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"Escape And Entry Mechanisms In The Multilateral Trade System"

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Abstract: Escape mechanisms from trade agreements are necessary because such agreements are incomplete, self-enforcing, contracts negotiated when the future is unknown. The essence of multilateral escape mechanisms is the principle of equivalent withdrawal of concessions, which allows trade agreements to result in efficient outcomes but implies that realized liberalization will be at the pace preferred by the most reluctant liberalizers. This in turn implies a possibly beneficial role for unilateral escape mechanisms featuring discrimination and partial compensation for restricted exporters. The fact that a large part of the globe, hitherto aloof from the multilateral trading system, is now actively trying to join it generates a critical need for entry mechanisms. Regional trade agreements provide entry mechanisms that maximize the extent of successful reform.

Keywords: escape mechanisms, equivalent withdrawal of concessions, insurance triangle, entry mechanisms, the new regionalism

JEL **Classification Codes:** F10, F13

Outline:

ESCAPE AND ENTRY MECHANISMS IN THE MULTILATERAL TRADE SYSTEM

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This paper addresses central aspects of a global issue: the basic nature of the process of multilateral trade liberalization accomplished under the auspices of the General Agreement on Tariffs and Trade (GATT) and the World Trade Organization (WTO), probably the most successful deliberate exercise of economic policy in human history.

I. Introduction

The GATT-WTO liberalization has been the big economic story of the last 60 years. I am concerned with two central features of this process.

- The trade agreements that constitute the GATT-WTO framework are *voluntary* agreements between *sovereign* states that must be *self-enforcing*.

This is in marked contrast to the picture, painted by (sometimes violent) protestors at recent international economic fora, of the WTO as a faceless, unelected, international bureaucracy imposing its will on national governments. In fact, the WTO cannot force any government to do anything it does not want to do, and it cannot itself punish any government for doing anything that that government chooses to do.

The future is uncertain. Governments signing on to a trade agreement cannot know the environment that will exist throughout the life of that agreement. Thus a viable self-enforcing system of agreements absolutely requires *escape* mechanisms that will allow individual governments to back out of their commitments *but* not destroy the structure of self-enforcing agreements.

- For most of its history, the GATT-WTO process involved primarily the industrial countries. The larger part of the globe (the communist bloc and most LDCs) consisted of half-hearted participants or non-participants.

So there have always been outsiders, larger, in terms of geography and population, than the insiders. This became of absolutely fundamental importance in the late 1980s and early 1990s, when communism collapsed, most LDCs tried to abandon import substitution, and all these countries determined, simultaneously, to join the multilateral system. This could well turn out to be the most significant economic event of the 20th century, eclipsing even the establishment of the GATT-WTO system. Anyway, it must focus attention, directly and powerfully, on modes of *entry* into the multilateral system.

I shall address these two central aspects of the GATT-WTO system: escape mechanisms from a necessarily self-enforcing structure of agreements, and entry mechanisms into a system that is not, at least initially, universal. This will require looking at familiar tools of policy from an unfamiliar perspective: Instead of focusing on their effects on purely national objectives, or upon their international implications independently of other tools, I'm concerned with their relation to the multilateral *system*.

II. The Multilateral System

This section briefly describes essential features of multilateralism, distilled into six stylized facts.

- *Tariffs* are the instruments of protection.

- Countries *multilaterally* negotiate tariff reductions.

- The negotiated liberalization is *gradual*.

- Negotiated agreements feature *reciprocity*: the mutual exchange of concessions.

- *Nondiscrimination* characterizes trading relations: Each country is a Most Favored Nation (MFN) of every other country.[1]

- Punishments for alleged violations of past agreements have consistently been *equivalent to the violation*, that is, tit-for-tat.

Multilateral liberalization has increasingly shifted from the further reduction of already reduced tariffs to *broadening* liberalization into additional areas, notably agriculture, services, and intellectual property. Attention has necessarily shifted to government policies other than tariffs. Consideration of these would not alter the following argument, so I abstract from them and pretend that continued multilateral liberalization is only the continued reduction of tariffs.

III. Escape Mechanisms

Escape mechanisms provide ways in which, in an uncertain world in which trade agreements must be self enforcing, individual countries can back out of agreed obligations without endangering the agreements themselves. I distinguish between *multilateral* and *unilateral* mechanisms. Multilateral mechanisms are those supplied by the WTO, while unilateral mechanisms are those created by individual countries themselves. Unilateral mechanisms may be either consistent or inconsistent with the WTO, and they may or may not be constrained by the WTO.

Multilateral mechanisms

The GATT and the WTO provide numerous multilateral escape mechanisms: See, *e.g.*, Articles XIX, XXIII, and XIV of the GATT. Fundamental to all of these mechanisms, and, indeed, pervasive throughout the GATT, is the principle of *equivalent withdrawal of concessions*. If a country "escapes" from an obligation to provide some trade liberalization,

[1]One country extends MFN status to another if the former agrees that goods from the latter will never face a duty higher than the duty applied to similar goods from any other country. In practice this raises the issue of defining "similar goods," but I shall abstract from such problems.

its trading partners can also withdraw from their obligations to liberalize to a substantially equivalent degree. As noted above, this is also the standard used to punish violations of trade agreements. If a defendant fails to abide by a negative dispute-settlement finding, the WTO authorizes the complainant to retaliate by withdrawing concessions equivalent to the harm it suffers from the failure to abide. In addition, such punishments have commonly been threatened when trade disputes have been conducted outside the GATT framework, as often happened before the WTO was established.

The withdrawal of equivalent concessions is the common denominator, and the dominant constituent, of the GATT-WTO escape mechanisms. It fits in neatly with the philosophy of the multilateral system outlined in the previous section. Trade agreements are necessarily self-enforcing, and they are also necessarily incomplete contracts negotiated when the future is known to be uncertain. An ability to escape from (*ex post*) politically untenable commitments is therefore necessary for trade agreements to be viable; the principle of withdrawal of equivalent concessions allows such escape to preserve *reciprocity*, the fundamental negotiating principle underlying the GATT-WTO system.

The fact that the withdrawal of equivalent concessions is intimately consistent with the philosophy of the multilateral system does not, however, imply that it makes economic sense. That reciprocity should be a fundamental negotiating principle is by no means obvious,[2] and the dominant theoretical depiction of trade agreements as solutions of a repeated game sustained by trigger strategies suggests that tit-for-tat punishments could be pathetically anemic. But a simple argument suggests a presumption in favor of the efficiency of the principle of the withdrawal of equivalent concessions.

Suppose that two governments are to negotiate a trade agreement. Each government believes (assuming symmetry for simplicity) that a tariff reduction at the rate τ, negotiated under reciprocity, would give it a payoff of $u(\tau)$; presuming that each government would like to negotiate an agreement that does not go all the way to free trade, suppose that u attains a unique maximum at a positive but finite value τ_{ORL}, the *optimal reciprocal liberalization.* Suppose further that a unilateral liberalization at the rate τ_U, that is, a departure from reciprocity in that amount, would generate a negative payoff of $w\tau_U$ for the home government, whereas a positive payoff in the same amount would be generated by a foreign unilateral liberalization of τ_U.

At the time of the negotiations it is known that one government (it is not known which) will *ex post* be confronted with the temptation to escape from its agreed commitment in the amount e, thereby reducing its effective liberalization from the negotiated τ to $\tau - e$. Its payoff for this will be $v(e)$, assumed to reach a maximum at e_{OUE}, the *optimal unilateral escape* were trade of no consideration.

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[2] Bagwell and Staiger (1999) and Ethier (1999) advance alternative arguments for reciprocity.

The trade agreement consists of a negotiated rate τ of reciprocal liberalization plus a *withdrawal factor* ρ: if one country escapes from the negotiated liberalization by the amount e, its partner withdraws concessions in the amount ρe. Thus the *ex post* payoffs of the escapee and the punisher, respectively, will be given by:

$$\phi^E = u(\tau - e) + v(e) + we[1 - \rho] \quad \textbf{(1)}$$

and

$$\phi^P = u(\tau - \rho e) - we[1 - \rho] \quad \textbf{(2)}$$

The escapee will choose e to maximize **(1)**, given the negotiated τ and ρ.

$$0 = -u'(\tau - e) + v'(e) + w[1 - \rho] \quad \textbf{(3)}$$

Now turn to the negotiation stage. Assume each government wants to maximize the expected value of its objective function. Since each government has equal probability of turning out to be E or P, both governments share a common *ex ante* objective equivalent to maximizing the sum $\phi^E + \phi^P$. The first order conditions are:

$$0 = u'(\tau - \rho e) + u'(\tau - e) \quad \textbf{(4)}$$

$$0 = -u'(\tau - \rho e)e \quad \textbf{(5)}$$

Then, **(3)**, **(4)**, and **(5)** imply the following solution.

$$\tau - e = e_{OUE}, \qquad \rho = 1, \qquad e = e_{OUE}.$$

So, the principle of equivalent withdrawal of concessions ($\rho = 1$) emerges endogenously. It allows negotiation of a trade agreement that will in the end both deliver the optimal rate of reciprocal liberalization and allow the optimal unilateral escape. This is just what the countries themselves would have negotiated directly had they been able to completely foresee the future, or been able to write a fully state-contingent agreement.

Of course this simple argument is highly stylized. But it does serve to provide a potentially powerful rationale for the principle of the equivalent withdrawal of concessions, the essence of the GATT-WTO multilateral escape mechanisms.[3]

Unilateral mechanisms

Prominent unilateral escape mechanisms include antidumping duties (ADDs), countervailing duties (CVDs), safeguards (SFGs), and voluntary export restraints (VERs). These are unilateral in the sense that they are implemented unilaterally, or, in the case of VERs, bilaterally. However, they are not ignored by the WTO, which has codes of conduct for ADDs, CVDs, and SFGs, is attempting to curtail the use of VERs, and has a dispute settlement procedure which has been used to deal with disputes about the implementation of these mechanisms.

Much less widely appreciated is the relationship between these unilateral escape mechanisms and the multilateral mechanisms discussed above. To make this clear, I must first describe important stylized properties of the unilateral mechanisms and also present a simple analytic framework for investigation.

First I identify three stylized facts that characterize—more or less—the operation of the unilateral mechanisms.

- ***Exporters are COMPENSATED, at least in part.***

Rents generated by VERs accrue to the exporters, who administer the quotas. Usually the exporting firms themselves capture the rents. SFGs may require that exporters be compensated, though any compensation is to the exporting *country* rather than to the exporting *firms*. ADDs and CVDs are tools for forcing exporters to raise their prices. Sometimes they generate tariff revenue and sometimes they deprive the exporters of their markets, but most often they result simply in higher prices for exporters, who thereby obtain the rents.

- ***The mechanisms are DISCRIMINATORY.***

SFGs, however, should be nondiscriminatory. But their use has greatly declined relative to that of the other three instruments and it is now sometimes permissible to employ them in a discriminatory manner.

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[3]Further discussion of these and related issues can be found in Bagwell and Staiger (2001), Bütler and Hauser (2000), Ethier (2001b), and Rosendorff (2000).

- ***The mechanisms are designed by officials DISTINCT FROM THOSE WHO NEGOTIATE international trade agreements.***

This applies to some degree to most industrial countries, but most dramatically to the U.S. For over 60 years the Congress has repeatedly ceded to the executive considerable authority to set actual tariff levels via reciprocal trade negotiations, and throughout this period the executive has consistently been less protectionist than Congress. Yet, at the same time, Congress has repeatedly revised the laws governing unilateral escape mechanisms to limit executive discretion and to make protection a more likely response to petitions for relief. More generally, trade policies of the developed countries are dramatically schizophrenic, simultaneously negotiating further multilateral liberalization while making increasing use of unilateral escape mechanisms.

The basic reason for escape mechanisms is that countries must negotiate tariff reductions before they know fully the economic environment in which the lowered tariffs will apply. The domain of relevant environmental aspects is huge (the reason they cannot be accommodated by state-contingent trade agreements), but, to be more concrete, I simply suppose that no one knows in advance which country will have the most technologically-advanced exporting firms.

Suppose that, *ex post*, each country might find itself in any one of three groups. *Leaders* experience a technical advantage in their export sectors. *Followers* compete with the leaders in their export markets. *Laggards* find their import-competing sectors competing with goods from the leaders, as well as from the followers. For simplicity, I ignore other possible combinations.

Here is where the multilateral escape mechanisms prove decisive. The principle of equivalent withdrawal of concessions implies that, regardless of what has been negotiated *ex ante*, the realized rate of liberalization cannot exceed what any country wants *ex post*.

Since the rate of multilateral tariff reduction will be determined by that group which prefers the smallest multilateral reduction, look at each group individually. Leaders are the countries whose exporters are most able to compete. They can make the most use of foreign market access and so would probably be most willing to give up something for it. Laggards, by contrast, are the countries whose import-competing firms are taking it on the chin from the technological leaders, but they do benefit from cheaper imports. Followers are at a disadvantage in competing with the exporters of the leaders and do not obtain cheaper imports.

The bottom line is that, *ex post*, the leaders should want the largest tariff reduction, followed by the laggards, with the followers the most reluctant liberalizers.

Consider the possible use, by the countries that turn out to be laggards, of unilateral escape mechanisms. They would not employ them were they confident that such use would prompt retaliation: The withdrawal of equivalent concessions would result in a roll-back of negotiated tariff reductions which are already less than what they want *ex post*. So, the unilateral escape mechanisms must be fashioned in such a way as not to cause retaliation.

Look first at the leaders. Allowing them to capture the rents generated by the mechanisms may prevent them from retaliating. They need not be fully compensated for their loss of market access, just compensated enough so that they are not tempted to forsake the compensation by retaliating instead. Furthermore there will be another source of compensation, if these mechanisms allow a higher rate of tariff reduction to be negotiated (more on this below). This unambiguously benefits the leaders, who *ex post* want more liberalization.

Next consider the followers. They compete, at a disadvantage, with the leaders in the import markets of the laggards. Thus the rents associated with the use of unilateral escape mechanisms by the latter are worth much less to the followers than to the leaders. Also, they would not gain from an increase in the negotiated rate of tariff reduction, already what they most prefer *ex post*. So these countries would retaliate. Furthermore, the increase in the negotiated rate of reduction that could be the second source of compensation for the leaders will not in fact take place; indeed, that rate may well decrease.

For this reason, the unilateral escape mechanisms must necessarily be discriminatory. If the measures apply to the leaders but not to the followers, the latter will have nothing to retaliate against. The mechanisms will instead enhance the ability of the followers to compete in the markets of the laggards. Consequently they will now prefer a greater common rate of tariff reduction: The negotiated tariff reduction will increase, further compensating the leaders. It will also benefit the laggards, who *ex post* want more *reciprocal* liberalization, giving them an incentive to employ the escape mechanisms.

But this brings up another problem. From the viewpoint of those who negotiate trade agreements, the actual rate of liberalization is less than that desired, *ex post*, by the laggards: A little more protection will harm exporters more than it will benefit import-competing interests. Thus the use of unilateral escape mechanisms by the laggards would produce a protective effect harmful to themselves (again, from the viewpoint of those who negotiate trade agreements). Of course this could be less than the benefit from the higher negotiated rate of reciprocal liberalization. But, even so, there will be a *time-consistency* problem: When the laggards are to utilize the escape mechanisms, the trade negotiations will be past history. Nor would the negotiators be willing irrevocably to delegate authority to utilize unilateral escape mechanisms to a more protectionist agent: the higher negotiated liberalization that constitutes the benefit to the laggards is the result of the laggards *collectively* employing escape mechanisms. The negotiators of any individual country would prefer that country to free-ride whenever it became a laggard. Thus the crucial relevance of the third stylized characteristic of unilateral escape mechanisms, that they “are designed by officials distinct from those who negotiate international trade agreements.”

That protectionist tools, such as escape mechanisms, might provide insurance is not a new idea: See Eaton and Grossman (1985), Staiger and Tabellini (1987), and Dixit (1987, 1989).

What is distinctive about the above argument is that it is grounded in the underlying logic of multilateral liberalization. This is reflected in four of its subtleties.

- The multilateral escape mechanisms, by ensuring that the pace of liberalization equals that of the countries that, *ex post*, are the most reluctant liberalizers, establishes the potential for the beneficial use of unilateral escape mechanisms.

- This beneficial potential arises from a subtle insurance-like relation between three groups of countries, what I have elsewhere[4] referred to as the *insurance triangle*: the countries that turn out to be laggards utilize escape mechanisms that are acceptable to the *ex post* leaders and beneficial to the followers, thereby increasing the rate of liberalization desired *ex ante* by all.

- Discrimination is essential to the insurance triangle, in sharp contrast to the central role of nondiscrimination in the GATT-WTO system.[5]

- The fact that the use of unilateral escape mechanisms by the laggards features a time-consistency problem compounded by a free-rider problem requires that these mechanisms be designed by officials distinct from those who negotiate international trade agreements. This in turn generates the *complementarity problem*: The mechanisms may be designed in such a way as to encourage liberalization, or they may not. The WTO codes of conduct for unilateral escape mechanisms may be interpreted as responses to this problem.

IV. Entry Mechanisms

Entry mechanisms were of marginal significance during much of the history of the GATT. Developing countries either remained outside the GATT or adopted inactive roles within it; the communist world was firmly outside. All this changed dramatically about fifteen years ago when developing countries in droves turned their backs on import substitution and most

[4]Related arguments can be found in Ethier (1998c, 2001a,b, 2002).

[5]For the latter, see Bagwell and Staiger (1999) and Ethier (1999).

communist countries ceased to be communist. All have struggled to implement economic reform including, especially, achieving full participation in the multilateral trading system. Entry mechanisms are now crucial.

One obvious mechanism is the procedure by which countries negotiate membership into the WTO: This is analogous to the *multilateral* escape mechanisms discussed above. There are also analogs to the *unilateral* mechanisms: the efforts of individual reforming countries to encourage international trade and foreign investment by reducing trade barriers and developing institutions conducive to trade. This is all quite obvious. Much less understood and appreciated is a third set of mechanisms: regional trade agreements.

Reforming countries believe that, for reform to succeed, they must attract significant foreign direct investment: Multinational firms are a prime means of technology transfer, and can supply international contacts and modern commercial methods to countries whose past policies have left them with little of either. But there are two potential pitfalls. *First*, since many similar countries are attempting reform at about the same time, they are competitors for foreign direct investment. That is, a reforming country needs to distinguish itself from its rivals. *Second*, a major concern of potential investors is that the reforms not be undone in the future. That is, the reformers need to *bind* future regimes to the reforms.

Competition among reforming countries to attract foreign direct investment is keen. A small national advantage offers the hope of attracting a large amount of foreign direct investment. There are three mutually reinforcing reasons for this. First, with similar countries competing, small advantages can prove decisive. Second, direct investment is lumpy: you have to put a factory in one place. Third, the basic advantages that reforming countries see in direct investment involve externalities, and these externalities render a site more attractive for additional direct investment. Multinational firms are tempted to invest in the potential reformers, to take advantage of the latter's comparative advantages, but they have substantial latitude in where to invest, since there are many reformers with fairly similar economic characteristics. However, they will tend to locate together, because of the lumpy nature of direct investment and because of positive externalities between foreign subsidiaries.

Under these circumstances, successful reform by an individual country, always uncertain, will be more probable the greater the aggregate amount of direct investment it can attract. Thus its prospects will be improved if a reforming country can somehow distinguish itself from its rivals.

Regional trade agreements play a key role here.

Regional trade agreements as entry mechanisms

Regionalism has followed a curious history since World War II. Numerous regional arrangements in the 1950s and 1960s (the "old regionalism") were followed by a period of quiescence, succeeded in turn by frenetic activity (the "new regionalism") beginning in the late 1980s and continuing today. Our theory of regionalism, based on the Vinerian distinction between trade creation and trade diversion, was developed in response to the earlier episode and blindly applied to the latter.[6]

What the application of "old-regionalism theory" to the new regionalism ignores is that the world has changed dramatically since the 1950s-60s. In particular, trade barriers are very much lower now (with low barriers even a huge amount of trade diversion need not mean much, from a welfare perspective), direct investment is vastly more important, and the larger part of the world—determinedly aloof from the multilateral system in the earlier period—is now desperately trying to join it.

Especially interesting is the fact that the simultaneous decisions of many less developed and formerly communist countries to try to join the multilateral system coincided with the emergence of the new regionalism. This suggests a possible causal relation,[7] the central focus of "new-regionalism theory."

To pursue this further, consider a simple abstract model of many developed countries, linked in a multilateral trading system, and many, similar, less developed countries, initially aloof from that system. The developed countries trade manufactures among themselves; the less developed countries have a comparative advantage in the labor-intensive stages of the production of those manufactures, but, with these countries outside the multilateral system, this advantage is not being exploited.

Suppose that cumulative trade liberalization among the developed countries has made participation in the multilateral system attractive to the less-developed countries, who now undertake reform. This reform consists of reducing trade barriers and allowing inward foreign direct investment by developed-country firms to undertake the labor-intensive stages of manufacturing production. To highlight the crucial role of such investment, assume that a country's reform program succeeds if and only if that country attracts some direct investment.

Such a country can choose between two paths of attempted reform. It can take the *nondiscriminatory* route of adopting the common multilateral tariff and participating in subsequent multilateral negotiations. Alternatively, it can attempt to negotiate a regional arrangement with some developed country (and participate in subsequent multilateral negotiations). I define such a regional agreement as follows.

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[6]For "old-regionalism theory" see Bagwell and Staiger (1997A,B), Baldwin and Venables (1995), Bhagwati, Krishna, and Panagariya (1999), and Bond and Syropoulos (1996).

[7]For more detail about this and about "new-regionalism theory," see Ethier (1998a,b,c).

An agreement between one developed country and one would-be reforming country in which:

The developed country commits—

- *To the details of an attempted reform,*
- *To give the goods of its partner preferential treatment;*

The reforming country commits—

- *To make a* small *reduction in the duty applicable to goods imported from its partner country.*

Note that this definition depicts regionalism as one or more small, reforming, countries linking up with a large developed country in an arrangement characterized by asymmetrical concessions and deep integration. This is just what characterizes the new regionalism.

Suppose for simplicity that each potential reformer regards the products of all developed countries as perfect substitutes. Together with my other assumptions, this removes the possibility of negative welfare effects from trade diversion. But this is a pertinent oversimplification. The historical success of the developed countries in reducing trade barriers makes trade diversion—even if very large in magnitude, as high substitution would suggest—of much less welfare significance.

Consider first the effects of such an arrangement on a potential reformer. The trade preference implies trade diversion to the partner country, though this does not matter. But the preference granted by the developed-country partner, though only marginal, does matter. From the point of view of firms considering direct investment to provide labor-intensive inputs for the developed-country partner's products, all reforming countries are equivalent, except for this marginal preference. So it attracts all of this investment, and this *investment diversion* ensures the reform will succeed.

This is why reforming countries find regional arrangements attractive even though they typically receive only "minor" concessions from their partners. The goal is to compete with other *similar* countries for direct investment, not to expand greatly exports to their partners or to attract from them direct investments that would otherwise not be made at all. Such *investment creation* will be modest at best.

But regional arrangements are not the only way reforming countries can compete for direct investment. They might also offer subsidies, tax holidays, and the like. Here is where the second potential pitfall comes in.

One way—sometimes the only way—to bind future regimes to the reforms is to establish an external commitment. The more likely is backsliding from an external commitment to induce retaliation, the more likely is such a commitment to sustain reform. The more that specific reform measures are embodied in an external commitment, the likelier that commitment is to sustain reform. Multilateral negotiations are of little practical use in furnishing a commitment. They provide no enforcement mechanism should a country backslide, and developed countries would not put the multilateral system at risk merely to punish a single deviant reformer. Even if they wanted to punish they are likely to have little formal justification for doing so, since multilateral agreements would not embody detailed reform measures by individual countries.

But regional arrangements can address both problems. An agreement with a large country (often the dominant trading partner) adds a credible enforcement mechanism. Because such arrangements allow for deep integration, they can contain obligations to undertake specific measures central to the reform effort. This commitment aspect gives regional arrangements a unique role in the competition for direct investment between reforming countries.

An individual regional arrangement, however, will not be uniformly beneficial. Other reforming countries will suffer. Suppose a country that would try reform anyway enters into a regional arrangement. Then direct investment producing labor-intensive intermediate goods for that country's partner will all be diverted there, and the country still remains a potential host for other direct investment. So less direct investment remains for other reforming countries, reducing their prospects for success and perhaps deterring some of them from even attempting reform. Regionalism can produce *reform destruction*, causing fewer countries to attempt reform and lowering the proportion of those who succeed. On the other hand, the country with the regional arrangement may not itself have attempted reform in its absence: *reform creation*. So the number of reforming countries may either rise or fall.

But it would be a mistake to consider only the effects of an isolated regional arrangement when they are in fact becoming ubiquitous. So consider the general equilibrium that will emerge if all countries are allowed freely to negotiate regional arrangements, including the possibility of a single country entering multiple relationships.

If several reformers establish regional arrangements with a single developed country, the value of the arrangements to the former will be eroded since direct investment may well cluster mainly in some subset of them all. For this reason, the reforming countries will spread themselves out in their choices of partners. If there are at least as many developed countries as potential reformers, each of the latter can find a partner that will guarantee the success of its reform effort. This may or may not be true if there are fewer developed countries, depending upon the amount of direct investment forthcoming. Nevertheless, the ability to enter freely into regional arrangements will maximize the extent and the probability of successful reform, and, by doing so, also maximize the number of countries that are induced to attempt reform.

The global interest calls for successful reform to be as widespread as possible. This will maximize the multilateral trading system, accentuating both the benefits that it generates and the number of nations which receive those benefits. But this global externality will be ignored by multinational firms, who would cluster their foreign investments together. A single regional arrangement may be either good or bad by itself. But this regional general equilibrium will in effect internalize the global externality and produce an outcome unambiguously superior to what can be achieved without regionalism as an entry mechanism.

V. Concluding Remarks

The basic argument of this paper can be summarized as follows.

- Escape mechanisms from trade agreements are necessary because such agreements are incomplete, self-enforcing, contracts negotiated when the future is unknown.
- There is a presumption that the principle of *equivalent withdrawal of concessions*, the essence of multilateral escape mechanisms, allows trade agreements to result in efficient outcomes.
- The principle of equivalent withdrawal of concessions implies that realized liberalization will be at the pace preferred by those countries who, *ex post*, are the most reluctant liberalizers.
- This in turn implies a possibly beneficial role for unilateral escape mechanisms featuring discrimination and partial compensation for restricted exporters (the *insurance triangle*).
- The presence of time-consistency and free-rider problems implies that actual unilateral escape measures may not be desirable from the point of view of trade liberalization (the *complementarity problem*).
- The fact that a large part of the globe, hitherto aloof from the multilateral trading system, is now actively trying to join it generates a critical need for entry mechanisms.
- These reforming countries are competing with each other for foreign direct investment, which they see as key to successful reform.
- Regional trade agreements provide entry mechanisms that, by internalizing a key externality, maximize the extent of successful reform by "spreading out" direct investment.

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