

INTERNATIONAL AGREEMENTS (continued)

PREFERENTIAL TRADING AGREEMENTS (PTAs)

Departure from MFN explicitly permitted by GATT/WTO

A group of countries can lower barriers to others in the group, provided

[1] within-group trade in goods is essentially free,

[2] on average, bloc members do not raise their barriers against non-members

As usual, these are vague provisions subject to interpretation and dispute

Forms of preferential trading agreements

[1] Free trade area: each member chooses its own tariffs against non-members

Requires “rules of origin” to prevent non-members shipping via members

[2] Customs union: all members have common policy against non-members

[3] Economic union: not just flow of goods, but services, capital flows,
labor movements etc are also liberalized among members

Usually requires coordination of regulations, perhaps also taxation

Will ignore these distinctions in analysis below

PTAs reduce some trade barriers; increase none. So they should raise world welfare.
 No! They have two effects, one beneficial, one harmful

[1] Trade creation: fuller exploitation of comparative advantage

among member countries as tariffs between them are lowered

[2] Trade diversion: even when a non-member is more efficient producer,
 trade may shift to a member because of its tariff advantage

Example loosely based on NAFTA

| Unit costs and prices | Trade creation case | | | Trade diversion case | | |
|---------------------------------------|---------------------|--------|-------|----------------------|--------|-------|
| | US | Mexico | China | US | Mexico | China |
| Unit cost of production | 20 | 12 | 15 | 20 | 12 | 8 |
| Delivered price in US with MFN tariff | 20 | 24 | 30 | 20 | 24 | 16 |
| Delivered price in US after NAFTA | 20 | 12 | 30 | 20 | 12 | 16 |

Trade creation: MFN tariff was 100% and precluded all imports

After NAFTA, US imports from Mexico, US consumers gain surplus $20 - 12 = 8$

Trade diversion: Before NAFTA, US imported from China,

cons. surpl. (per unit) $20 - 16 = 4$, tariff revenue = 8, total welfare = 12

After NAFTA, US imports from Mexico, even though China could produce
 at a lower cost. Difference $12 - 8 = 4$ is worldwide efficiency loss.

In US, cons. surpl. = 8, tariff revenue = 0; total 8. So US bears the cost!

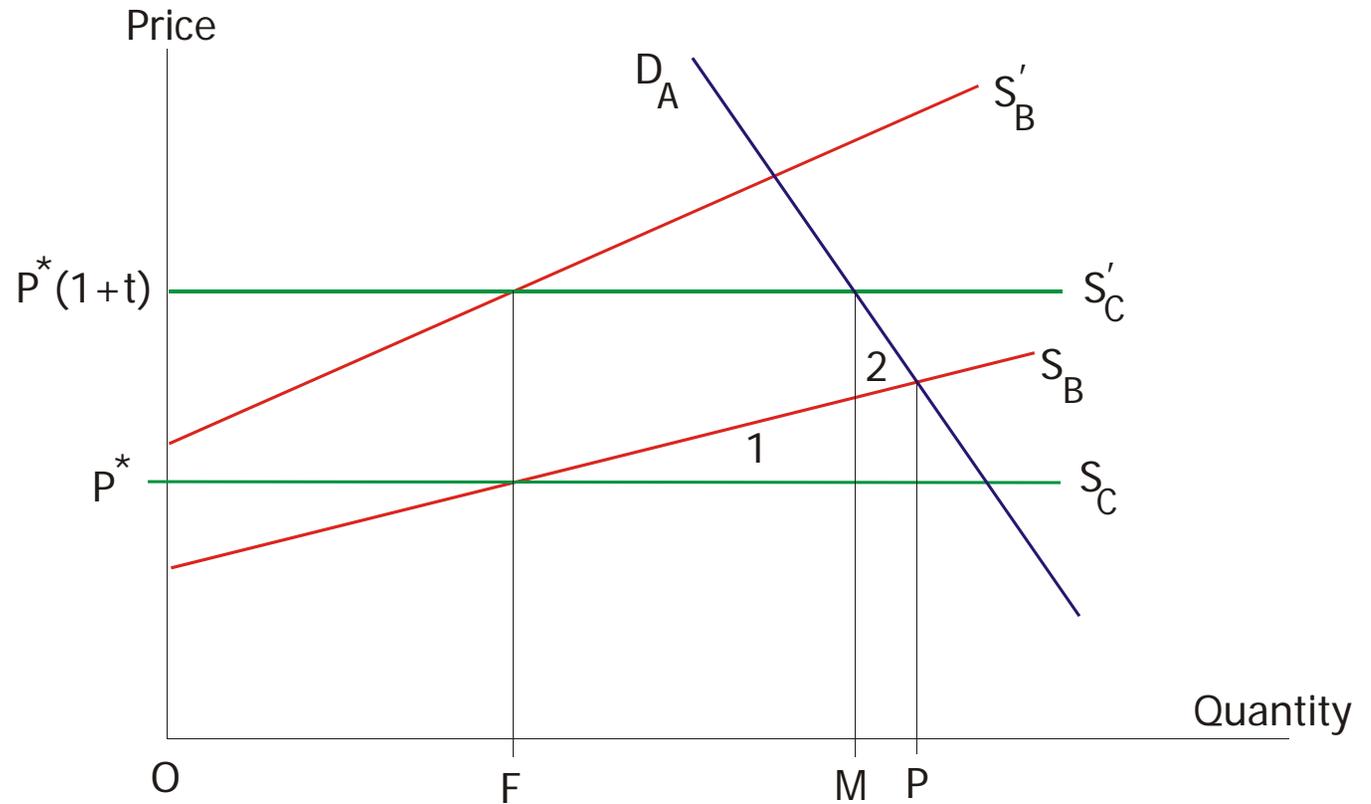
Somewhat more general case:

Importer A
Partner B
ROW C

MFN: A buys
OF from B
FM from C

PTA: A buys
OP from B
none from C

Trade creation MP,
efficiency gain
equals area 2



Trade diversion: FM switched from C to B, efficiency loss area 1

Who gets these gains or bears the losses? A and B do, not C.

Exercise: Identify A and B's gains and losses as areas in the figure; verify assertion.
(More generally, if C's supply is upward-sloping, some gain / loss can fall on it.)

This theory raises several questions, and possible answers.

1. Why allow 100% within-bloc reduction, but not partial reduction?

- a. This is just enlarging the concept of a “nation” for purpose of trade
- b. The requirement makes it less likely that many PTAs will break out
- c. The PTAs that do form can be a step toward further liberalization across them

2. What kinds of PTAs are more likely to create than divert trade?

Consider one popular type: determined by geographical proximity

If comparative advantage is the basis of trade, and closer countries are more alike then there will be little within-bloc trade under MFN but lowering of tariffs will shift trade into within-bloc especially if external (MFN) tariffs are high

If scale economies govern trade, and closer countries have low transport costs then lowering of tariffs may lead to more trade creation

This could be relevant for the EU, and for PTAs among LDCs, or for Mercosur
But empirical studies of Mercosur suggest that there was more trade diversion

3. Dynamic time-path: will PTAs expand / merge into better worldwide freer trade?

If PTA becomes a sufficiently large market to exploit most of the available comparative advantage and scale economies
Then incentive for further expansion will be reduced
(but gains from further expansion will be small, too).

Special interest groups in multiple countries may benefit from trade diversion
and therefore oppose further multilateral liberalization

Governments have limited time and political capital to devote to trade issues
If this is used up in forming a PTA, that may
preclude efforts to enlarge or merge it for multilateral liberalization

Therefore the answer is at best unclear

If the answer is "no", and PTAs will become permanent,
then assessing the costs of trade diversion becomes even more important

ISSUES PARTIALLY OR INDIRECTLY RELATED TO TRADE

1. International external economies/diseconomies and public goods/bads

Examples: Transborder pollution – acid rain etc

Spillovers of knowledge

Common resource pool problems – fisheries

Climate change

General principles

These problems are best tackled by directly targeted policies

Taxes on activities that create external diseconomies

Subsidies for activities that create external economies

But when the spillovers are international, this needs cross-country transfers

Alternative: creation and enforcement of property rights (Coase Theorem)

This is also harder in international context

There is no effective forum for negotiation over taxation, regulation

Therefore policies often become part of trade negotiation

Currently WTO has : strong role in intellectual property rights issues,

some role in environmental issues, almost none on labor issues

Simultaneous bargaining over multiple issues can be

Good: [1] Joint discussion of trade and regulatory issues needed to prevent “race to the bottom” in taxes, standards, environmental policies etc.

[2] extra dimensions expand the scope of mutually beneficial deals
e.g. US and EU can offer Brazil trade concessions in exchange for better conservation of its tropical rain forest

Bad: [1] WTO lacks the skills, authority for tackling these other issues

[2] a country can make threat in one dimension to get concession in another
e.g. Brazil can threaten to speed up destruction of its rain forest to get trade concessions from US and EU

Problems of credibility of commitments to longer term plans of action

Need suitably balanced stream of exchanges to retain incentives to perform
e.g. Brazil gets year-by-year renewable concessions in exchange for its protection of the rain forest during that year

2. Ethical and moral issues

Examples

Labor standards – [1] child, sweatshop, convict, or slave labor; [2] “fair” wages

Production processes – tuna fishing nets that trap dolphins

Alternative responses

Prohibition: Demanded by activist groups

- May be hijacked by domestic protectionist special interests

- “Fair wage” argument may negate the very basis of beneficial trade

- Will raise domestic price just as would a quota for any other reasons

- Those who don't care about the issue will also pay the cost

- Should make these costs explicit and weigh tradeoffs

Labeling: Retains greater freedom of choice

- Expands information; individuals can act on that basis

- But will not satisfy the activist who feel most strongly

- Questions of who decides the criteria, ensures accuracy of information, ...

Other difficult issues

Banning imports produced by child labor and sweatshops

- may reduce the incomes of poor families in LDCs,

- and so harm the very children and families one wants to help

Enforcing “fair wage” may lead to competition for the limited number of

- fair wage jobs, corruption in the allocation of these jobs, etc.

If we care about dolphins, should we also ban eating dolphin meat?

- Should we ban imports from countries where dolphin meat is eaten? ...

CONCLUDING REMARKS

From the WTO web site:

Nobel laureate Paul Samuelson (1969) was once challenged by the mathematician Stanislaw Ulam to "name me one proposition in all of the social sciences which is both true and non-trivial." It was several years later than he thought of the correct response: comparative advantage. "That it is logically true need not be argued before a mathematician; that it is not trivial is attested by the thousands of important and intelligent men who have never been able to grasp the doctrine for themselves or to believe it after it was explained to them."

Lunch-table quote from Samuelson:

"If the students in my International Trade course understand the concept of comparative advantage well enough to answer questions on the final exam correctly, that is as much as I can hope for."

I am more ambitious!

WHAT I EXPECT

Short-term memory (for final exam): Everything done in the course :-)

Long-term memory:

1. Comparative advantage and its determinants
2. Distinct explanations of North-South (differences of endowment / technology) and North-North (scale economies, product differentiation) trade.
3. Aggregate gains and distributive conflict resulting from trade
4. Principle of policy targeting: Fitting policy to the margin of market distortion