Lecture 24
Economics 181: International Trade
Trade Policy instruments, continued
Introducing Regional Trade Blocs

I.   Tariffs in general equilibrium (small country case)
- Partial equilibrium analyses like those we have been doing miss the impact on other sectors
- In general equilibrium, we can see that an import tariff on one sector acts as an export tax on the other sector. You miss this in partial equilibrium.
- See appendix to chapter 8 in your text for further details.

II.   The Softwood Lumber agreement with Canada (see Tuesday's notes)
III.   Regional Trading Blocs: An Introduction

Definitions
* Free Trade Area (FTA): Internal tariffs and quotas eliminated but keep original tariffs against the rest of the world. NAFTA is an example of an FTA.
* Customs Union: Internal barriers are removed, and a common external tariff is agreed upon (CARICOM, MERCOSUR)
* Common market: This goes beyond a customs union to also remove barriers on factor movements (ie labor and capital). The EEC is an example of a common market.

The basic economic analysis of regional trading agreements is based on the concept of trade creation and trade diversion. The intuition is as follows: these agreements are welfare enhancing if they encourage more trade with the least cost producers of the good. These arrangements are welfare worsening if they divert trade to members of the union who are less efficient than those outside the union. In both cases, there will be more trade within the region once the union is formed. However, with trade diversion, this is "bad".

See the diagrams below. Country A starts out with initial tariff to against countries B and C. It forms a union with B and they agree on a common tariff against C given by t1.

(I).   Case $P_B < P_c$.

Then $P_B(1+t_0) < P_c(1+t_0)$ and $P_B < P_c(1+t_1)$, i.e., B is this supplier before and after union. Trade expands and can occur at true opportunity cost. Net gain = Cons. surplus gained – Tariff revenue lost. This is <u>trade creation</u>.
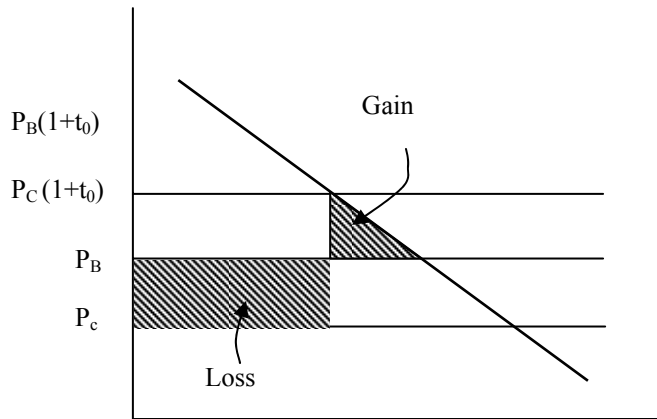
CASE I: Trade Creation
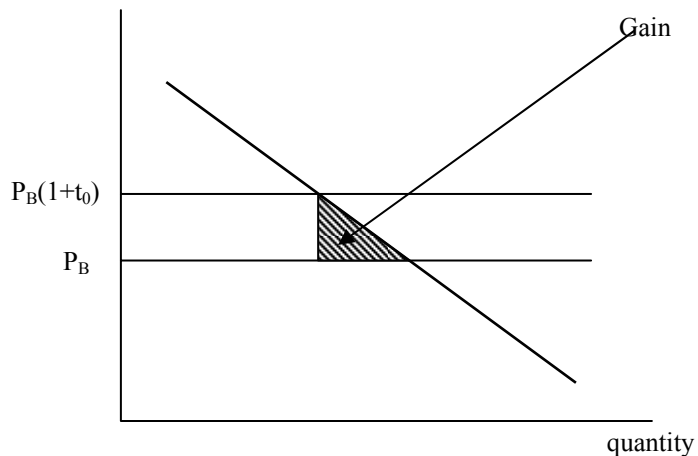
(II).   Case $P_c < P_B < P_c(1+t_1)$

The supplier switches from C to B, i.e., <u>trade diversion</u>. Possible gain to consumers from
lower price must be set against higher cost of buying from .B. The case in the Figure shows a net loss.

CASE II: Trade Diversion leads to an ambiguous impact on welfare.

When is trade creation more likely?

        * The union covers many countries
        * The tariffs imposed on those outside the union are kept low.

What are other gains from these unions (aside from the above welfare gains)

        (1) Increased competition for those in the union.
        (2) Increased benefits from a large market: economies of scale
        (3) Lower transaction costs (ie border controls, transport costs)
        (4) More negotiating power vis-vis third parties
        (5) Terms of trade gains
        (6) Joint projects like communications
        (7) Greater product diversity

        <u>Implications for Business Strategy</u>

        (1)   If you are outside the regional agreement, need to make sure you will not be shut
                out when internal tariffs fall and make your goods artificially more expensive (ie
                trade diversion). In that case, it may make sense to move in via foreign
                investment (joint venture or subsidiary) if the region constitutes a large share of
                your export market.
   •   Investment in Europe with EC '92
   •   Auto Investment in Brazil with MERCOSUR
   •   Costs to Caribbean competitors with NAFTA

        (2)   If you are already inside, you could still lose from the additional competition.
                You may need to restructure to face the additional competition.

        (3)   As an outsider to the bloc (Japan, the developing countries vis-a-vis NAFTA and
                the EEC) it makes sense to try to keep blocs from growing or to form your own
                bloc in "retaliation".