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Guest Lecture
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Preferential Trading Arrangements

1. Preferential Trading Arrangements (PTAs): Overview
2. Trade Creation and Trade Diversion
3. Other Issues and Arguments in PTAs

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1. Preferential Trading Arrangements (PTAs): Overview

- PTA (or Regional Trading Agreement (RTA)):
An agreement between two or more countries to, in principle, eliminate duties or other restrictive regulations on trade between the agreeing countries (or “members”).
- Two types of PTA:
 - Customs Union (CU): the members determine and apply the common trade duties/policies (e.g., tariffs) to other countries (or “non-members”).
 - Free Trade Area (FTA): the members do not necessarily determine and apply the common trade policies, but maintain/determine/apply their own individual trade duties/policies to non-members.
 - * *Note*: There is other term, a “free trade agreement,” which is also called an FTA.
- The GATT/WTO permits its member countries to form a PTA(s), *provided* that the members do not adopt to non-members a higher or more restrictive duty or regulation that the members have applied to the non-members prior to the formation of the PTA (GATT Article XXIV).
- Currently-effective PTAs in the world: Find at the following web site:
 - World (WTO’s RTA Database): <http://rtais.wto.org/UI/PublicMaintainRTAHome.aspx>
 - U.S. (USTR website): <https://ustr.gov/trade-agreements/free-trade-agreements>

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- PTAs contradict the principle of non-discrimination (MFN treatment). Why has the GATT/WTO allowed PTAs?
 - A frequently referred argument/view: a PTA is the “second best”:
 - Trade liberalization is good, but the ultimate goal of universal trade liberalization through multilateral negotiations (say, GATT/WTO) should be practically difficult and slow.
 - Expansion of bilateral (or plurilateral) trade liberalization could contribute to the world-wide trade liberalization.
 - With a PTA, the members would form an integrated market that is virtually border-free. This is expected to be free-trade enhancing for non-members, too.
 - This should be the case for a CU, but is not so for the case of a FTA, indeed.
In practice, when forming a FTA, the members set up the **rules of origin** that requires goods traded between the members to be actually produced in a member country (typically, by setting a “local-contents requirement” of some fraction of the value added of a good). Rules of origin are provided to avoid “trade bypassing” from other countries.

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2. Trade Creation and Trade Diversion

- A PTA is expected to have two possible effects: *trade creation* and *trade diversion*.
 - **Trade Creation:** with a PTA, new trade will occur between the members (i.e., trade will increase in already-traded goods, and/or trade in not-ever-traded goods will occur).
 - **Trade Diversion:** with a PTA, a member country will replace its imports from a non-member country(ies) to other member country(ies).
- Trade creation is expected to improve the world-wide (non-member inclusive) economic welfare. However, trade diversion can be welfare-reducing.
 - This is a conventional argument about why economists are often cautious about PTAs.

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Trade Creation vs. Trade Diversion (1): Very simplified model/analysis

- Three countries: A , B , and C
 - A = Home
 B & C = A 's potential trading partners
 - B 's MC = \$6 (constant → horizontal supply curve)
 C 's, MC = \$4 (constant → horizontal supply curve)
→ C is the lowest-cost (i.e., most efficient) producer.
 - In A , the domestic (autarky) equilibrium price is \$8.
(→ graph to be shown in class.....)



- Case of Trade *Creation*:
 - Initially; A imposed a specific tariff of \$5/unit on all imports.
 - Now; A forms a PTA with B (only).
(→ graph & analysis to be shown in class.....)
- Case of Trade *Diversion*:
 - Initially; A imposed a specific tariff of \$2/unit on all imports.
 - Now; A forms a PTA with B (only).
(→ graph & analysis to be shown in class.....)

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Trade Creation vs. Trade Diversion (2): A bit more generalized model/analysis

- Three economies: A , B , and the “rest of the world” (ROW)
 - A = Home (importer)
 B & ROW = A 's potential trading partners
 - A does not have the domestic production (or, A 's MC is too high to compete with other economies).
 - * We can generalize this model to allow A also to produce, relatively straightforward.
 - B has an up-sloping MC (= Supply Curve)
ROW's MC (= S) is horizontal, assuming that A and B are both small.



- Initially; A imposed a specific tariff of \$ t /unit on all imports.
- Now; A forms a PTA with B (only).



- Case I: Welfare-Reducing Trade Diversion:
(→ graph & analysis to be shown in class.....)
- Case II: *Potentially* Welfare-Improving (or Reducing) Trade Creation & Diversion:
(→ graph & analysis to be shown in class.....)

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Trade Creation vs. Trade Diversion (3): Global View using the MD-XS Framework

- Three economies: A , B , and C
 - A = importer
 B & C = potential exporters to A
 - Both B and C have an up-sloping export supply curves (XS).
 C is the most efficient exporter (i.e., C 's XS is lower or outer than B 's).
- ↓
- Case of Potentially Welfare-Improving/Reducing Trade Creation & Diversion:
 - Initially, A imposed a specific tariff of \$/unit on all imports.
 - Now, A forms a PTA with B (only), maintaining the tariff of \$/unit on imports from C .
- (→ graph & analysis to be shown in class.....)

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3. Other Issues in PTAs

- ❖ It is indeed possible that trade within a PTA is not entirely “free.”
 - The GATT Article XXIV permits the existence of “an interim agreement leading to a formation of” a CU or FTA.
 - The article also states that such an interim agreement must be led to a complete CU or FTA “within a reasonable length of time,” but does not define or mention any on how long the “reasonable length of time” should be.
 - Moreover, in its definition of a PTA, the GATT article says that a CU or FTA must free “substantially all the trade” (underscore by me).
 - The article also permits the exception of the range of to-be-freed trade (in accordance with the exception of the GATT/WTO’s general disciplines—e.g., agricultural products).

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- ❖ For CUs, the Article XXIV says that a CU's trade duties to other countries shall not “on the whole be higher or more restrictive than the general incidence of the duties and regulations..... applicable..... prior to the formation of such a union” (underscore by me). However, it is not clear what the phrase “on the whole” indicates.
 - This can be an issue when one member country applies a higher tariff/duty than another member before they form a CU. I.e., for some non-member countries, this could actually be a raise of a duty.
 - Indeed, the EU (former EEC) once used an average of its members' pre-CU duties as their measure, and refused to apply the lowest among the members.
- ❖ PTAs can give countries motives and opportunities to jointly protect their domestic industries against other more efficient producers.
- ❖ In the past, PTAs were sought more as a “second-best” trade liberalization option. Today, it seems that PTAs are motivated more by formation of regional trading bloc.
 - It seems to have been significant since Europe's progress to form an integrated market.

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- ❖ There is an argument saying that PTAs will be more efficient to fix some trade-related issues (e.g., IP protection, labor standard, etc.)
 - However, it may be because a large country can more easily exercise its dominant influence on a smaller country(ies) in a negotiation for a PTA, rather than it can in a multilateral negotiation (small countries could create a collective “voice”)?
- ◆ Some recent PTAs have gone beyond the traditional/conventional trade liberalization (i.e., the reduction of tariffs and other trade barriers) and are seeking deeper economic integration (“FTA+”, EPAs, common market, etc.) involving, for instance;
 - Harmonization of domestic rules/standards/regulations among members
 - Expansion of the scope of an agreement (trade in services, investment, IPRs, etc.)
 - In some cases, supernational institution or governance body, (e.g., EU)
 - Such deeper integration is (at least partially) due to increasing demand from global production networks (or global value chains: GVCs).
 - Deeper-integration agreements could be complement to the multinational trading system (e.g., providing a ‘model’ to future potential worldwide arrangements?), but could also make the current WTO/GATT system more difficult to play their traditional roles.
 - Economic theories/models more than the conventional trade-creation/diversion framework are desired to understand/analyze these deeper-integration agreements.