Preferential Trade Agreements

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Preferential Trade Agreements

- ## Economics of Preferential Trade Agreements
  - Trade Creation vs Trade Diversion
    - Country Size Asymmetries
    - Geography

- ## PTAs and the Multilateral Trade System - Political Economy

Preferential Trade Liberalization

- Welfare Analysis:

    - Are free trade areas the same as "free trade"?

    - Do bilateral agreements deliver a simple proportion of welfare gains from multilateral liberalization?

Trade Creation vs Trade Diversion

- Viner (1950):

  - Two distinct effects of preferential trade liberalization on the pattern of trade flows possible (trade creation and trade diversion)

  - Welfare effects of preferential liberalization may be correspondingly different; specifically, preferential liberalization may be welfare improving or welfare decreasing

Trade Creation

Home Country A
Partner countries, B and C

B is more *efficient* than C --
Export supply curve from B
lower than export supply curve
from C

Preferential liberalization towards
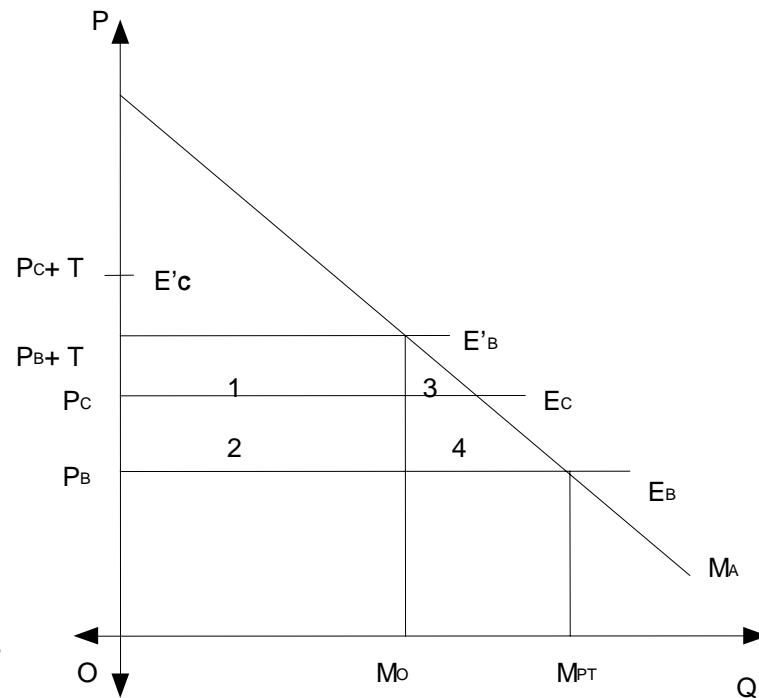B implies creation of trade and
is welfare improving

Figure 2.1

Trade Creating Tariff Preferences
Change in Welfare = (3+4)

Trade Diversion

Home Country A

Partner countries, B and C

B is less *efficient* than C
Export supply curve from B
higher than export supply curve
from C

Preferential liberalization towards
B implies diversion of trade away
from the more efficient trading partner –
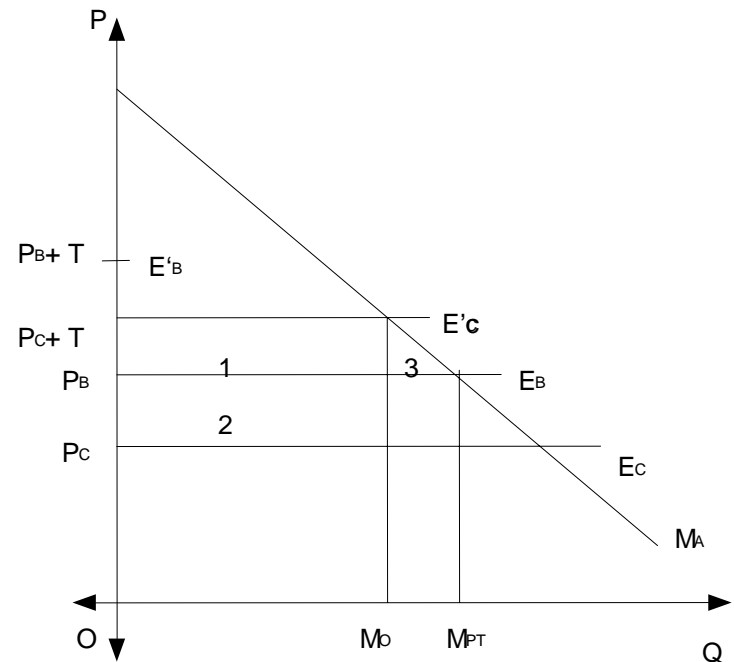Possibly welfare decreasing

Figure 2.2

**Trade Diverting Tariff Preferences:
Change in Welfare = (3-2)**

MERCOSUR: Analysis of Trade Creation/Diversion

- Yeats (1998) – Uses two sectoral measures:

  - Revealed Comparative Advantage: RCA_i

    - [(MERCOSUR exports of good i)/(Total MERCOSUR exports)]/ [(World exports of good i)/(Total World exports)]

  - Regional Orientation: RO_i

    - [(Within MERCOSUR exports of good i)/(Within MERCOSUR exports)]/ [(MERCOSUR exports of good i)/(Total MERCOSUR exports)]

MERCOSUR: Analysis of Trade Diversion

- Compare [Change in RO_i] with RCA_i

- Yeats (1998) finds: Largest increases in regional orientation after MERCOSUR are in goods in which the region has very low comparative advantage

- Suggests significant trade diversion as a result of the trade preferences

Yeats (1998) – Trade Diversion in MERCOSUR

Table 5. *Mercosur Exports with the Largest Change in Regional Orientation toward Mercosur Markets, 1988–94*

Commodity[a]	Exports (thousands of dollars)		Regional orientation index[b]			Revealed comparative advantage index[c], 1994
	1988	1994	1988	1994	Change, 1988–94	
Nonalcoholic beverages (111)	349	26,238	2.35	48.47	46.12	0.05
Lead (685)	642	219	3.03	25.42	22.39	0.00
Prepared dairy (022–024)	23,495	204,019	4.31	22.49	18.17	0.13
Nonwheat meal or flour (047)	4	954	0.05	17.26	17.21	0.04
Perfumes and cosmetics (553)	4,766	86,282	5.22	13.37	8.16	0.14
Wheat meal or flour (046)	65	35,051	0.22	5.67	5.44	1.08
Cork manufactures (633)	18	721	1.18	6.30	5.13	0.05
Preserved vegetables (055)	23,404	48,745	17.66	22.61	4.95	0.13
Articles of paper (642)	15,763	72,249	2.16	7.10	4.93	0.20
Nonmotor road vehicles (733)	3,118	35,854	2.23	6.88	4.65	0.13
Alcoholic beverages (112)	4,137	81,671	1.87	6.48	4.61	0.19
Agricultural machinery (712)	39,608	121,294	2.08	5.88	3.81	0.45
Domestic electrical equipment (725)	12,568	97,322	2.19	5.94	3.76	0.23
Road motor vehicles (732)	206,996	2,112,750	1.25	4.42	3.17	0.45
Materials of rubber (621)	3,636	30,780	3.13	6.26	3.13	0.32
Glassware (665)	5,381	45,017	2.21	5.09	2.88	0.38
Synthetic fibers (266)	13,381	21,170	6.28	9.14	2.87	0.11
Rice, glazed or polished (042.2)	22,583	148,079	9.28	11.65	2.37	1.03
Lace and ribbons (654)	1,386	13,157	3.56	5.86	2.29	0.22
Food preparations not specified elsewhere (099)	7,727	45,412	2.10	4.35	2.25	0.28

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External terms of Trade Effects: MERCOSUR

- Chang and Winters (1998)

- Measure changes in export prices faced by US, Japan and other countries in their exports to MERCOSUR

- Significant deterioration of the terms of trade of non-MERCOSUR countries in their trade with MERCOSUR
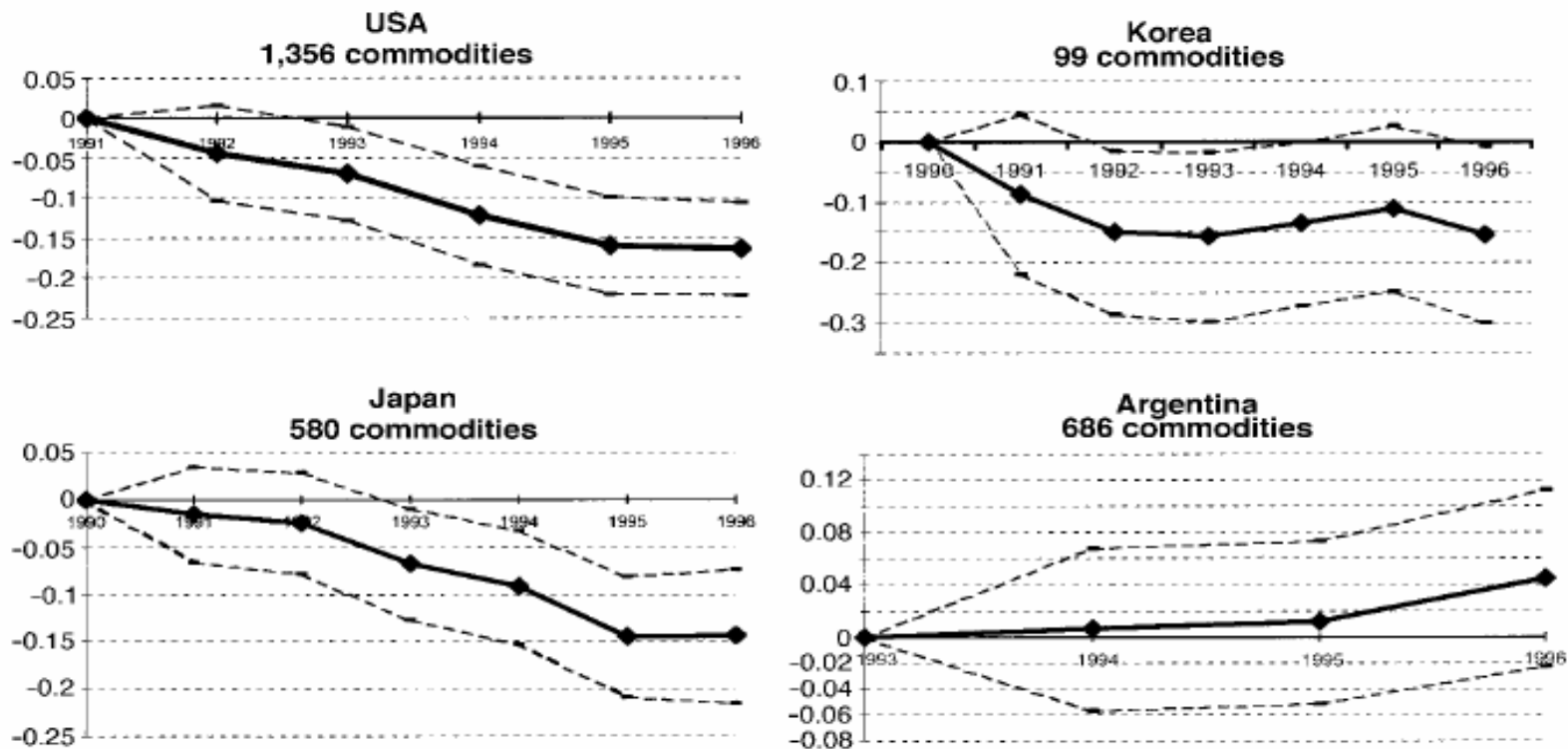
Export Prices to Brazil relative to the Rest of the World: Chang and Winters (2002)

FIGURE 1. EXPORT PRICES TO BRAZIL RELATIVE TO EXPORT PRICES TO THE REST OF THE WORLD

Country Size and Welfare Effects of PTAs

Partner country, B, is small Relative to A

Rising export supply curve, E_B

Preference towards B is unambiguously *welfare decreasing*
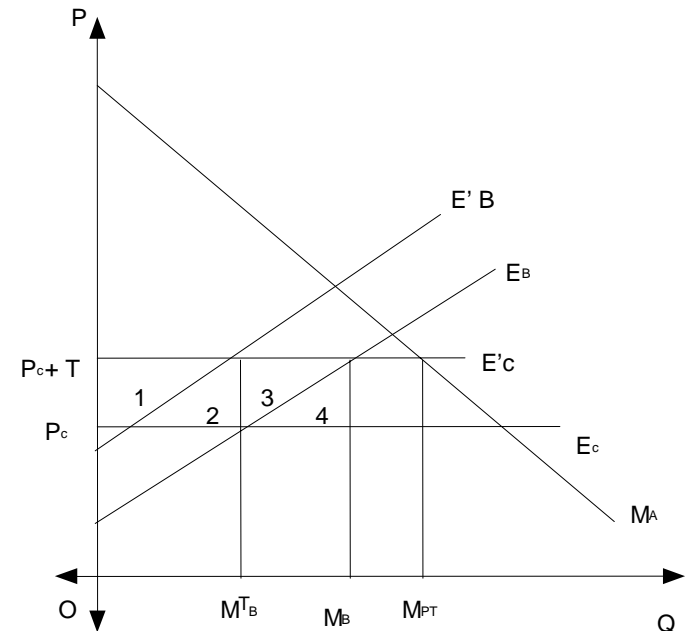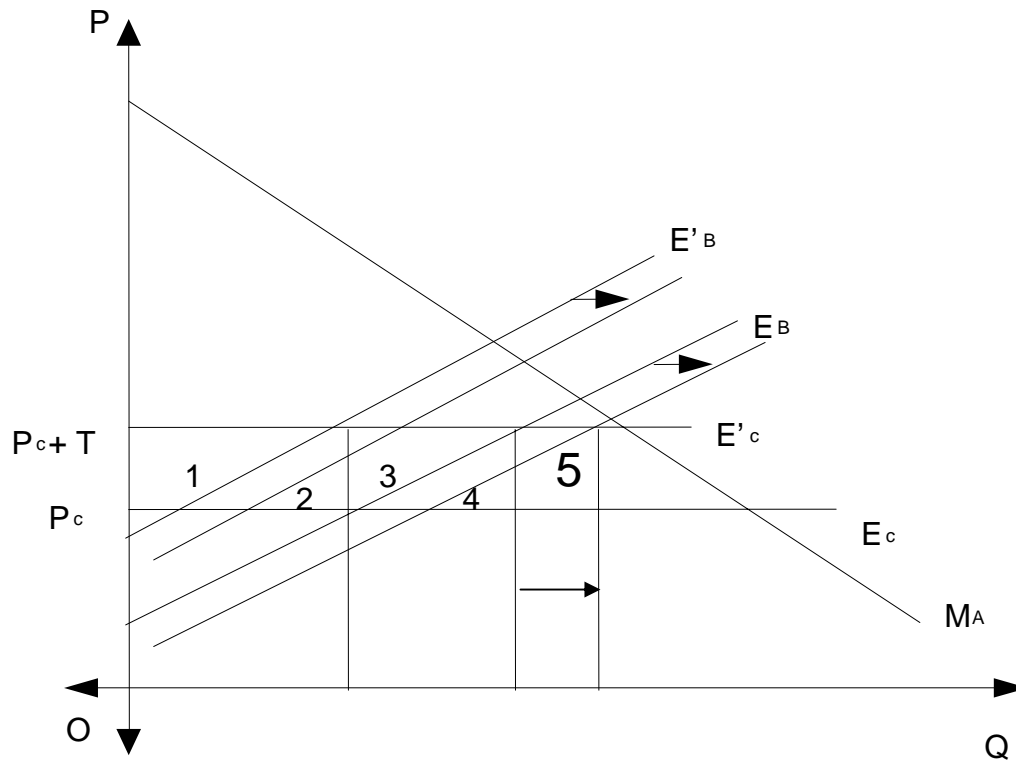
Note: Welfare Effects non-monotonic

Figure 2.3

Change in Welfare for Home = - (1+2+3+4)
Change in Welfare for Partner = (1+2+3)
Change in Welfare for Union = -(4)

Trade Volume and PTA Welfare

Initial Trade Volume with B higher implies welfare losses higher as well – Loss to Home Country: (1+2+3+4+5)

Geography and Preferential Trade

- Are geographically proximate countries "better" partners in the context of preferential trade liberalization

- Theoretical Conjecture:

  - Trade creation is larger or trade diversion is smaller when countries already trade a lot with each other

  - Geographically proximate countries have greater volumes of trade with each other (after conditioning for other variables)

Trade Creation and Trade Diversion – Empirical Issues

- **Trade Creation may be correlated with Trade Diversion**

  - Significant trade partners generally compete in large numbers of markets with a large number of suppliers from the rest of the world

  - Competition in US markets: between Japan and the EU on the one hand and, say, Sri Lanka and Bangladesh on the other

  - Countries with whom you experience a low (high) level of trade creation may also divert less (higher) trade
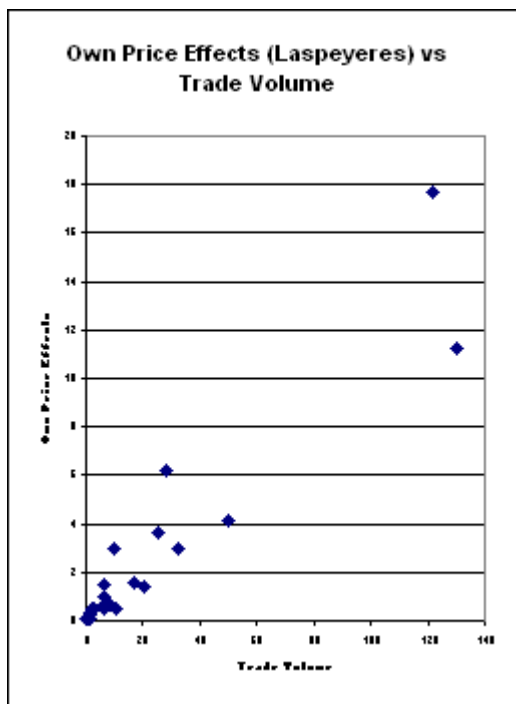
- Krishna (2003): Estimating welfare effects from preferential tariff reduction by the US against a number of potential partner countries
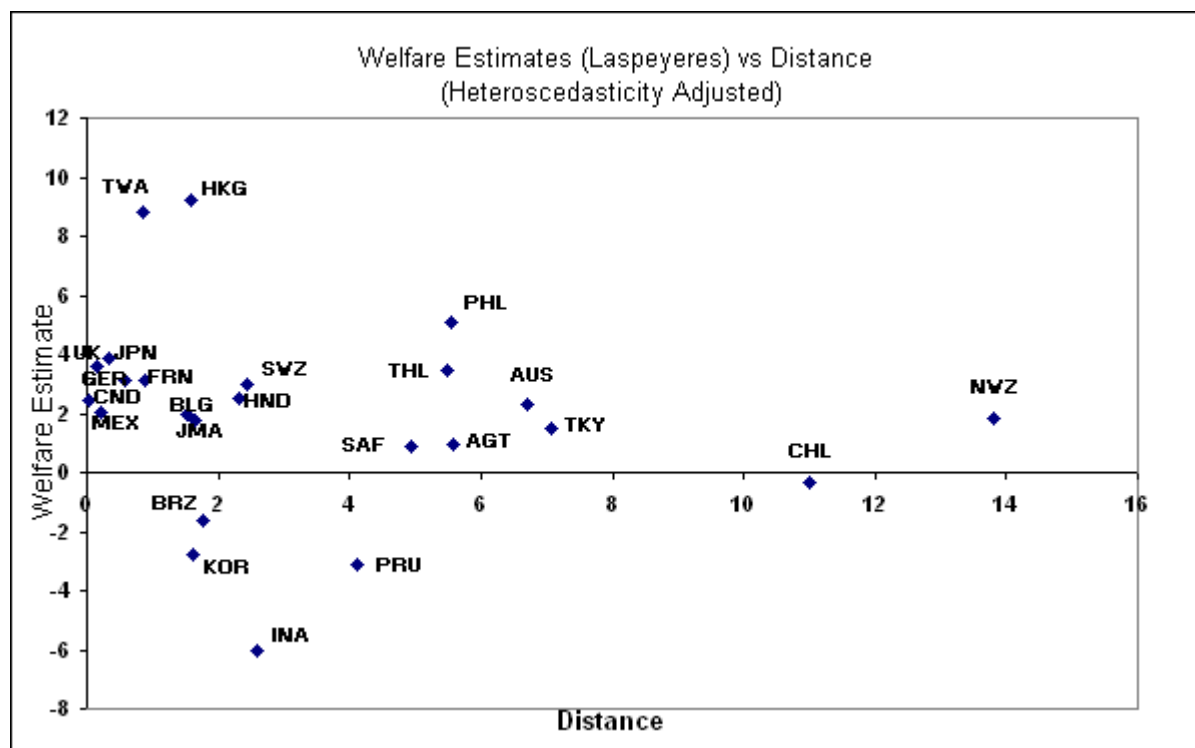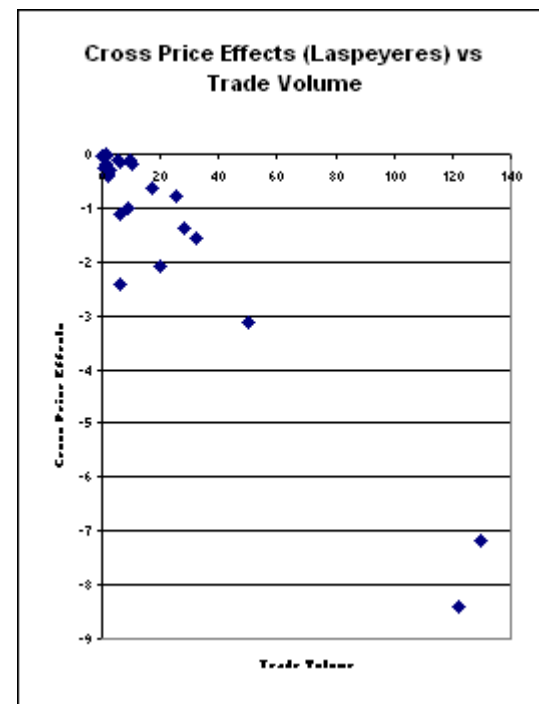
Trade Creation and Trade Diversion – Correlated?

Trade Creation

Trade Diversion

Partner Country Characteristics and Welfare

- Initial volume of trade not a good predictor of welfare gains – a larger partner may give you greater losses (or not)

- Distance not a good predictor of welfare gains – closer countries may or may not bring larger welfare gains

- Trade creation and Trade diversion are not independent

- Overall point: Hard to identify country characteristics that will ensure welfare gains will preferential liberalization

Preferential Trade Agreements and the Multilateral Trade System

- Are trade blocs "building blocs" or "stumbling blocs" in the path towards multilateral free trade?

  - Will PTAs expand and coalesce so we eventually get to multilateral free trade?

  - Or will PTAs create incentives within countries that inhibit progress towards multilateral free trade?

Building Blocs or Stumbling Blocs?

- **Krishna (1998)**

  - To analyze the incentive effects of PTAs (for further multilateral liberalization), important to first consider the determinants of PTAs

  - Trade diversion key force driving the formation of PTAs – absent trade diversion, exchange of market access between partner countries closer to a political zero sum game. With trade diversion, both countries gain against the rest of the world, making liberalization easier to achieve politically

  - In this case, PTAs lower the incentives for multilateral liberalization, as this reverses the trade diversion gains to firms within the partner countries (i.e, both partner countries have to give up preferential access to each others markets)

Building Blocs or Stumbling Blocs?

- Baldwin (1995)

  - Non-member countries (excluded) countries will have a greater incentive to liberalize trade than they did before
  - PTAs may increase the incentives for multilateral liberalization

- Open Membership Rules

Conclusions

- Preferential trade liberalization not the same thing as free trade -- welfare analysis of PTAs highly complex

- Quantitative analysis suggests potential for adverse effects on both member countries and on countries in the rest of the world

- Proliferation of PTAs with countries belonging to multiple PTAs simultaneously ("spaghetti-bowl regionalism") distorts incentives for economic activity substantially

- PTAs are not necessarily stepping stones in the path to global free trade

PTA Implementation

- Internal Barriers to Trade

- External Barriers to Trade

- Rules of Origin (FTA)
    - Regional Value Criterion
    - Transformation Criterion

Internal Barriers to Trade

- GATT Article XXIV specifies that internal trade barriers must be eliminated on substantially all trade

- In practice, numerous exceptions are made and many sectors are excluded from liberalization

- Problem particularly acute in the context of PTAs notified under the Enabling Clause (developing country exceptions)

External Barriers to Trade

- GATT Regulation: Trade barriers may not be raised against non-members ("on the whole")

- Theory suggests that not raising trade barriers will not be enough to eliminate costs imposed on the rest of the world – in general external tariffs would have to be lowered.

- Gap between applied and bound tariffs at the WTO implies that tariffs may even be raised on non members

Rules of Origin

- Theory suggests that rules of origin (ROO) which prevent trade deflection, but allow any goods with within-union value added to cross internal borders freely, will improve welfare

- In practice, ROO are elaborately specified and appear to deviate substantially from the levels necessary to simply prevent trade deflection

ROO as Protectionist Devices

- ROO may be specified to increase the level of protection offered to both:

  - (a) Final good suppliers within the union-- Final goods which do not satisfy the ROO criteria may not cross within union borders duty free

  - (b) Intermediates suppliers within the union - -- Greater demand for within union intermediates to satisfy ROO

- Thus ROO may be used to get around GATT regulations concerning both external and internal trade barriers