EC246-2-AU – Lecture 4

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Preferential Arrangements: Theory and Realities

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Plan of talk

- **Introduction**

1. **Theory of Preferential Arrangements**
    1. Forms and Rationale
    2. Welfare Effects
        1. Trade creation
        2. Trade diversion
2. **Preferential Arrangements in Practice**
    1. EU
    2. NAFTA
    3. CMEA (ComEcon)

- **Wrap-up**

Aim and learning outcomes

- **Aim**: take a closer look at preferential arrangements and regional issues in trade policy and illustrate their welfare effects by the most prominent “case studies”
- **Learning outcomes**
  - understand the rationale behind preferential arrangements
  - distinguish their forms
  - analyse their welfare effects
  - describe their historical and regional evolution
  - argue why they co-exist with multilateral trade liberalisation

Preferential arrangements: forms

- **Definition**: *inside* no tariff barriers, *outside* yes
- **Forms**
  1. *Free Trade Area (FTA)*: free movement of *goods* inside
  2. *Customs Union*: 1. + *common* external tariff
  3. *Common Market*: 2. + free movement of *factors* of production inside
  4. *Economic (and Monetary) Union*: 3. + *coordinated/unified* (macro-/micro-)economic (and social) *policies* inside
- Clearly **discriminatory**: recall MFN and GATT
- But **offsetting virtues**: hence, *exception* under GATT

Preferential arrangements: rationale

- Up to now: pattern of ***a* country's trade** => Ricardo
- Today: address the *volume* and *composition* of trade (exports + imports) flows between ***pairs* of countries**
- The **gravity equation**: focus on *two* key determinants
  - economic *size* of each country
  - transportation costs as a function of *distance* b/n countries

  Frankel's (1997) *summary* of the gravity model: implications

$$\ln\left(T_{ij}\right) = 0.7\ln\left(GNP_i GNP_j\right) + 0.3\ln\left(\frac{GNP_i}{Pop_i}\frac{GNP_j}{Pop_j}\right) - 0.7\ln\left(Dist_{ij}\right)$$

Trade creation and trade diversion

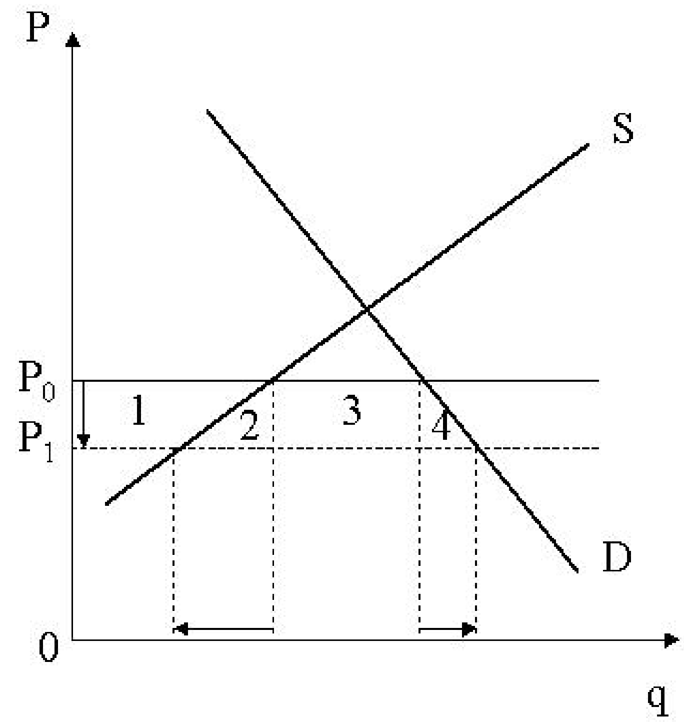
- Preferential arrangements are **complex** => interesting
- They *both*
  - **liberalise** trade: inside, by lower or zero restrictions
  - **distort** trade: b/n inside and outside, by forcing inside consumers to pay different prices for identical goods at the same (inside) market location depending on product origin
- Jacob Viner, *The Customs Union Issue*, 1950

  1st *formal* analysis that tariff preferences can
  - either **improve** allocations
  - or **worsen** them

Trade creation

- CFJ, Figure 14.1 (next slide) – **assumptions**:
  1. *A* and *B* *inside* the union
  2. *B* the *most efficient world producer* of good *x*
  3. *B* the *sole world exporter* of good *x*
  4. *x* is produced in *B* under conditions of *perfectly elastic supply* $\Leftrightarrow$ an unlimited quantity of *x* is available at its price
  5. *C* (the rest of the world) remains *outside* the union
- CFJ, Figure 14.1 – just the **inverse** logic of CFJ, Figure 10.1: welfare effects of imposing a *tariff*
- 2+4: *net* **benefit** from trade creation $\leftrightarrow$ deadweight loss

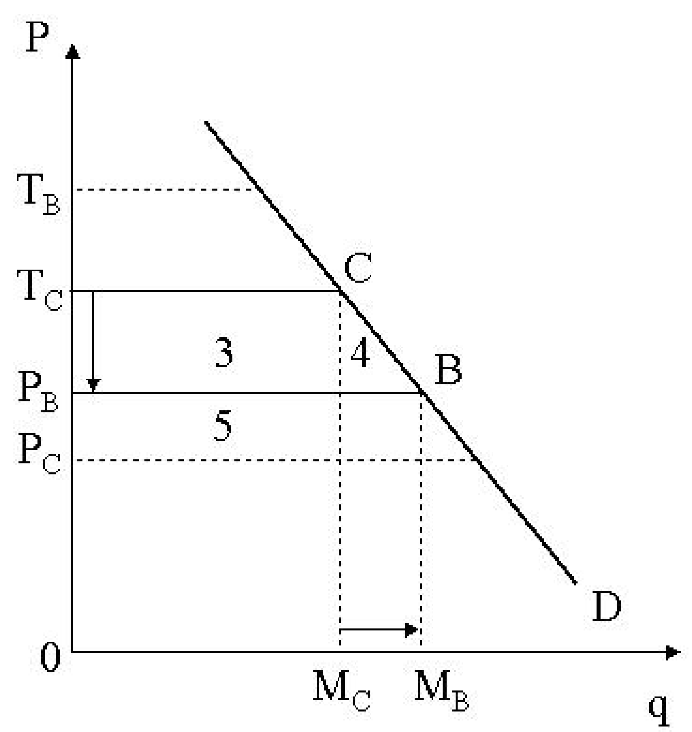
Trade creation – graph



Trade diversion

- CFJ, Figure 14.2 (next slide) – **assumptions**:
  1. *A inside* and *C outside* the union
  2. *C* the *most efficient world producer* of *another* good *y*
  3. *y* is produced in *C* under conditions of *perfectly elastic supply* ⇔ an unlimited quantity of *y* is available at its price
  4. *B* can *also* produce (and export) *y*…
  5. … not as efficiently as *C* but *efficiently enough to undercut C* in *A*'s market *when C* pays a *tariff* but *B* not (since it is *inside* the union)
- *If* area 5 > area 4: *net* welfare **loss** from trade diversion

Trade diversion – graph



The ToT channel: income redistribution

- Recall the **Prebisch-Singer** thesis
- **Here**, the ToT channel again: Viner's analysis of trade creation vs diversion implicitly assumes that **ToT do not** change via the *perfectly elastic supply of imports* (for A, and of exports, for B, C)
- **Redistribution** of *real* income induced by
  - insider(s) vs *outsider(s)* (in a given union) ToT movements
  - insider vs *another insider* (in a given union) ToT movements
- Countries could pick partners inside preferential arrangements to extract ToT gains: what *tariff structure* would maximize their **joint monopoly gain** over the products exported?

European Union: a sketch of key dates

- **1957: EU6** (F, D, I, NL, B-L)
- 1968: staged reductions in inside **tariffs** completed
- 1985: EC made a list of **300 NTBs** => obstacles to intra-EU entry
  - product-safety standards: e.g. childen's toys, oxygen tanks
  - licensing of professions: e.g. accountants, nurses
  - protection of the financial sector: banks and other financial companies
- 1988: nontariff restrictions scheduled to be removed by 1992
- **1992**
  - most NTBs removed but some still remain, e.g. technical standards
  - **Maastricht Treaty** establishing **EMU**: commitment to long-run economic and political convergence
- 1995: EU12 to EU15 (3 former EFTA member countries join)
- 1999: **euro** introduced as common currency
- **2004: EU25**, biggest ever member-country increase
  - 10 new countries
  - of which 8 (Central and) Eastern European economies in transition

Trade creation and diversion in EU

- **Mordechai Kreinin**, *Trade Relations of the EEC: An Empirical Investigation*, 1974
  - how to detect trade creation and trade diversion in the **data**?
  - by looking at *changes* in the **sources of supply** of manufactures in EU countries
  - Kreinin used
    - the **reduced** share of each EU country's consumption of manufactures supplied by its *domestic* producers to identify/approximate trade **creation**
    - the **increased** share of EU countries' imports coming from exporters of EU *partner countries* to identify/approximate trade **diversion**
  - and found that in 1969-1970 EU caused trade *diversion* of $ 1.1 billion vs trade *creation* of $ 8.4 billion => huge positive net effect
- **Gravity model estimates**: in 1970-1990 EU members traded with each other 36% more than otherwise similar nonmembers

NAFTA: the original agreement

- 1987: **US and Canada** negotiated a FTA
- 1989: a removal over a decade of all tariffs and quotas on most goods and services began
- Geographical proximity and substantial levels of pre-FTA protection in Canada imply **important effects**
  - US-Canada bilateral trade is by far the world's largest
  - US trade with Canada is 21% of US total trade
  - Canada's economy is ≈ 1/10 the size of the US one => Canada gets proportionally larger benefits, for 2 reasons
    1. being smaller, Canada takes advantage of trade at "alien" set of prices, so that formerly distorted relative prices (due to protection) are invalidated
    2. scale economies from freely entering the immense US market

NAFTA: the enlarged agreement

- 1992: US-Mexico and Canada-Mexico negotiated similar bilateral FTAs => **NAFTA** in effect since 1994
- US as the biggest industrial economy and Mexico as a large developing economy => because of so **different endowments**, a huge scope for trade diversion
- Experience with NAFTA hard to interpret: how to isolate **effect?**
  - Mexico lowered tariffs and NTBs in 1985-1994 and a currency crisis occurred in 1994 => large effects on trade
  - share of US exports to Mexico and Canada ↑, Mexican imports to US ↑ too => evidence for trade creation
  - US substituted East Asian imports with Mexican ones =>trade diversion
  - Anne Krueger, NAFTA's Effects: A Preliminary Assessment, *The World Economy*, 2000: Mexican exports also ↑ to other destination markets…

CMEA (ComEcon): post mortem

- **Rationale**
  - because of political reasons during the early stages of the Cold War
  - ex-socialist countries wished to achieve *self-sufficiency* within their “camp”
  - which isolates them from the uncertainties in world markets
- **1949**
  - *administered trade* imposed
  - through an international organisation of communist countries, the **Council for Mutual Economic Assistance (CMEA)**, also known as ComEcon
  - *in-CMEA national specialisation* pursued via long-term planning
- **1991**: CMEA **dissolved**, as transition to market advanced

CMEA: 3 grave defects

1. **No relation of production** (capacities) **to** final **demand**
   - consumers were not free to make choices
   - a 5-year central plan determined what quantities to produce and how much, prices had no true role as there were no real markets =>
   - heavy industrialisation achieved at distorted prices (of oil, steel and other basic materials)
2. Suppliers simply filled in their planned quotas, **no marketing** or any attention to customers tastes at all
3. State enterprises had **little incentive to be efficient**: labour could not be discharged, managers did not have a direct stake in the firm => productivity and quality were both low

Concluding wrap-up

- **What have we learnt?**
  - Why preferential agreements co-exist with multilateral trade liberalisation
  - What their welfare effects are in theory and in practice
  - What their forms are, with historical examples:
    - EU
    - NAFTA
    - CMEA (ComEcon)
- **Where we go next**: to the late GATT rounds and their response to the disarray of world agricultural markets