilateral agreements to conclusion under the RTAA, and in each it implemented the unconditional MFN rule. In 1947, this approach was consolidated into a multilateral framework as the General Agreement on Tariffs and Trade (GATT). The multilateral GATT system was transformed into the World Trade Organization (WTO) in 1995.

The United States abandoned pursuit of bilateral deals until the mid-1980s. It signed its first bilateral free trade agreement (FTA) in 1985 with Israel, followed by the US-Canada FTA in 1987, adding Mexico to form the North American Free Trade Agreement (NAFTA) in 1994. It has negotiated additional FTAs since 2000, and now has such agreements with 20 (mostly small) countries.

Under WTO rules, permissible FTAs must essentially eliminate tariffs on trade among the partners. For this reason, countries do not need to worry that some other partner will later receive a better *tariff* deal, because tariffs are already set at their minimum value (zero). Owing to WTO rules, these discriminatory arrangements are thus quite distinct from the chequered history of partial liberalisation arrangements in Europe and elsewhere before 1934.

Still, there are plenty of other ways for ‘better’ future FTA deals to erode the preferential concessions offered in a current deal in the modern global economy. Examples include offering additional preferential access through non-tariff concessions in areas such as services trade, or intellectual property and investor-rights protections.

In any event, because most US FTA partners are small, most US trade is still conducted under WTO rules and is thus subject to unconditional MFN. As a result, most of the exports of US companies and farmers are protected only by the trading partners’ commitment to MFN that the WTO system provides.

Implications for today

History indicates that a bilateral approach to trade liberalisation does not work well. President Trump’s potential shift toward bilateral and discriminatory negotiations would run into many of the same bargaining problems that negotiators ran into before 1934.

Modern trading partners may learn to be hesitant to conclude bargains with the United States without an unconditional-MFN type guarantee extended to include non-tariff concessions, due to fears that Trump's future deals with others would erode the value of their concessions. Moreover, without an analogous unconditional-MFN type guarantee from the other side, there would be nothing to prevent US FTA partners from offering better future deals to *other* countries.

President Trump seems motivated to negotiate bilateral deals in part out of the belief that his form of one-on-one bargaining will be more effective in getting better terms for the United States. But, looking at trade deals as a zero-sum game where 'their win is our loss' – rather than as a win-win where the benefits of a good agreement are shared mutually – does not lead to better trade deals, for a number of reasons.

First, when it comes to trade negotiations, countries are savvy to the bluff and bluster that might prove effective in other kinds of deal-making. Their positions are not easily swayed: European countries tried such techniques in the 1930s, as countries jacked up their tariffs on the eve of bargaining, in an attempt to influence the subsequent negotiations. Their negotiating partners quickly saw through these 'bargaining tariffs'; as a result, explicit rules designed to prevent the use of bargaining tariffs were introduced into both the RTAA and the GATT/WTO.

And second, as there is no international 'police force' that can compel countries to follow the rules of any trade agreement, all countries must have a stake in the deal. Trade agreements are only successful if it is in countries' mutual interest to obey the rules. So, even if – through bluff and bluster – the United States were successful in negotiating 'the best deal' for itself and left its partners with little in return, the United States would face major headaches down the road in trying to enforce the agreement's rules.

Another of President Trump's motivations for pursuing bilateral trade bargains appears to be to target trading partners with which the United States has large bilateral trade deficits, and to negotiate 'more reciprocal' tariff levels with these partners to address these imbalances. But this thinking is also misguided on two counts.

First, the reciprocity successfully embedded in the multilateral trading system is, again, a 'first-difference' form of reciprocity. It does not imply uniform reciprocal tariff rates – that if the United States has a 2.5% tariff for cars, then China should have a 2.5% tariff for cars – across countries.

Second, addressing trade imbalances through trade agreements makes little economic sense. Multilateral trade imbalances reflect differences between national levels of savings and investment that have little to do with tariffs and trade policy. And *bilateral* trade imbalances reflect comparative advantage and patterns of trade which, if blocked, would prevent the United States from enjoying these benefits.

Nevertheless, the United States and the global trading system do face challenges.

Does the WTO face a serious 'latecomer's problem' in that, owing to their relatively recent entry into the global economy, major emerging markets like Brazil, India and China apply much higher tariffs to US exports than the United States imposes? The key to resolving that issue may be less about how to 'level the playing field', than, instead, how to re-harness use of 'first-difference reciprocity' of the sort that resulted in the remarkable trade liberalisation of industrialised countries beginning under the GATT and then WTO.

Furthermore, how does the system integrate a large non-market economy like China into a multilateral system and rules that are built on market principles?[7]

There may be need for a new deal on trade to address these and other challenges. But the problems solved by the US commitment to unconditional MFN and first difference reciprocity in the 1930s and 1940s also exist today. There is no reason to believe that a bilateral and discriminatory approach would be effective in meeting current challenges. And with pre-1934 history as a guide, such an approach could unravel many of the achieved gains.

7 On a discussion of China and its evolution toward a market economy, see Bown (2016) and Wu (2016).

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