The Economics of European Integration

Chapter 5

Essential Economics of Preferential Liberalization

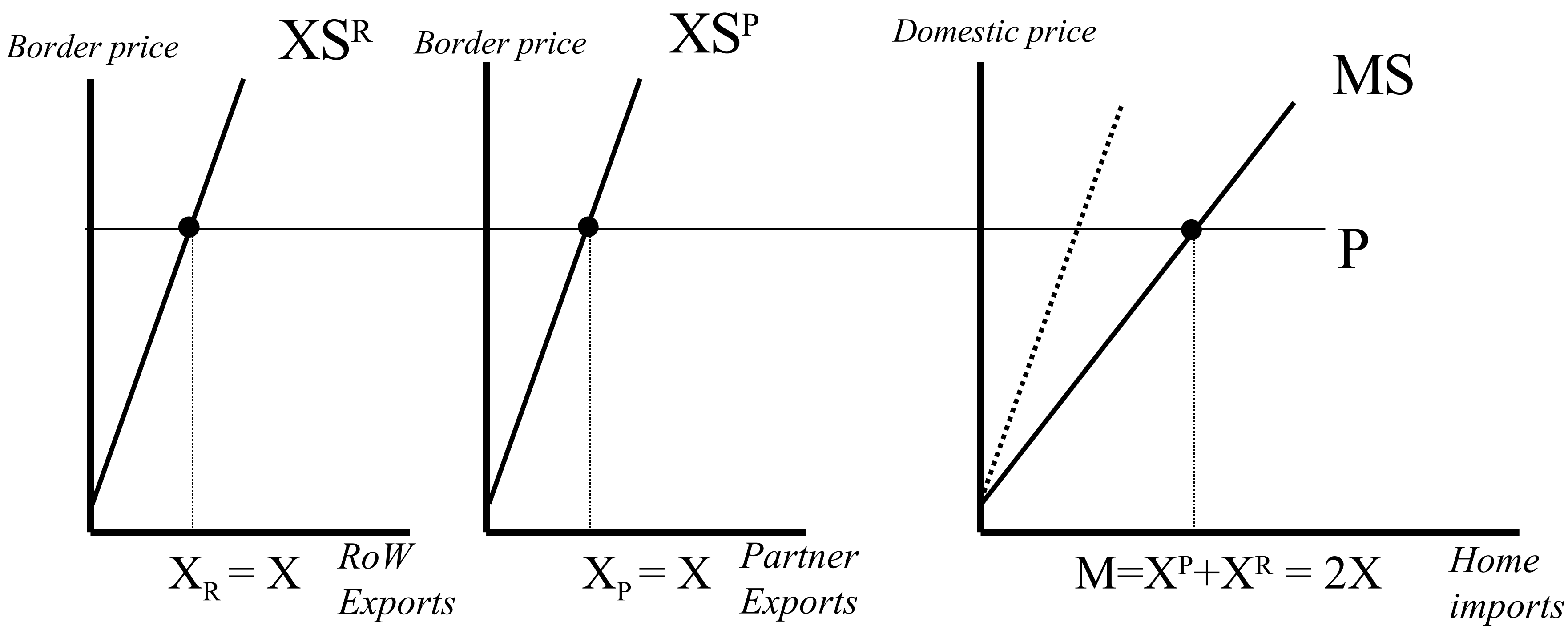
- Unilateral discriminatory liberalization
- Customs unions
- Free trade agreements

Unilateral discriminatory liberalization

- Studying European integrations, e.g. EEC's customs union – which were discriminatory, i.e. preferential, requires:
  - at least three countries:
    - at least two integrating nations
    - at least one excluded nation
  - ability to track domestic and international consequences of liberalization.
- Modify MD-MS diagram to allow for two sources of imports→ Preferential Trade Arrangement (PTA) diagram

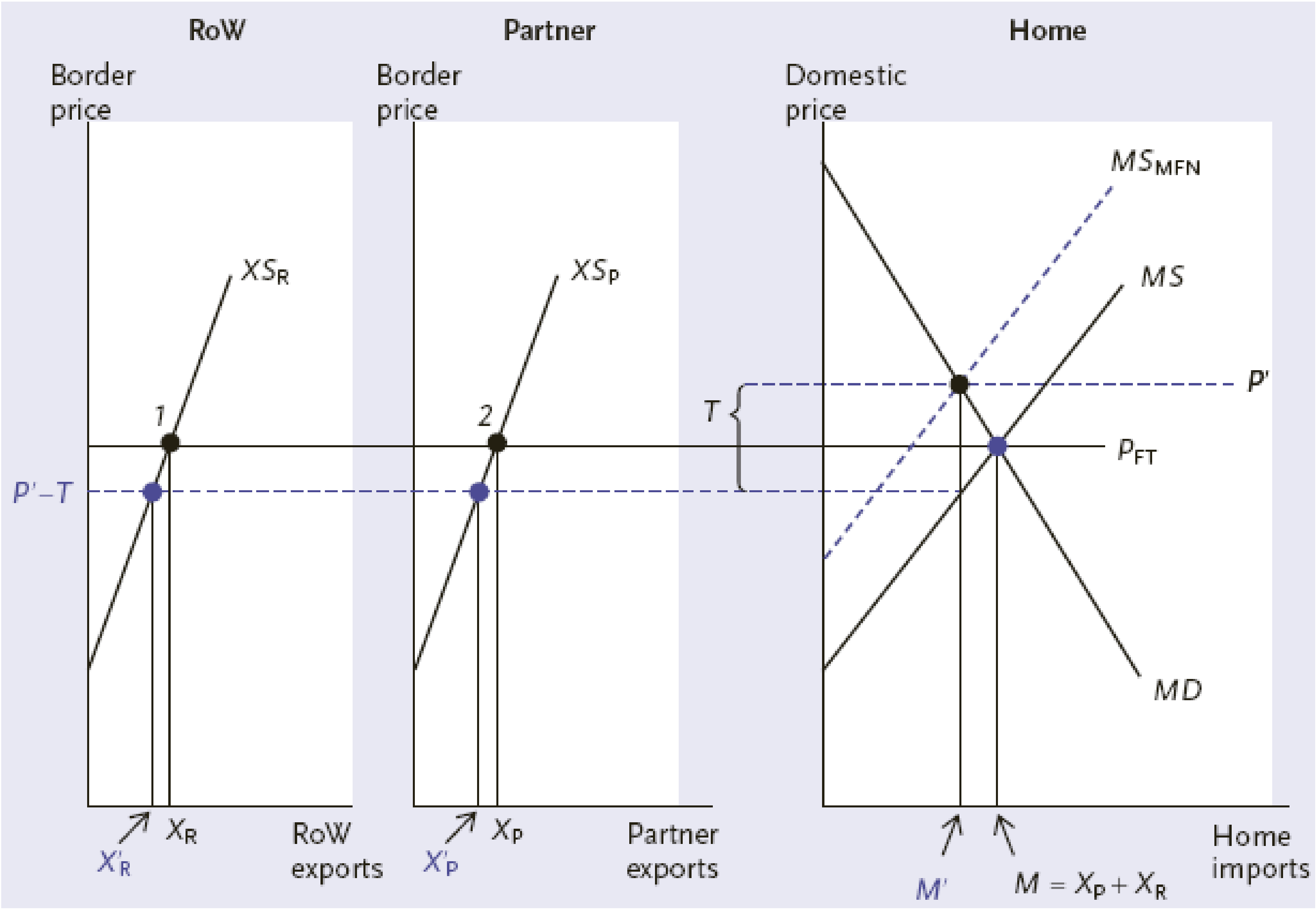
Unilateral discriminatory liberalization
1- The PTA Diagram

- Assume No Imperfect Competition – No Increasing Returns: the simplest framework
- Assume Rest of the World (RoW) and Partner are identical: minimize complications



1- The PTA Diagram:

Free Trade
MFN tariff (non discriminatory)

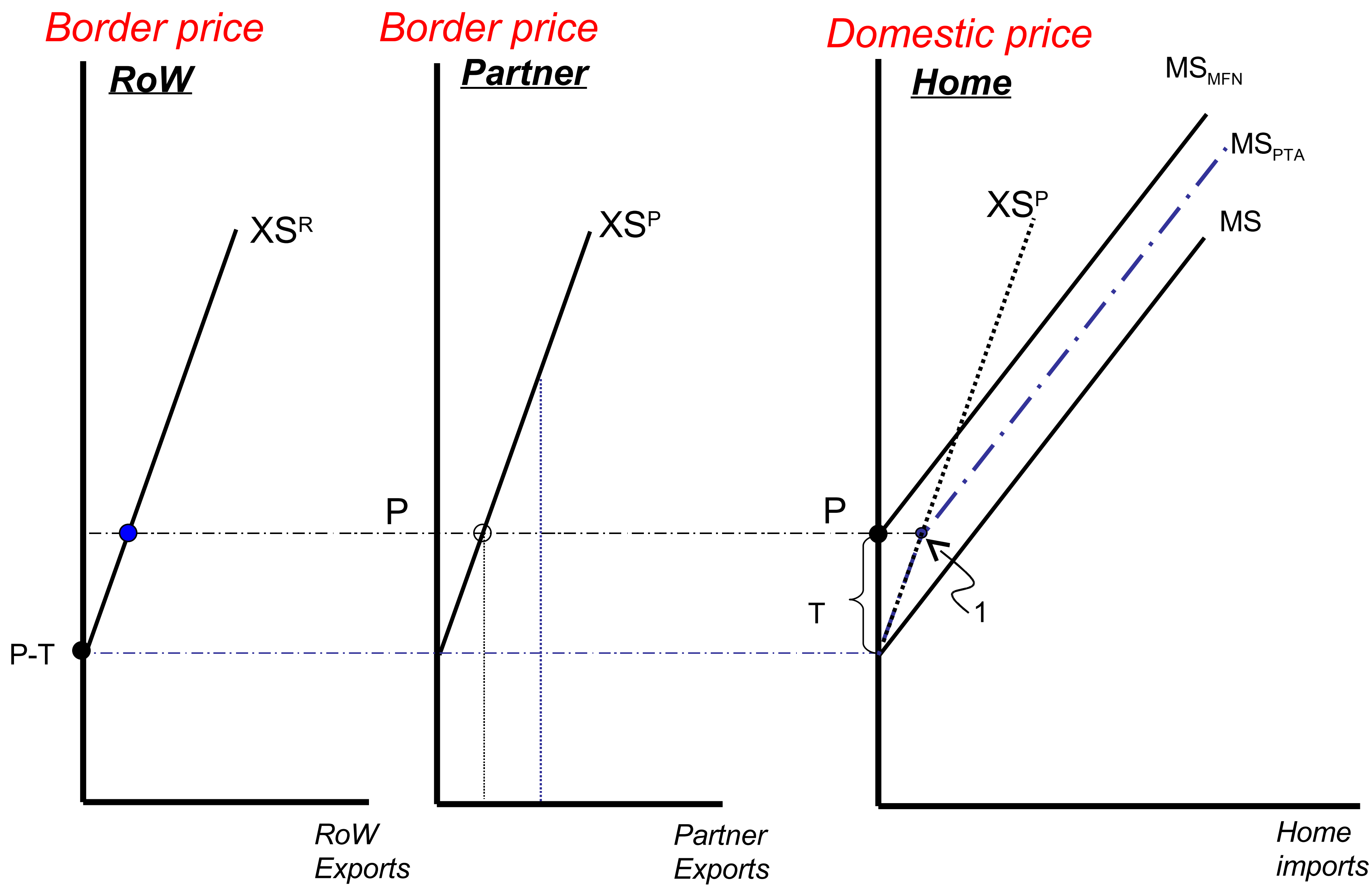


Unilateral discriminatory liberalization

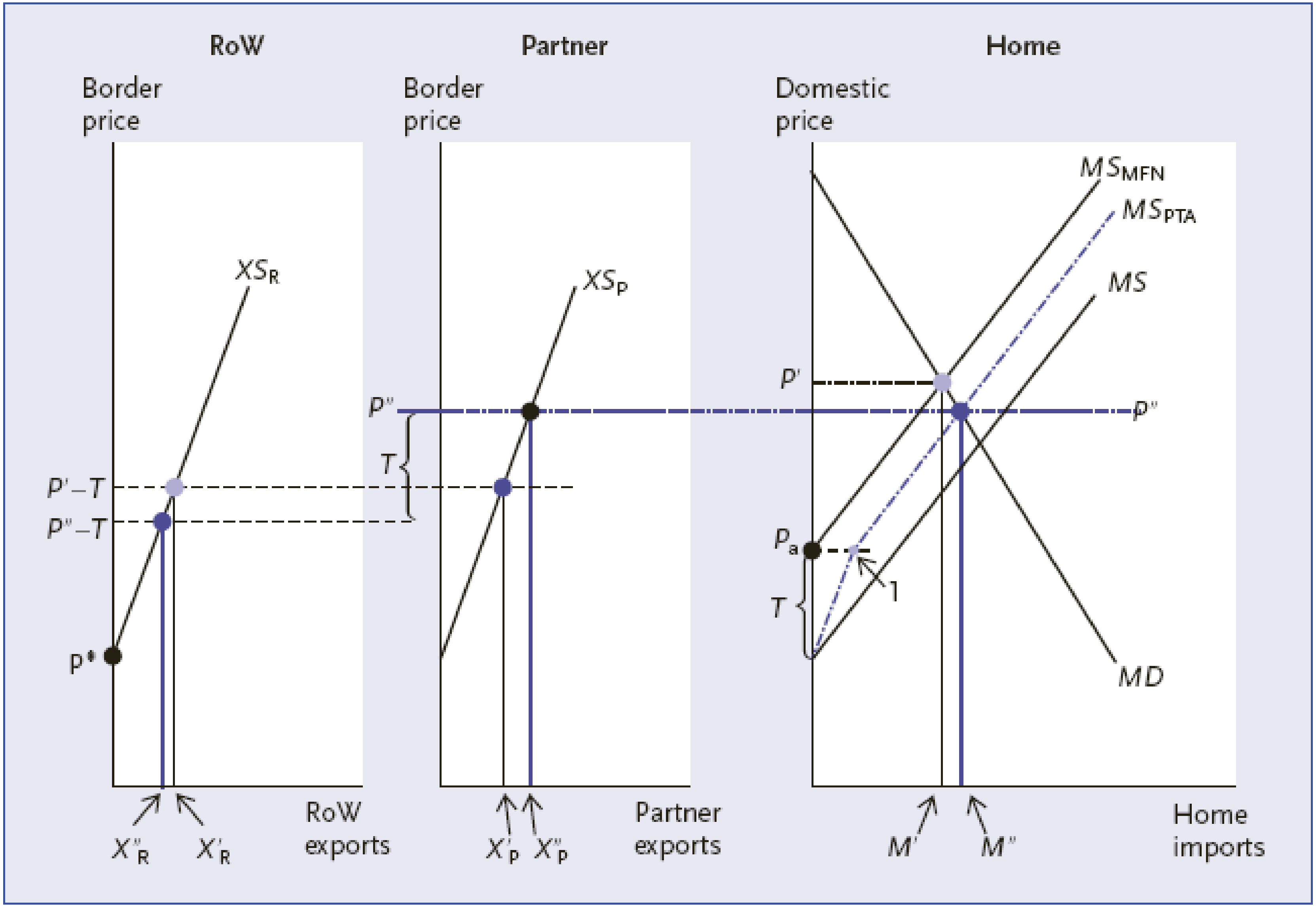
1- The PTA Diagram: MS curve with PTA

- consider home removes T on imports from partner only.
- First step is to construct the new MS curve:
  - the liberalization shifts down MS (as with MFN liberalization) but not as far since only on half of imports (shifts down MS to half way between MS (free trade) and MS (MFN T)
  - Note: kinked MS curve with PTA.

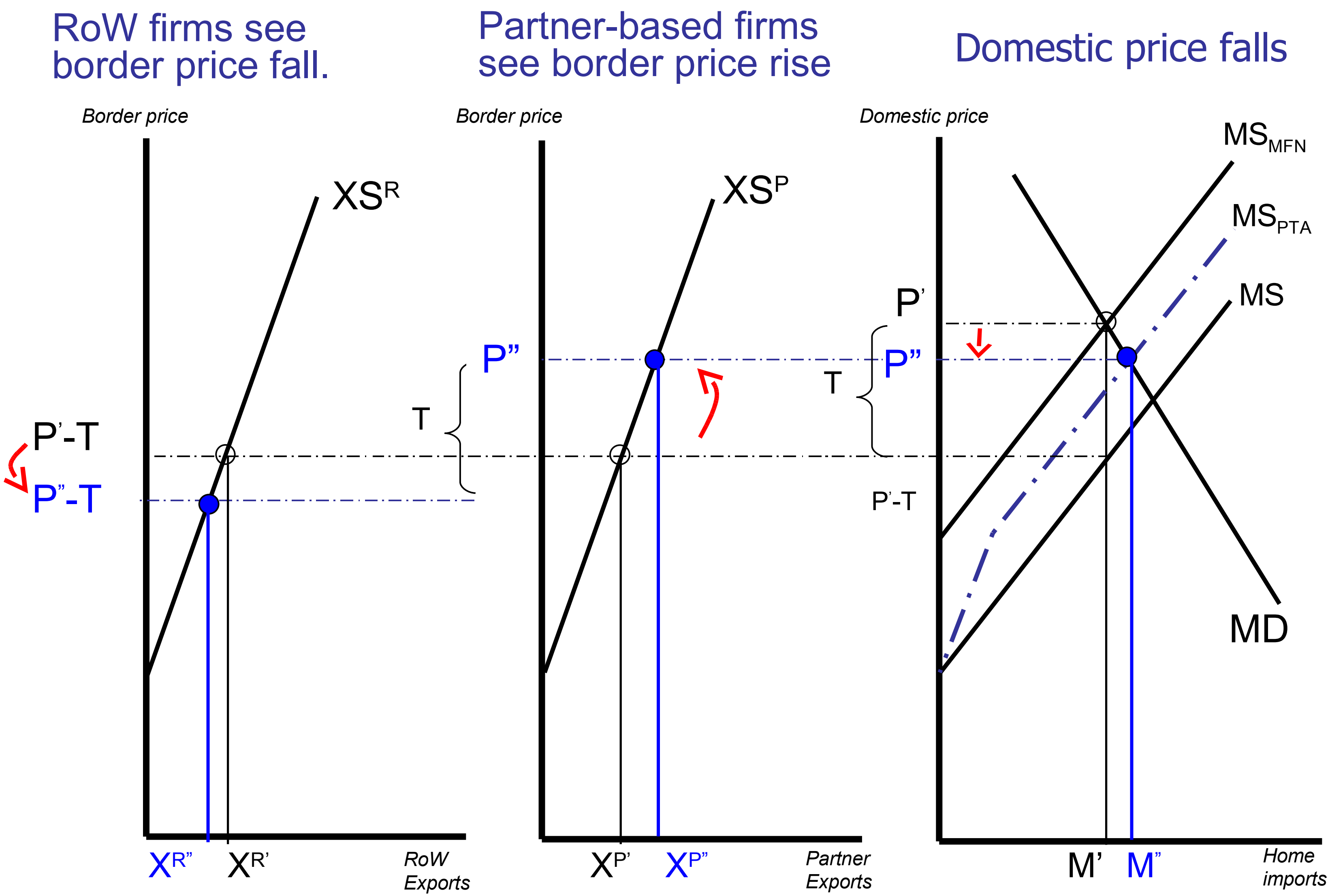
1- The PTA Diagram: MS curve with PTA



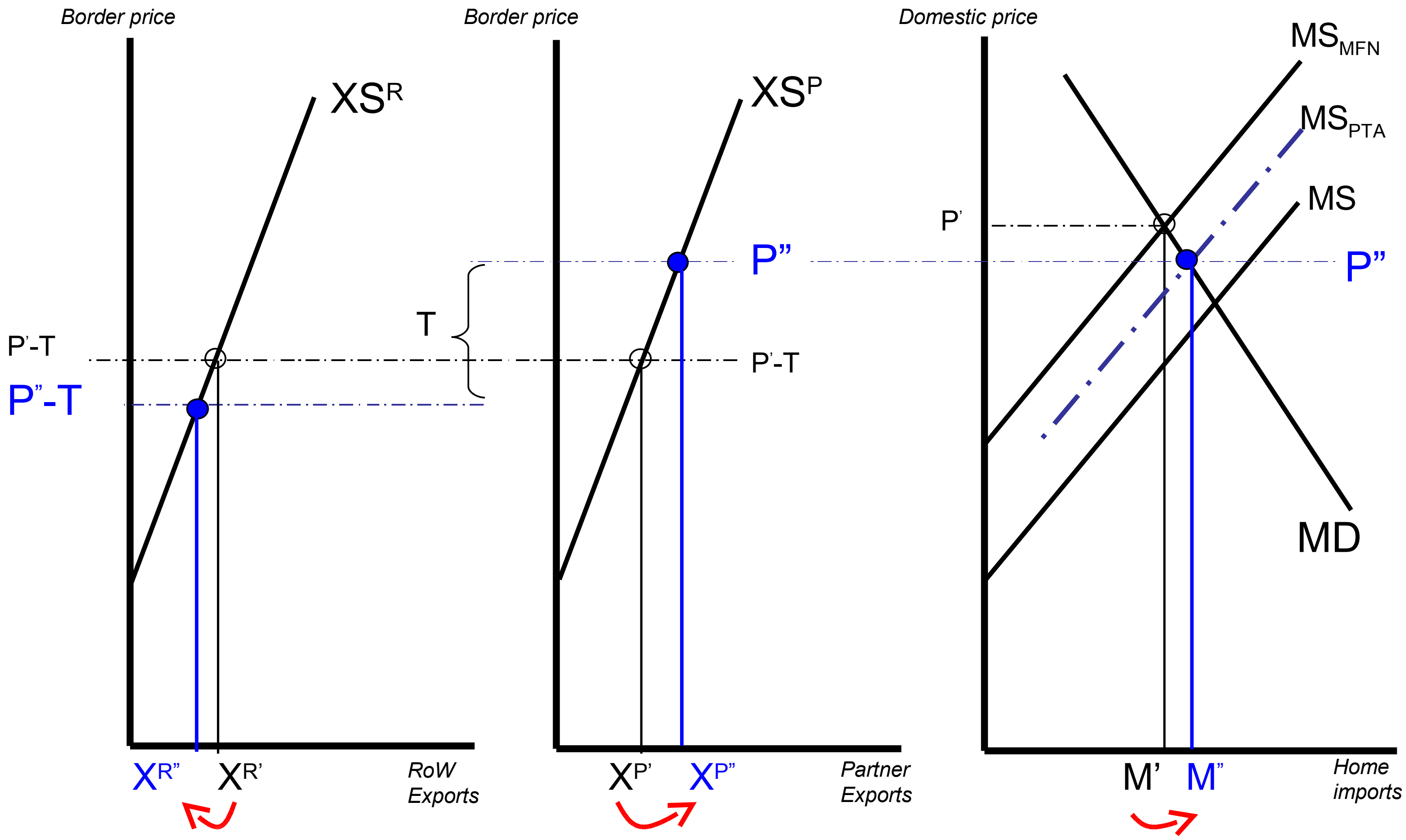
2- The equilibrium under PTA



Unilateral discriminatory liberalization
2- Domestic Price and Border Price Changes



Unilateral discriminatory liberalization
2- Quantity Changes: Supply Switching



RoW exports fall

Partner exports rise more than RoW exports fall.

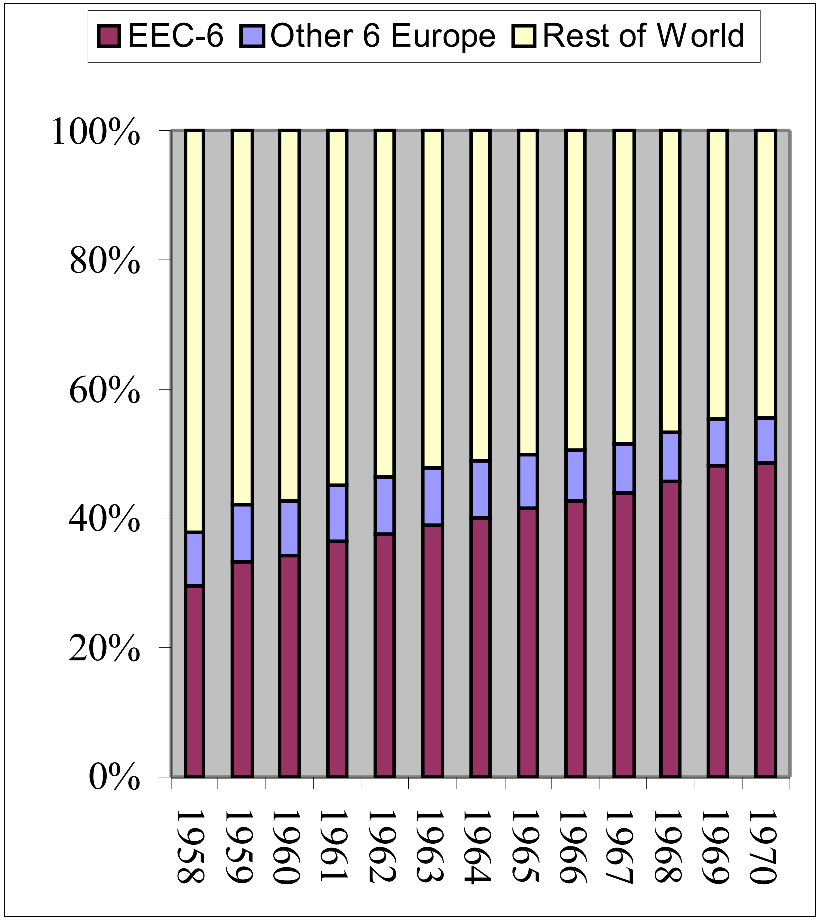
Therefore domestic imports rise.

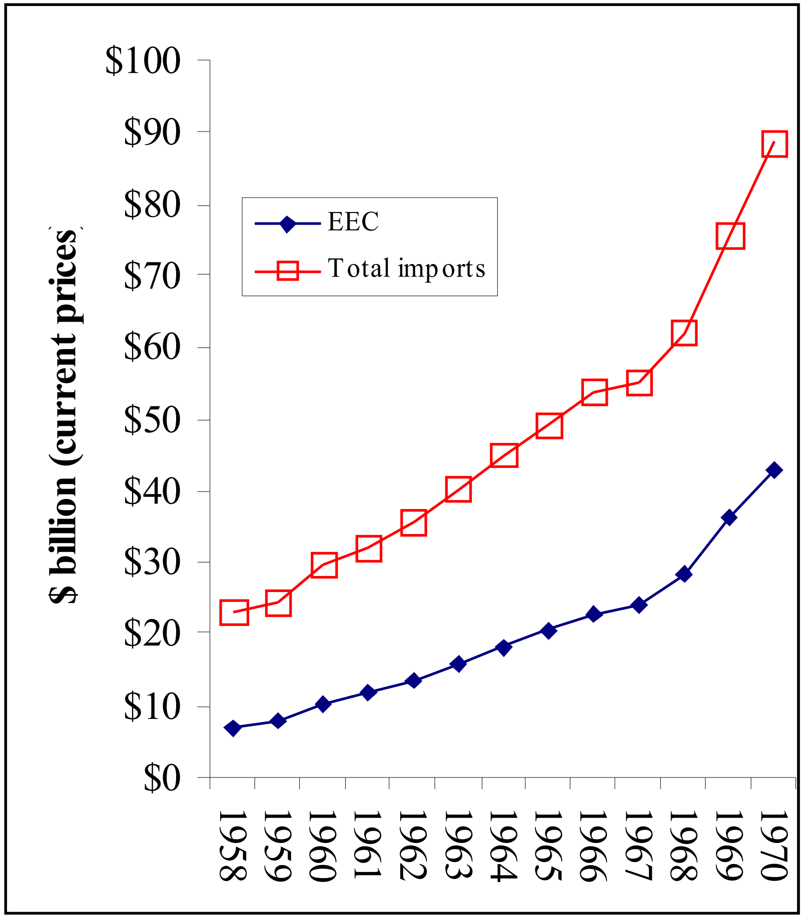
Unilateral discriminatory liberalization
2- price and quantity changes: recap

- Preferential liberalization implies supply switching i.e. “trade diversion”
  - Home imports more from Partner (who benefits from PTA)
  - Home imports less from RoW (excluded from PTA)

- Preferential liberalization creates price distortions:
  - To home consumers, all prices are the same (P”)
  - Partner goods cost the nation more than RoW goods (P” > P”-T)

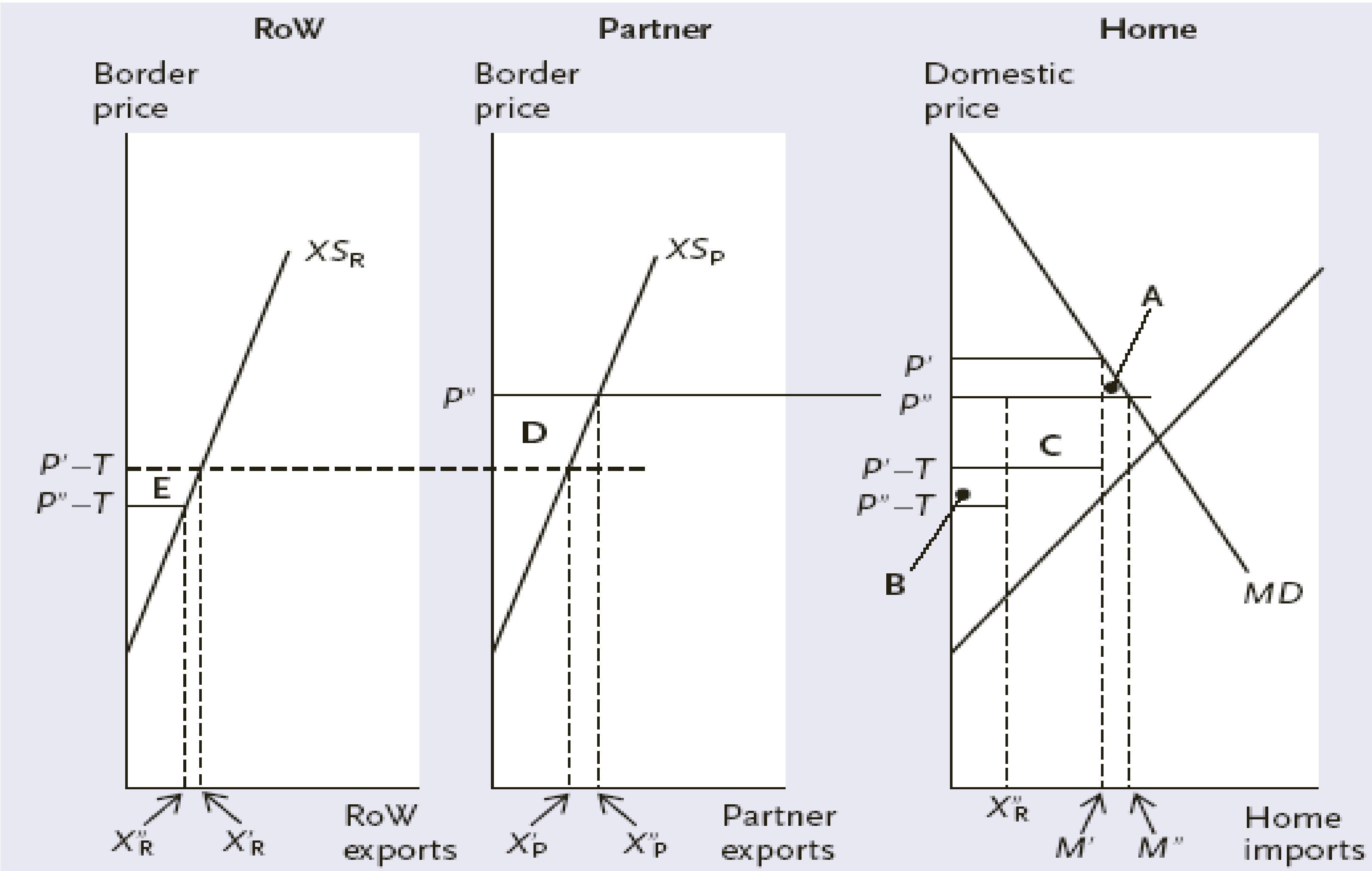
Supply switching in early EU





Note: Left panel shows share of EEC6's import from the three regions. Other Euro-6 are the 6 countries that joined the EU by the mid 1980s, UK, Ireland, Denmark, Spain, Portugal and Greece.
Source: Table 5, External Trade and Balance of Payments, Statistical Yearbook, Recapitulation, 1958-1991,

Unilateral discriminatory liberalization 3- Welfare Effects



RoW's net change = -E   Partner's net change = +D   Home's net change = A+B-C

Unilateral discriminatory liberalization
3- Welfare Effects

- Partner gains D:
  - Positive border-price effect
  - Positive trade volume effect
- RoW loses E:
  - Negative border-price effect
  - Negative trade volume effect

Unilateral discriminatory liberalization
3- Welfare Effects

- Home gain is ambiguous:

  ↓ home price → ↑ consumer surplus

  → ↓ producer surplus

  ↓ Tariff → ↓ government revenue

Or:

Positive trade volume effect (+A)

Twofold border price effect

↓ price on imports from RoW (+B)

↑ price on imports from Partner (-C)

Unilateral discriminatory liberalization 3- Welfare Effects

- Home gain is ambiguous: “Viner’s ambiguity”

  discriminatory liberalization may help or harm a country

  To get the intuition: remember marginal cost = price (NICNIR)

“Liberalization”: remove tariff wedge between (high cost) domestic firms and (low cost) foreign firms + shift some purchases to lower-cost foreign firms (in Partner)

→ more efficient **trade creation**

“Discriminatory”: a new wedge between prices faced by “Partner” and “Row” firms + more purchases from “Partner” (at higher costs) and less from “RoW” (at lower cost)

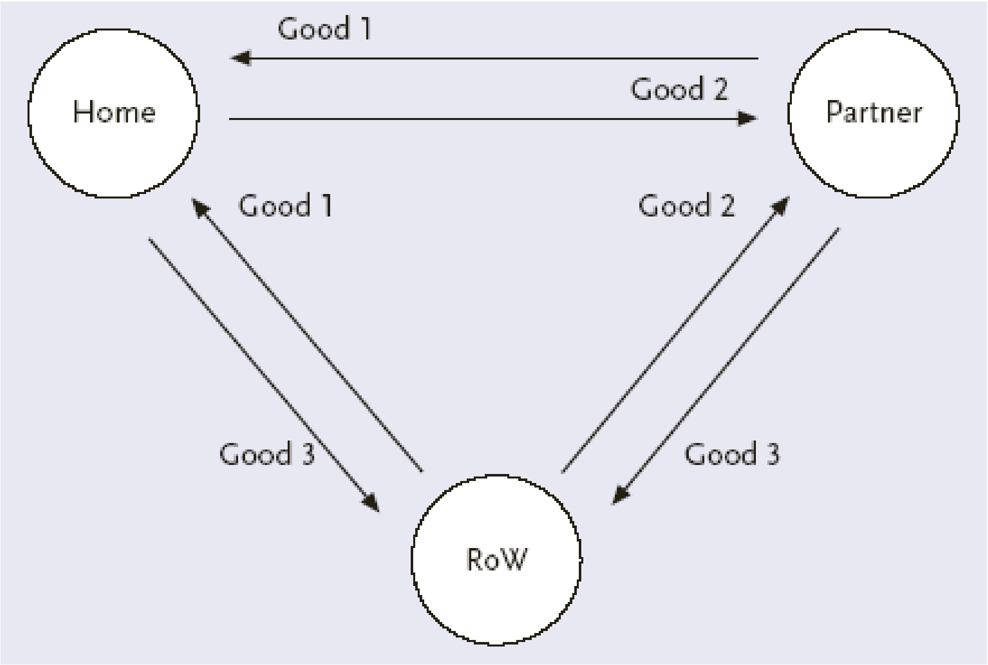
→ less efficient **trade diversion**

Analysis of a Customs Union

- European integration involved a sequence of preferential liberalisations, but all of these were reciprocal:

→ both home and partner drop T on each other's exports.

- Need to address the three-nation trade pattern.



Assume symmetric trade pattern between the three nations

Until now, only "good 1" was considered.

Analysis of a Customs Union

- FTA vs Customs Unions:
  - given symmetry three-nation set up, FTA between home and partner is automatically a customs union
    - home-partner CU has Common External Tariff (CET) equal to T:
  - in the real world, things are more complicated (see below).

Analysis of a Customs Union

- Analysis is simply a matter of recombining results from the unilateral preferential case:
  - in market for good 1, analysis is identical
  - in market for good 2, home plays the role of partner
  - in market for good 2, partner plays role of home.
- CU is more favourable for participating countries than unilateral liberalization
  - Home exporters gain from Partner tariff cuts

Analysis of a Customs Union

Welfare Effects

In market for good 1:

Home change = $A+B-C_1-C_2$.

In market for good 2

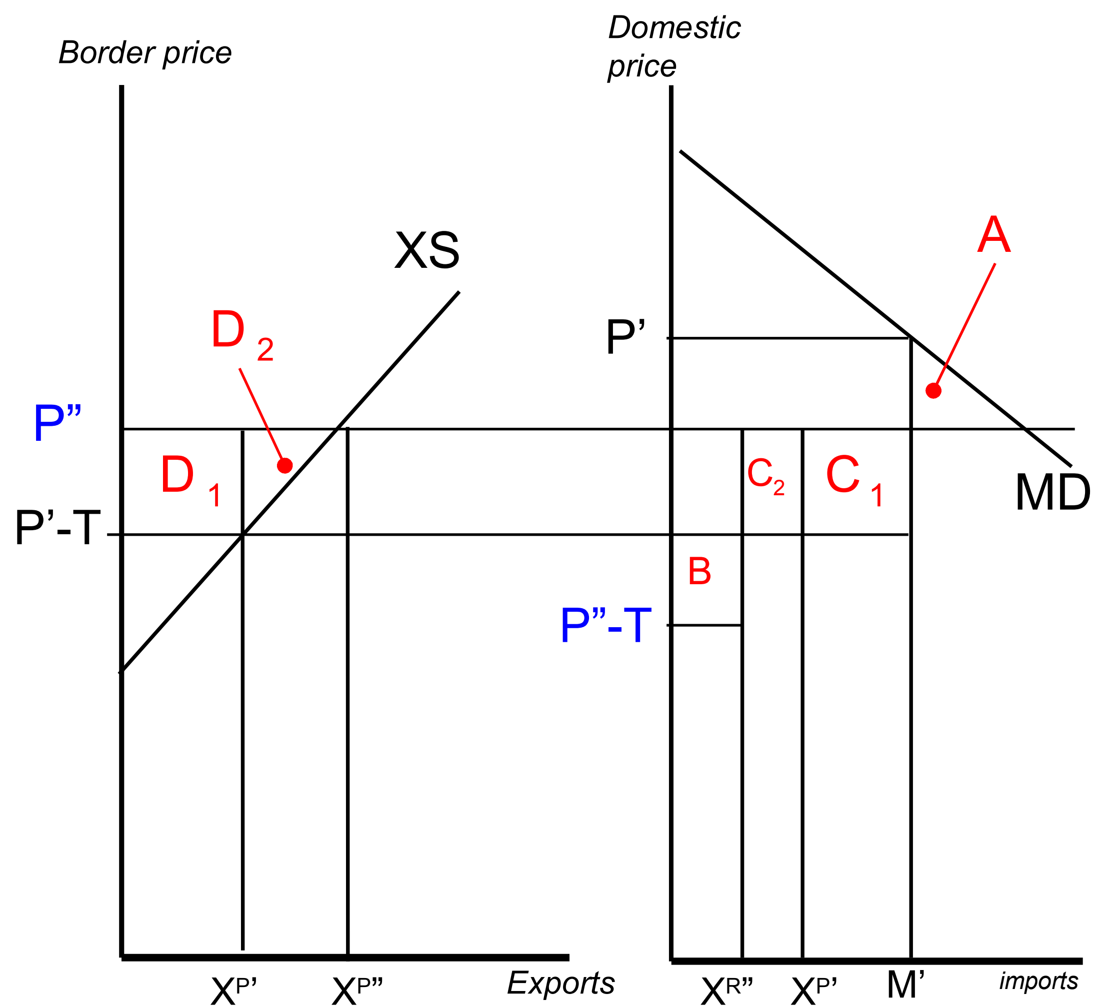
Home change = $+D_1+D_2$.

Note: $D_1=C_1$.

Net Home impact =$A+B-C_2$.

Partner impact identical.

RoW loses.



Analysis of a Customs Union

- Frictional Barrier Preferential Liberalization
  - Tariff barriers removed in Europe in the first stage of integration (up to mid 1970s)
  - Frictional barriers removed on implementing the Single Market Programme (1992)
- Consider Home, Partner and RoW impose a frictional barrier whose tariff equivalent is T
  - Lower T to 0 on all trade between Home and Partner only.

Analysis of a Customs Union
Frictional Barrier Preferential Liberalization

- Price and Quantity effects (good 1)
  - ↓ Domestic price → ↑ imports
  - ↑ Partner's border price → ↑ exports to Home
  - ↓ RoW border price → ↓ exports to Home (supply switching)
- Welfare effects (Home)
  - Good 1: ↑ welfare (no loss in tariff revenue)
  - Good 2: ↑ welfare
- Home and Partner gain, RoW looses

Customs Union vs FTA

- 1957 Treaty of Rome
  - Eliminate all tariffs and quotas on internal trade
  - Harmonize all tariffs on imports from non members
- Reaction of other western European countries: form a free trade area (EFTA), but no common external tariff
- Customs Union = Free Trade Area + Common External Tariff
- FTA without CET opens door to 'tariff cheats':
  - goods from RoW destined for home market enter via Partner if Partner has lower external tariff, called 'trade deflection'

Customs Union vs FTA

- 2 solutions to trade deflection
  - Adopt a CET → turn FTA into a CU
  - Restrict duty free treatment of imports: ‘rules of origin’ (establish where a good was made)
- Problems with ‘rules of origin’ :
  - difficult and expensive to administer, especially as world get more integrated
  - rules often become vehicle for hidden protection.

Customs Union vs FTA

- Despite the origin-problem in FTAs, almost all preferential trade arrangements in world are FTAs → CU's require some political integration:
  - agree on CET
  - agree on anti-dumping duties
  - agree on CET reductions in the context of GATT/WTO negotiations
- In the EU: the Commission has the power to set tariffs on goods
  - Transfer national sovereignty

WTO Rules

- The world trading system: rules (GATT) + institution (WTO)
- A basic principle of the WTO/GATT is non-discrimination in application of tariffs (MFN).
- FTAs and CUs violate this principle
- GATT allowed FTA and EU
  - CU like a bigger nation
  - Original GATT members wanted to maintain existing PTAs (esp. UK's Commonwealth preferences)

WTO Rules

- FTAs and CUs subject to conditions:
  - substantially (80%) all trade must be covered (cannot pick and choose products)
  - intra-bloc tariffs must go to zero within reasonable period (10 years)
  - if CU, the CET must not on average be higher than the external tariffs of the CU members were before:
    - in EEC's CU this meant France and Italy lowered their tariffs, Benelux nations raised theirs (German tariffs were about at the average anyway).