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Martin Richardson

Correspondence to:

Dr Martin Richardson

Department of Economics

University of Otago

PO Box 56

Dunedin

NEW ZEALAND

mrichardson@business.otago.ac.nz

Phone: ++ 64 3 479 8654

Fax: ++ 64 4 479 8174

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INTRODUCTION

Recent years have seen a great deal of trade liberalisation worldwide, particularly via the vehicles of regionalism and bilateralism. Certainly, the focus of analysts and policy economists has been firmly on these means of liberalisation. At the same time, however, many countries have also chosen to liberalise their international trade regimes unilaterally. Only recently have analysts begun to focus on unilateralism as a means of trade liberalisation: see Bhagwati (1999).

But why would countries wish to choose this route to liberalise? Standard economic analysis can explain it for small countries (where the mystery is then why it is such a recent phenomenon) but for large countries it appears simply to sacrifice some "bargaining power". This paper considers a number of reasons why unilateralism – meant here to indicate *liberalisation* as opposed to its more common current use indicating increased trade barriers (see Ethier (1998)) – may be attractive to countries, both large and small. We first look at arguments in a standard, neoclassical setting before turning to political economy contexts.

What effects, if any, does liberalisation through other multilateral[1] means have on the incentive to liberalise unilaterally? We argue that one of the most important sets of reasons for unilateral reforms is precisely that it occurs in an environment of multilateral liberalisation. We discuss some theoretical reasons for this before looking briefly at two recent cases. The first is the APEC experience which we argue is best thought of as a qualified unilateralism and the second is recent experience in New Zealand where unilateralism has been a leading means of liberalisation. We suggest that unilateralism has been almost necessary for New Zealand, by virtue of the breadth of its microeconomic reform programme. A final section concludes.

[1] Typically the word "multilateralism" is used in this paper to include all forms of agreement regardless of the number of participants. Thus it includes bilateralism and regionalism. This is in contrast to its current usage, which tends to refer solely to large-group agreements (typically the WTO.)

WHAT IS UNILATERALISM?

The defining feature of unilateral as opposed to multilateral trade liberalisation is the absence of reciprocity. Classification of reforms would then seem to be a simple exercise but several commentators have noted that what appears to be a fairly straightforward notion is in fact rather complicated. McCulloch (1997) talks of "soft" reciprocity – apparently unilateral reductions in trade barriers actually executed in return for non-trade-related benefits such as loans. We might also talk of "soft unilateralism" in which apparently unilateral actions are taken in the expectation that they benefit the reforming country through a non-obvious reciprocity. McCulloch (1997), for instance, notes that the aggressive practices of one country might induce apparently unilateral reforms from trading partners where in fact it is the threat of actions in the *absence* of such reforms that triggers them: she suggests that many recent reforms in Latin America are attributable to this sort of soft unilateralism.

Nevertheless, there are notable cases in which countries have liberalised their international trading regimes without being subject to these pressures and without any obvious reciprocity. A good example is the liberalisation of New Zealand's trade policy since 1984.[2] The WTO has commented, "New Zealand has transformed its economy from one that was highly protected and regulated to one that is among the most market-oriented and open in the world" (World Trade Organization (1996 p.1.)) and New Zealand is very explicit in recognising unilateralism as a means of liberalisation separate from, if complementary to, alternative routes. "The overall goal of New Zealand's trade policy…is simultaneously pursued through four interrelated policy tracks. (i) Domestic policy: the unilateral track…(ii) The bilateral track…(iii) The regional track…(iv) The WTO: the multilateral track." (World Trade Organization (1996 p.144.)) This suggests another aspect of unilateralism: that it may be only partial and discriminatory. I discuss below a number of reasons why preferential tariff reductions against a partner might lead a country unilaterally to reduce trade barriers against other countries. This sort of unilateralism appears non-discriminatory on its face but is *de facto* preferential in that previously favourably treated partners now no longer get preferential treatment.

[2] But see our discussion below suggesting that the reforms may have been attributable in part to external pressure on some political *consequences* of the initial protection.

WHY UNILATERALISM?

In a neoclassical setting

The case for unilateralism in a competitive, neo-classical world is very clear but probably of little use as a guideline to trade reforms in practice. Essentially, a country's optimal unilateral tariff is increasing in the country's size (measured in terms of its ability to affect its terms of trade.) Accordingly, the only case for unilateral free trade is when a country has no price-making ability at all in its international markets.[3] Even then, the timing of moves is relevant. Raimondos-Moller & Woodland (1997) show that a perfectly small country may have a non-zero optimal tariff when it is a first mover in a tariff-setting game. Second, in richer models in which countries produce differentiated products, no country is ever small in the sense of having a zero optimal tariff (Gros (1987)). Third, in practice most countries have some degree of price-setting power in their actual international markets, if only because of rigidities in contractual arrangements, transport costs and so on. Fourth, there are some notable historical episodes of large countries unilaterally liberalising their trade, an observation which casts some doubt on the relevance of terms of trade effects in driving tariff-setting. Fifth and perhaps most significant for our purposes this simple observation says nothing on the *process* of liberalisation; that is, on the *transition* from high tariffs to lower tariffs. In general, if low tariffs are optimal for a small country, why do we not observe them at all times? More particularly, why should a global environment of multilateral reforms trigger this realisation of a country's best interests?

One possible response to the first of these questions is that policy-makers are mistaken about their country's best interests and something happens to correct their faulty perceptions; that something could be multilateral reforms. In itself this is an unsatisfactory answer, of course, as it leaves policy-makers' ignorance unexplained, but it is possible to construct rather more sophisticated stories in which there is a "demonstration effect" from tariff reforms in other countries – perhaps through

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3 In a dynamic setting, of course, a large country might recognise the possibility of retaliation and thus choose a zero tariff sustained by the threat of punishment – see Bagwell and Staiger (1999) and references therein for the extensive literature on this argument. This is hardly unilateralism, however.

multilateralism – which convinces a country to reform. This has been argued as a practical matter. Garnaut (1998b) writes concerning the "far-reaching trade liberalization" of many countries in the Western Pacific since the mid-1980s that, "[t]he fact that many have followed this course at the same time has supported the process in each … through demonstration of the domestic gains of unilateral liberalization" (p.9). In the standard terms-of-trade setting of the optimal tariff argument one might suppose that policy-makers are unsure of a country's impact on world prices but downgrade their beliefs about their own market power on observing the consequences of liberalisation by similar, neighbour countries.

Political economy

An alternative context to the neo-classical one in which to examine unilateralism is one in which we consider the political economy of actual tariff-setting. The rationale for non-zero tariffs in a small country is then much greater, potentially. Tariffs and other trade restrictions may be used for income-distributional reasons (see Hillman (1989) and the references therein) and may be the outcome of a voting procedure (Mayer (1974)) or a political lobbying game (Grossman & Helpman (1994)) for instance. Reforms can then be triggered by changes in the underlying policy-setting mechanism such as a change in the governing political party or shifts in political support.

The New Zealand experience fits well with this model where it was a change of government in 1984 that triggered trade – and other – reforms (see Evans & Richardson (1999).) However, in the decades prior to its reforms NZ evolved an elaborate system of "tariff compensation" as its manufacturing protection grew – it was recognised that this protection hurt exporters (notably in the agricultural sector) and various governments, committed to keeping protection in place, introduced assorted policies (export subsidies, minimum price schemes, fertiliser subsidies etc.) to "offset" its damage. Both the original system of protection in NZ and the tariff "compensation" were driven largely by income-distributional concerns and together they constituted some political equilibrium, one propping up the other. But the compensation aspect of the package came under fire from trading partners when the U.S. leaned on NZ in 1981 to sign the GATT code on CVDs (see Lattimore and

Wooding (1996) p.329.) The "stick" to induce this was the threat that otherwise no injury test would be applied in the U.S. for CVD complaints against subsidised NZ exports. Once the compensation was dismantled through the agency of this external pressure, the political equilibrium maintaining the protection was upset. So, in this view, NZ's apparently unilateral trade reforms were at least in part a political adjustment as an elaborate house of cards was dismantled by external pressure.[4]

In the political economy setting we could also again model uncertainty by a policy-maker, perhaps over the income-distributional consequences of trade policy, which is reduced on observation of reforms by similar countries, again generating a demonstration effect of trade liberalisation. Another route to unilateral reform here is through the political activity of foreign producers.

UNILATERALISM IN A MULTILATERAL SETTING

One can also argue that *preferential* liberalisation might also serve a "demonstration effect" purpose and lead to non-discriminatory liberalisation. Certainly this has been suggested in the New Zealand case where preferential tariff reductions against Australia did not lead to the collapse of the manufacturing sector and so emboldened reformers to liberalise all external tariffs.

We can, however, tell richer stories that explain unilateral liberalisation. The effect we have noted is the idea that one country's liberalisation demonstrates to others that liberalisation may be beneficial. If they then liberalise in turn this can benefit the original liberaliser: the initial reform might then be perceived as soft unilateralism, in the sense defined earlier. Coates & Ludema (1997) construct a model which illustrates precisely this effect. Two large countries are involved in a process of negotiations over tariff reductions. In this model policy-makers are interested in maximising national welfare as usually understood but domestic political interests may, with some probability, be able to block a prospective bilateral trade agreement that one government negotiates with another. If this happens in one of the countries then the government of the other country, although free to set its standard "optimal" tariff, may prefer instead to reduce its tariffs unilaterally.

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[4] I am grateful to Paul Wooding for this interpretation and line of argument.

Such a reduction serves two purposes. First, such an equilibrium action reduces the probability of the agreement being blocked in the first place. Import-competing producers in a country benefit from high tariffs no matter which of the countries imposes them (by Lerner symmetry a foreign tariff is equivalent to a foreign export tax which benefits domestic import competing firms.) So import-competers in one country who are hurt by the tariff cuts in the agreement and thus oppose it will have less to gain if foreign tariffs will be cut anyway, even if the agreement is defeated. Opposition is costly in terms of lobbying resources so the lower is the expected gain from such opposition, the smaller will be the resources devoted to it. (Coates and Ludema also consider the case of competing lobby groups in a country where export interests are also represented and show that, under fairly weak restrictions on the lobbying game, this result still goes through.)

The second motivation for a unilateral tariff reduction is that it encapsulates some degree of risk-sharing between the two countries. As the ratification of an agreement is subject to risk in one of the two countries so there is scope for mutually welfare-improving sharing of this risk across the countries. One can think of the country where the agreement may fail as buying insurance against that outcome from the other country (where failure is less costly) and the unilateral tariff reduction as being the payout to that insurance in the "bad state". What keeps the 'insurer' from reneging is the ongoing relationship between the two parties – it wishes to keep alive the prospect of beneficial trade agreements in the future. Coates & Ludema demonstrate that the trade-off between the incentive to renege (and set a high tariff) and that to preserve the relationship (and unilaterally cut the tariff) depends on the 'insuring' country's size in a surprising way: the larger is the country (and so the greater its power to affect its terms of trade) the greater may be the tariff reduction! The reason is that the greater its size the more valuable is the 'insurance contract' to the other country as total failure of the agreement would have more severe consequences. Accordingly, the other country is willing to pay a higher premium in the form of more favourable terms to the 'insurer' in any agreement that might be reached.

The Coates and Ludema argument is an insightful one and captures formally some common notions surrounding earlier historical episodes of unilateral liberalisation by large countries. In particular, British policy-makers arguing for tariff reforms in the mid 19th century were very clear that one potential benefit would be the likely reforms in other countries on the coat-tails of Britain's own "magnanimity" (although on this point it is also clear that proponents of reform perceived it to be in Britain's own best interests even if no other countries followed: see Bhagwati (1988) Chapter 2.)

There is a large literature on the possible effects of regional or bilateral agreements on the multilateral trading system (see Bagwell and Staiger (1999) and the references therein) and many of the arguments apply symmetrically to the situation considered here of the interaction between multilateralism and unilateralism. There are some additional issues, however. Ethier (1999) suggests that one of the stylised facts of the new regionalism is that it typically involves a large country linking up with one or more small countries and that,

> "[t]ypically, the small countries have recently made, or are making, significant unilateral reforms. This is dramatically true of the EA's central European participants …, of the members of Mercosur …and of Mexico. But it also characterizes, to a lesser degree, the small industrial-country participants in various regional initiatives …Canada …and the Scandinavian applicants to the EU." (Ethier (1999 p.132)).

We noted above that some episodes of unilateral reform involve *de facto* liberalisation of tariffs against only a subset of partners and this quote suggests that this is a matter of some practical significance. There are a number of reasons why, when a country joins a preferential free trade area (FTA), it may then wish also to liberalise its trading regime *vis-à-vis* non-member countries. To the extent that the FTA leads to trade diversion to the partner country that is harmful, a decrease in the external tariff against non-members has approximately zero consequences for domestic producers or consumers but can replace duty-free imports from the partner with revenue-earning imports from the rest of the world (Richardson (1993)). Thus whether in a political economy setting or not, one would anticipate declining external tariffs when a country joins a FTA.[5]

Another force leading to unilateral external liberalisation following membership of a FTA stems from the ability of domestic producers to sell duty-free in the partner country post-FTA, even if the country is a net importer (Richardson (1995)). In such a case a small external tariff reduction below the level levied by the partner country will again have approximately zero effect on domestic producers (who divert their sales from the home market to the partner market) and consumers but replaces duty-free imports with imports subject to tariffs. This incentive, if recognised by governments, leads to a Bertrand paradox type of outcome in tariff-setting: both members' external tariffs are driven to zero by each one's desire to undercut the other. In this case we get quite the opposite of soft unilateralism: both countries would prefer to bind themselves to *not* liberalise as their unilateral behaviour leads to a Prisoners' dilemma outcome of tariffs that are too low.

Aside from these arguments, there are other reasons why preferential liberalisation of tariffs might lead to unilateral liberalisation of trade policy *vis-à-vis* other countries. While there is no theoretical justification for any presumption that countries' tariffs are strategic substitutes rather than complements or vice versa, one might argue that the latter is the "usual" case when we are considering a single country's tariffs against different import sources (see Bagwell & Staiger (1999). But see Mayer (1981) for the 'standard' case of strategic substitutability in a 2-country tariff war setting.) Accordingly, preferential trade policy liberalisation would lead to unilateral liberalisation in a strategic policy setting. This need not be the case, of course, and there are many models of customs union formation (so we are outside the realm of unilateralism in the determination of external tariff policy, of course) where quite the opposite occurs. Perhaps the best-known is that of Krugman (1991) in which the expansion of a trading bloc leads to a higher external tariff to exploit its increased monopoly power. Subsequent work has shown this to be a fragile result, however (see Bond & Syropoulos (1996)) and, as noted, it is difficult to conclude that increasing external tariffs is at all a likely effect of preferential trading arrangements.

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[5] Again, this describes well the experience of New Zealand although the issue of causality is unclear in that example.

What is the empirical evidence? In a word, mixed. Winters (1996) provides a brief but useful review and suggests, for example, that Canada's accession to the CUSFTA was accompanied by external liberalisation whereas Mexico's accession to NAFTA was not. It is worth noting, however, his argument that in some cases external liberalisation is characterised by lesser *increases* in trade restrictions than might have occurred in the absence of a preferential agreement.

So far we have discussed reasons why membership of a preferential agreement might lead to unilateral reforms; there are also reasons why the causality might run in the other direction. Ethier (1999) notes (p.147) one such argument: in a world of transport and other trade costs a reform-minded government might wish to liberalise unilaterally and non-preferentially in order to heighten the relative importance of regional trade and thus render a regional agreement more attractive.

What of strict multilateralism; in particular, multilateralism in the most-favoured nation, non-discriminatory GATT context? Unilateralism is defined by the absence of reciprocity and an immediate consequence of GATT-style liberalisation is that it proscribes the nature of reciprocity. A common argument made to explain bilateral trade agreements is that they involve some politically optimal exchange of market access (see Hillman & Moser (1996).) Consequently a criticism of unilateral liberalisation is that it 'wastes' the bargaining chip of access to the domestic market: this could be parlayed, in a bilateral or multilateral deal into access to others' markets. The retort to this in a small country is immediate, of course: this 'chip' has no value. But it should also be noted that the chip may be less valuable to a large country in a GATT world than it appears because of GATT's twin principles of MFN and reciprocity. Bagwell and Staiger (1997, p.40ff) note that reciprocity has been taken in GATT to mean matching liberalisations that lead to equal increases in the value of import volumes. Suppose a country wishes to exchange only partial access to its markets. This 'chip' cannot be used in a bilateral deal as Article XXIV of the GATT limits permissible bilateral deals to those that involve complete internal liberalisation. Further, any reciprocity granted by partners if the country liberalises in the GATT setting must be granted to all *other* GATT members as well by MFN so the 'cost' of granting reciprocal access is greater than it would be in a world of unilateral decisions. That is, a country that wishes to lower its trade barriers may find it difficult to use that as a lever for foreign reductions when those reductions must be made on an MFN basis.

TWO RECENT CASES OF LIBERALISATION

So far we have considered the theoretical case for unilateral trade liberalisation in both standard neoclassical and political economy settings. We have suggested that there are a number of cases for soft unilateralism operating through demonstration effects as well as political repercussions and we have noted that there are important interactions between unilateral and other forms of trade liberalisation. We conclude by looking at two notable recent instances of reforms: the APEC grouping founded on "open regionalism" and the largely unilateral liberalisations that have occurred in the last fifteen years or so in New Zealand.

Asia-Pacific Economic Co-operation: APEC

A great deal of ink has been spilled in discussing exactly what is meant by APEC's "open regionalism" but if we take our earlier definition of unilateralism then it is perhaps best understood as 'co-ordinated' unilateralism. Member countries have scheduled a tariff reform program for each – at different speeds – which is executed on a non-discriminatory MFN basis with extra-regional countries as well as other APEC members. Garnaut (1998b pp7-9) notes three elements of this liberalisation. First is, "regional co-operation in multilateral and other extra-regional trade negotiations to secure non-discriminatory trade liberalization at home and abroad." Second is co-ordinated unilateralism and third is non-discriminatory liberalisation in sectors in which intra-regional trade is important. The rationale for this latter element is clear: it provides a *de facto* reciprocity of a sort in that large member countries which might otherwise prefer explicit reciprocity (the bargaining chip argument) will find that regional MFN liberalisation favours their export sectors as a practical matter.

The big question regarding APEC that arises from our earlier discussion is what binds participants to abide by the agreed liberalisation? Garnaut (1998a) (Chapter 2) argues that trade liberalisation in the Western Pacific contains elements of a "Prisoners' Delight" game as opposed to its usual Prisoners' Dilemma conception. That is, liberalisation is a dominant strategy and achieves the highest payoff for players when all do it. In such a case, of course, any international agreement to liberalise is unnecessary in the first place. One exception to this might be where policy-makers are unaware of the payoffs and we get back to the earlier demonstration effect argument. Coordinated unilateralism here amounts to an agreement to all jump into unknown waters together. Garnaut (1998a p.31)) places some stress on this in the APEC setting: "observation that trade liberalization has been associated with economic prosperity, historically at home, or contemporaneously abroad, strengthen perceptions that support the "prisoners' delight". This has been important to the emergence and sustenance of open regionalism in East Asia."

The question remains, however, of what happens to APEC liberalisation if one or more members renege on their undertakings? Recent and current events are likely to put some countries under internal domestic pressures to slow down or even halt their promised external liberalisation and this question may become of more than academic interest. The "prisoners' delight" view of APEC suggests that one member's failings will have no effect on others. A more cynical view, however, might see APEC itself as another example of soft unilateralism: "unilateral" reforms are undertaken only in the expectation that they will reinforce reforms elsewhere and this is the *quid* for the initial reforming *quo*. Under this view, backtracking by some members on their specific undertakings would lead to backtracking by others and the institution would fail. Which of these views is more realistic? The answer to that probably depends on which country we consider and we finish by reviewing briefly the experience of one APEC member which illustrates some of the arguments we have made concerning unilateralism and also raises some more.

The New Zealand experience: some brief remarks

As noted, New Zealand (NZ) has since 1984 pursued a program of extensive reforms including trade policy liberalisation. These reforms are well catalogued elsewhere (see Evans & Richardson (1999), Evans, Grimes, Wilkinson & Teece (1996) and Lattimore and Wooding (1996)) and we shall not review them here. For our purposes it is important to note, however, that trade reforms were primarily through two means: unilateralism and bilateralism, the latter in the form of Closer Economic Relations (CER), a deep FTA with Australia. NZ has been an ardent supporter of multilateral reforms particularly through the Cairns interest group in the Uruguay Round of GATT and as a member of APEC but most progress on trade reform has been achieved through CER and unilateralism.

We have already suggested that the success of CER had an important demonstration effect in NZ. Given NZ's comparative advantage as a small, primary producing country, one might anticipate that the manufacturing sector would suffer under a program of trade reforms. However, manufactured exports to Australia have been very significant in recent years, due in no small part to CER, and this has certainly helped maintain political support for ongoing unilateral reforms.

NZ has undertaken to achieve full free trade by the year 2006, four years earlier than its 2010 commitment under the APEC agreements. How would this goal be affected if other countries were to slow down their reforms? In the current political climate the answer is probably not at all. NZ's unilateral reforms have been so extensive that APEC, in some ways, appears much like the Uruguay Round of the GATT: an opportunity to "get credit" for actions which would be taken anyway. Certainly the latest GATT Round was seen as a free good by NZ. It is one of the countries estimated to gain most significantly from the Uruguay Round's achievements in terms of per capita income, largely because of the agricultural reforms brought into the GATT in this round. Nevertheless, NZ had very little to do itself in terms of meeting multilateral reciprocity obligations, simply because it had already achieved so much unilaterally. One might argue that NZ's commitment to APEC is similar in that it stands to gain a lot from APEC's success but is committed to doing little that it would not otherwise do.

Why did NZ choose unilateralism as the main vehicle of trade reforms? Partly it can be attributed to a realisation of economists' reasoning about trade policy for small countries. Partly, however, it can be attributed to the fact that trade reforms were nested in a broader web of policy reforms. In particular, Evans & Richardson (1999) have argued that reforms of NZ's competition policy made unilateralism an ideal, even necessary, means of trade liberalisation. In the Commerce Act of 1986 NZ removed almost all sector-specific regulatory bodies and imposed a system of what has been termed "light-handed regulation." In this regime, certain general principles of competitive behaviour are laid down in the Act (such as a proscription against a dominant firm using its position to deter entry) and a Commerce Commission is empowered to administer the Act. A crucial element is the focus on the "public benefit" in assessing apparently anti-competitive behaviours and that benefit has generally been construed as an economist would construe it.

> "NZ policy-makers drew on the economic arguments of contestability and …forged a strong link between competition and efficiency – efficiency being regarded as the essential foundation for international competitiveness and competition being the preferred …means of achieving this. Indeed, it is the competition-efficiency-economic welfare paradigm that has governed the New Zealand government's approach …to domestic policy reforms and deregulation in particular." (Vautier & Lloyd (1997 p.42.))

Thus a great stress was placed on openness to competition as a means of regulation. But that openness would be meaningless in the absence of liberalised trade (and, indeed, foreign investment) so NZ's liberal trading regime can be thought of as an essential underpinning to its light-handed competition policy.

Why does this favour unilateralism? Simply because bi- or mini-lateral negotiation of trade agreements would (1) be more limited in scope and (2) make NZ's openness contingent on the actions of co-signatory countries. The first of these stems from the observation that bilateral deals invariably exempt certain sectors considered by partners to be sensitive in some fashion. The second follows from the very nature of bilateral agreements: they are a mutual exchange of "concessions". Country A agrees to open its markets to country B's firms if B will reciprocate. Accordingly, if B does *not* abide by the agreement in some fashion and ignores any dispute settlement procedures, the agreement only has any content if A is prepared to withdraw its concessions. That is, a bilateral (or any) trade deal ultimately derives its enforceability from the power of signatories to withdraw from their obligations. But that power itself undermines the commitment to openness that is essential for NZ's competition policy to be credible.

CONCLUSION

This paper commenced by asking a number of questions. Why would countries wish to liberalise their international trading regimes unilaterally? In particular, why would large countries wish to sacrifice some “bargaining power”? What effects, if any, does liberalisation through other multilateral means have on the incentive to liberalise unilaterally? We have reviewed a number of existing arguments – as well as provided some novel ones – which attempt to answer these questions. We have also briefly considered two recent trading regimes (APEC and New Zealand) which illustrate certain aspects of unilateralism.

Two important conclusions follow from our discussion. First, perhaps the most significant rationale for unilateralism in big and small countries alike is the demonstration effect it can have on other countries. This supports an argument made strongly by many authors: what we have termed “soft” unilateralism could be significant for large countries in that the benefits from unilateral trade liberalisation may stem as much from the flow-on effects it has on others’ trade policies as from its direct consequences. Second, there are a number of reasons why multilateralism (taken still to include all size agreements from bilateral up to global) may sensibly induce unilateralism. To the extent that these two observations interact, one might reasonably feel confident that the future of a liberal global trading regime is bright.

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