

Lecture 23
EEP/Economics C181: International Trade
Trade Policy instruments, continued
Introducing Regional Trade Blocs

I. 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.

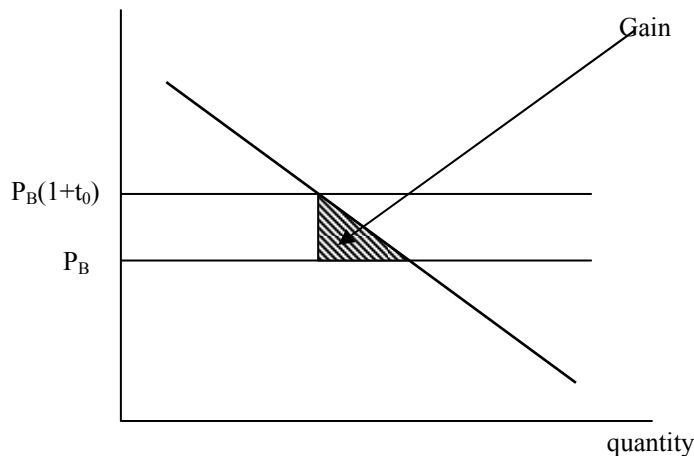
The basic economic analysis of regional trading agreements is based on the concept of trade creation and trade diversion. The intuition is as follows: these agreements are welfare enhancing if they encourage more trade with the least cost producers of the good. These arrangements are welfare worsening 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 t_1 .

(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 trade creation.

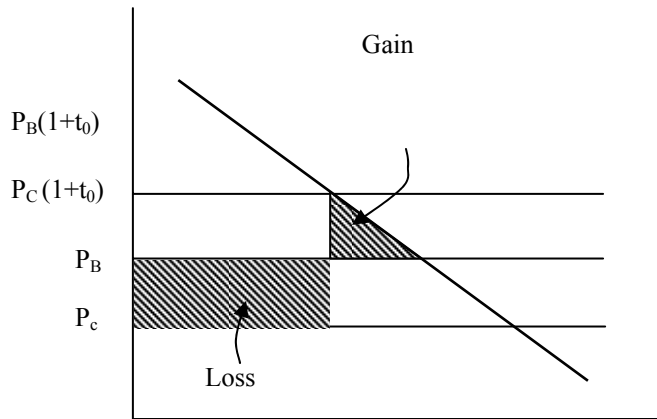
CASE I: Trade Creation



(II). Case $P_c < P_B < P_c(1+t_1)$

The supplier switches from C to B, i.e., trade diversion. 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

Implications for Business Strategy

- (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. Examples:
 - Investment in Europe
 - 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".

II. A numerical example of trade creation versus diversion

III. Some data on regional trade blocs

IV. A discussion on the gains for Mexico and the USA from NAFTA (if time)

Merchandise exports within bloc

	% of total bloc exports									
	1970	1980	1990	1995	1997	1998	1999	2000	2001	2002
High-income and low- and middle-income economies										
APEC ^a	57.8	57.9	68.3	71.8	71.6	69.7	71.8	73.1	72.6	73.3
CEFTA	12.9	14.8	9.9	14.6	13.4	13.0	12.1	12.2	12.4	12.2
European Union	59.5	60.8	65.9	62.4	55.4	56.8	62.9	61.6	60.8	60.6
NAFTA	36.0	33.6	41.4	46.2	49.1	51.7	54.6	55.7	55.5	56.7
Latin America and the Caribbean										
ACS	9.6	8.7	8.4	8.5	7.0	7.2	5.6	6.4	6.5	7.1
Andean Group	1.8	3.8	4.1	12.0	10.8	12.8	8.8	7.9	10.3	9.5
CACM	26.1	24.4	15.3	21.8	18.7	15.8	13.6	14.8	15.5	11.1
CARICOM	4.2	5.3	8.1	12.1	14.4	17.3	16.9	14.7	14.0	12.5
Central American Group of Four	20.1	18.1	13.7	22.2	20.2	17.1	14.6	15.1	14.8	12.8
Group of Three	1.1	1.8	2.0	3.2	2.7	2.6	1.7	1.7	2.1	1.8
LAIA	9.9	13.7	10.8	17.1	17.0	16.7	12.7	12.8	12.8	11.1
MERCOSUR	9.4	11.6	8.9	20.3	24.8	25.0	20.6	20.8	17.2	11.6
OECS	..	9.1	8.1	12.6	10.7	12.0	13.1	10.0	5.3	3.8
Africa										
CEMAC	4.8	1.6	2.3	2.1	2.0	2.3	1.7	1.0	1.3	1.5
CEPGL	0.4	0.1	0.5	0.5	0.4	0.6	0.8	0.8	0.8	0.7
COMESA	8.7	6.0	6.3	7.0	7.1	7.7	7.4	5.7	7.0	6.4
Cross-Border Initiative	9.3	8.8	10.3	11.9	12.7	13.9	12.1	10.6	10.0	10.2
ECCAS	9.6	1.4	1.4	1.5	1.5	1.8	1.3	1.1	1.3	1.3
ECOWAS	2.9	10.1	7.9	9.0	8.6	10.7	10.4	9.5	9.6	10.6
Indian Ocean Commission	8.4	3.9	4.1	6.0	3.9	4.7	4.8	4.2	5.5	5.3
MRU	0.2	0.8	0.0	0.1	0.5	0.1	0.4	0.4	0.3	0.2
SADC	8.0	2.0	4.8	8.7	10.4	10.4	11.9	11.9	10.2	9.3
COMESA	4.9	1.6	2.3	2.1	2.0	2.3	1.7	1.0	1.3	1.5
UDEAC	4.9	1.6	2.3	2.1	2.0	2.3	1.7	1.0	1.3	1.5
UEMOA	6.5	9.6	13.0	10.3	11.8	11.0	13.1	13.1	14.3	12.3
Middle East and Asia										
Arab Common Market	2.2	2.4	2.7	6.7	4.1	4.8	3.3	3.0	4.5	4.8
ASEAN	22.9	18.7	19.8	25.4	24.9	21.9	22.4	23.9	23.3	23.7
Bangkok Agreement	2.7	3.7	3.7	5.0	5.1	5.0	5.1	5.1	5.5	5.6
EAEG	28.9	35.6	39.7	47.9	47.8	42.0	43.8	46.6	46.6	48.2
ECO	1.5	73.2	3.2	7.9	7.5	6.8	5.8	5.6	5.5	5.9
GCC	2.9	3.0	8.0	6.8	6.5	8.0	6.7	4.5	4.5	4.6
SAARC	3.2	4.8	3.2	4.4	4.2	4.8	4.0	4.1	4.3	4.2
UMA	1.4	0.3	2.9	3.8	2.7	3.3	2.5	2.3	2.6	2.7

and Zimbabwe; **Cross-Border Initiative**, Burundi, Comoros, Kenya, Madagascar, Malawi, Mauritius, Namibia, Rwanda, Seychelles, Swaziland, Tanzania, Uganda, Zambia, and Zimbabwe; **Economic Community of Central African States (ECCAS)**, Angola, Burundi, Cameroon, the Central African Republic, Chad, the Democratic Republic of the Congo, the Republic of Congo, Equatorial Guinea, Gabon, Rwanda, and São Tomé and Príncipe; **Economic Community of West African States (ECOWAS)**, Benin, Burkina Faso, Cape Verde, Côte d'Ivoire, the Gambia, Ghana, Guinea, Guinea-Bissau, Liberia, Mali, Mauritania, Niger, Nigeria, Senegal, Sierra Leone, and Togo; **Indian Ocean Commission**, Comoros, Madagascar, Mauritius, Reunion, and Seychelles; **Mano River Union (MRU)**, Guinea, Liberia, and Sierra Leone; **Southern African Development Community (SADC; formerly Southern African Development Coordination Conference)**, Angola, Botswana, the Democratic Republic of the Congo, Lesotho, Malawi, Mauritius, Mozambique, Namibia, Seychelles, South Africa, Swaziland, Tanzania, Zambia, and Zimbabwe; **Central African Customs and Economic Union (UDEAC; formerly Union Douanière et Economique de l'Afrique Centrale)**, Cameroon, the Central African Republic, Chad, the Republic of Congo, Equatorial Guinea, and Gabon; **West African Economic and Monetary Union (UEMOA)**, Benin, Burkina Faso, Côte d'Ivoire, Guinea-Bissau, Mali, Niger, Senegal, and Togo; **Arab Common Market**, the Arab Republic of Egypt, Iraq, Jordan, Libya, Mauritania, the Syrian Arab Republic, and the Republic of Yemen; **Association of South-East Asian Nations (ASEAN)**, Brunei, Cambodia, Indonesia, the Lao People's Democratic Republic, Malaysia, Myanmar, the Philippines, Singapore, Thailand, and Vietnam; **Bangkok Agreement**, Bangladesh, India, the Republic of Korea, the Lao People's Democratic Republic, the Philippines, Sri Lanka, and Thailand; **East Asian Economic Caucus (EAEC)**, Brunei, China, Hong Kong (China), Indonesia, Japan, the Republic of Korea, Malaysia, the Philippines, Singapore, Taiwan (China), and Thailand; **Economic Cooperation Organization (ECO)**, Afghanistan, Azerbaijan, the Islamic Republic of Iran, Kazakhstan, the Kyrgyz Republic, Pakistan, Tajikistan, Turkey, Turkmenistan, and Uzbekistan; **Gulf Cooperation Council (GCC)**, Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates; **South Asian Association for Regional Cooperation (SAARC)**, Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan, and Sri Lanka; and **Arab Maghreb Union (UMA)**, Algeria, Libya, Mauritania, Morocco, and Tunisia.

a. No preferential trade agreement.



6.6

Regional trade blocs

Merchandise exports within bloc

	Year of creation	Year of entry into force of the most recent agreement	Type of the most recent agreement ^a	\$ millions						
				1990	1995	2000	2003	2004	2005	2006
High-income and low- and middle-income economies										
APEC ^b	1989		None	901,560	1,688,708	2,261,791	2,436,516	2,924,291	3,309,117	3,763,569
CEFTA ^c	1992	1994	FTA	322	2,886	2,136	3,147	3,915	5,382	6,474
CIS	1991	1994	FTA	..	31,529	28,753	38,576	43,446	59,423	66,583
EEA	1994	1994	EIA	1,070,201	1,444,732	1,680,468	2,175,403	2,589,764	2,780,586	3,142,002
EFTA	1960	2002	EIA	782	925	831	967	1,128	1,252	1,524
European Union ^e	1957	1958	EIA, CU	1,022,933	1,385,805	1,608,174	2,087,311	2,482,418	2,649,078	2,987,188
NAFTA	1994	1994	FTA	226,273	394,472	676,141	651,060	737,591	824,550	902,085
SPARTECA	1981	1981	PS	4,737	8,535	8,139	10,864	13,047	14,413	14,531
Trans-Pacific SEP	2006	2006	EIA, FTA	1,110	2,614	1,438	1,621	2,096	2,345	2,927
Latin America and the Caribbean										
Andean Community	1969	1988	CU	1,312	4,812	5,293	5,064	7,619	8,676	11,300
CACM	1961	1961	CU	667	1,594	2,586	3,156	3,574	4,064	5,022
CARICOM	1973	1997	EIA	456	877	1,078	1,419	1,746	2,090	2,429
LAIA (ALADI)	1980	1981	PS	13,350	35,986	44,252	40,425	57,732	71,711	91,651
MERCOSUR	1991	2005	EIA	4,909	16,811	20,082	13,765	19,675	24,211	30,902
OECS	1981 ^d	1981 ^d	NNA	29	39	38	48	60	68	84
Middle East and Asia										
ASEAN	1967	1992	FTA	27,365	79,544	98,060	116,831	141,934	165,169	194,321
Bangkok Agreement	1975	1976	PS	2,429	21,728	37,895	70,845	99,369	127,277	150,545
EAEC	1997	1997	CU	..	13,556	15,467	19,933	17,291	27,297	27,930
ECO	1985	2003 ^d	PS	1,243	4,746	4,518	7,468	9,989	13,936	19,053
GCC	1981	2003	CU	6,906	6,832	7,954	9,915	12,532	16,507	20,050
PAFTA (GAFTA)	1997	1998	FTA	13,204	12,948	16,140	21,918	35,328	44,468	54,862
SAARC ^g	1985	1995	PS	863	2,024	2,680	4,954	5,830	7,266	9,109
UMA	1989	1994 ^d	NNA	958	1,109	1,094	1,338	1,375	1,926	2,400
Sub-Saharan Africa										
CEMAC	1994	1999	CU	139	120	96	146	174	198	245
COMESA	1994	1994	FTA	1,164	1,390	1,448	2,041	2,427	2,869	3,546
EAC	1996	2000	CU	230	530	595	706	750	857	1,059
ECCAS	1983	2004 ^d	NNA	163	163	191	198	240	271	334
ECOWAS	1975	1993	PS	1,532	1,875	2,715	3,037	4,366	5,497	5,957
Indian Ocean Commission	1984	2005 ^d	NNA	73	127	106	179	155	159	172
SADC	1992	2000	FTA	677	1,015	4,383	5,609	6,590	7,668	8,571
UEMOA	1994	2000	CU	621	560	741	1,076	1,233	1,390	1,545

Merchandise exports within bloc

	Year of creation	Year of entry into force of the most recent agreement	Type of agreement ^a	% of total bloc exports						
				1990	1995	2000	2003	2004	2005	2006
High-income and low- and middle-income economies										
APEC ^b	1989		None	68.3	71.7	73.1	72.7	72.2	70.8	69.4
CEFTA ^c	1992	1994	FTA	4.1	10.5	7.3	7.0	6.8	7.8	7.9
CIS	1991	1994	FTA	..	28.6	20.0	20.3	17.6	18.0	16.5
EEA	1994	1994	EIA	68.6	67.5	68.1	68.4	68.1	67.5	67.7
EFTA	1960	2002	EIA	0.8	0.7	0.6	0.6	0.5	0.5	0.6
European Union ^e	1957	1958	EIA, CU	67.1	66.1	66.8	67.2	66.8	66.0	66.2
NAFTA	1994	1994	FTA	41.4	46.2	55.7	56.1	55.9	55.8	53.8
SPARTECA	1981	1981	PS	9.4	12.1	10.2	11.8	11.6	10.8	9.6
Trans-Pacific SEP	2006	2006	EIA, FTA	1.5	1.7	0.8	0.8	0.8	0.8	0.8
Latin America and the Caribbean										
Andean Community	1969	1988	CU	4.1	12.0	8.9	8.9	9.7	8.2	8.1
CACM	1961	1961	CU	15.3	21.8	19.1	20.2	20.9	18.9	16.2
CARICOM	1973	1997	EIA	8.0	12.1	14.4	12.0	12.2	11.5	11.1
LAIA (ALADI)	1980	1981	PS	11.6	17.3	13.2	11.5	13.2	13.6	14.3
MERCOSUR	1991	2005	EIA	7.6	18.9	16.4	10.3	11.1	11.0	11.6
OECS	1981 ^a	1981	NNA	8.1	12.6	10.0	7.6	11.7	11.4	8.0
Middle East and Asia										
ASEAN	1967	1992	FTA	18.9	24.5	23.0	24.7	24.9	25.3	24.9
Bangkok Agreement	1975	1976	NNA	1.6	6.8	8.0	10.0	10.6	11.0	10.7
EAEC	1997	1997	CU	..	14.8	12.5	12.6	8.5	9.6	8.0
ECO	1985	2003 ^d	PS	3.2	7.9	5.6	6.6	6.7	7.6	8.5
GCC	1981	2003	CU	8.0	6.8	4.8	5.2	5.0	4.8	4.8
PAFTA (GAFTA)	1997	1998	FTA	10.2	9.8	7.2	8.7	10.0	9.8	9.7
SAARC ^e	1985	1995	PS	3.2	4.4	4.2	5.8	5.7	5.6	5.6
UMA	1989	1994 ^d	NNA	2.9	3.8	2.3	2.4	1.9	2.0	2.0
Sub-Saharan Africa										
CEMAC	1994	1999	CU	2.3	2.1	1.0	1.4	1.2	0.9	0.9
COMESA	1994	1994	FTA	4.2	5.4	3.7	4.4	4.1	3.4	3.2
EAC	1996	2000	CU	13.4	17.4	20.5	18.3	16.7	15.1	16.5
ECCAS	1983	2004 ^d	NNA	1.4	1.5	1.1	1.0	0.9	0.6	0.6
ECOWAS	1975	1993	PS	8.0	9.0	7.6	8.5	9.3	9.3	8.3
Indian Ocean Commission	1984	2005 ^d	NNA	4.1	6.0	4.4	6.2	4.3	4.6	4.7
SADC	1992	2000	FTA	6.8	9.2	9.4	10.1	9.7	9.2	9.1
UEMOA	1994	2000	CU	13.0	10.3	13.1	13.3	12.9	13.4	13.1