The Economics of European Integration

Chapter 5

Essential Economics of Preferential Liberalisation

The PTA Diagram

- 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 liberalisation.
- Must MD-MS diagram to allow for two sources of imports.
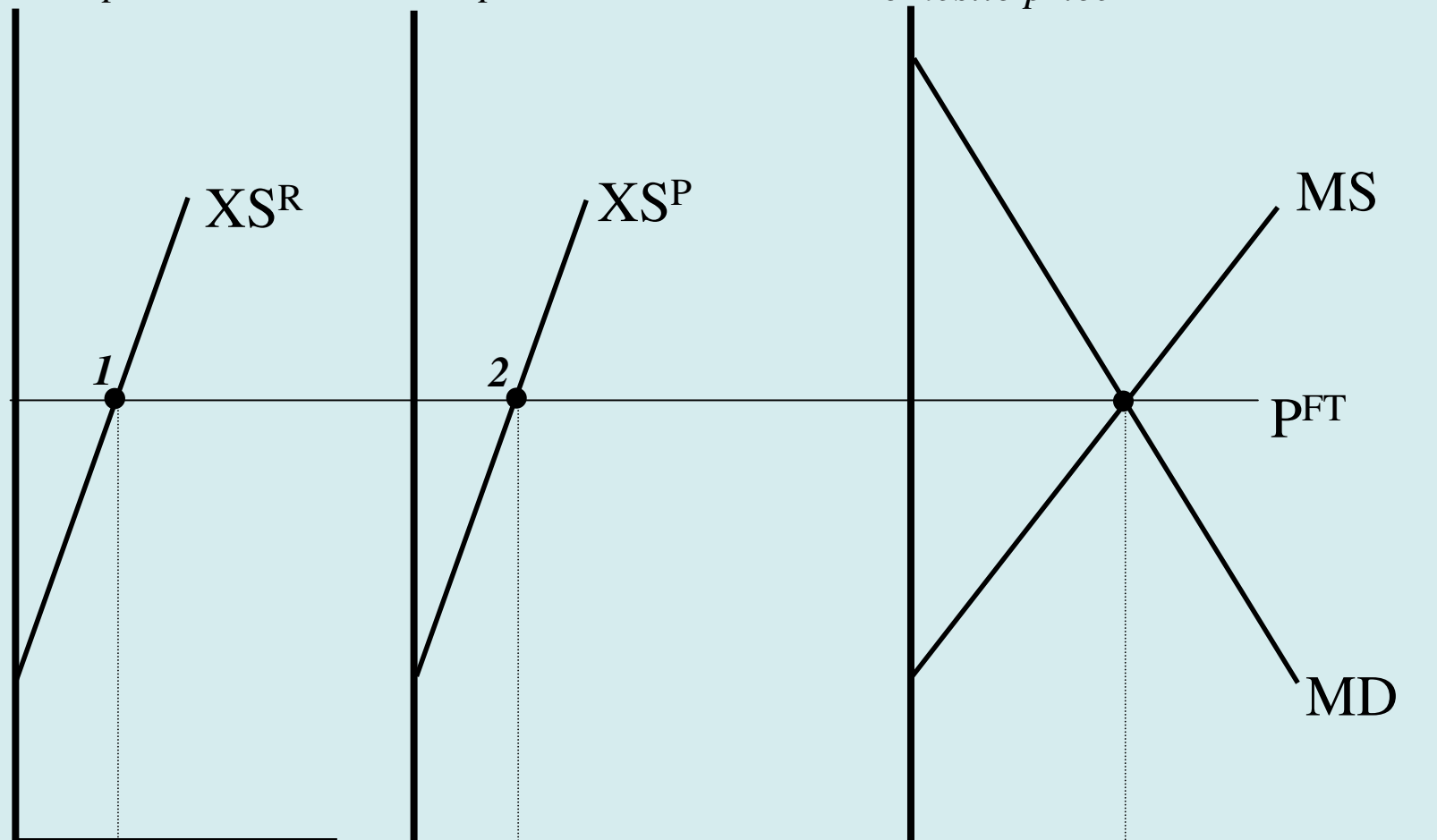
The PTA Diagram: Free trade eq'm

RoW

Partner

Home

Border price

Border price

Domestic price

XS^R

XS^P

MS

1

2

P^{FT}

MD

X_R

RoW Exports

X_P

Partner Exports

$M = X^P + X^R$

Home imports

The PTA Diagram: MFN tariff eq'm

RoW   _Partner_   _Home_

Border price   _Border price_   _Domestic price_

MS_{MFN}

XS^R XS^P MS

P'

1   **2**   T

$P'-T$ P^{FT}

MD

X'_R X_R _RoW Exports_ X'_P X_P _Partner Exports_   M' $M=X^P+X^R$ _Home imports_
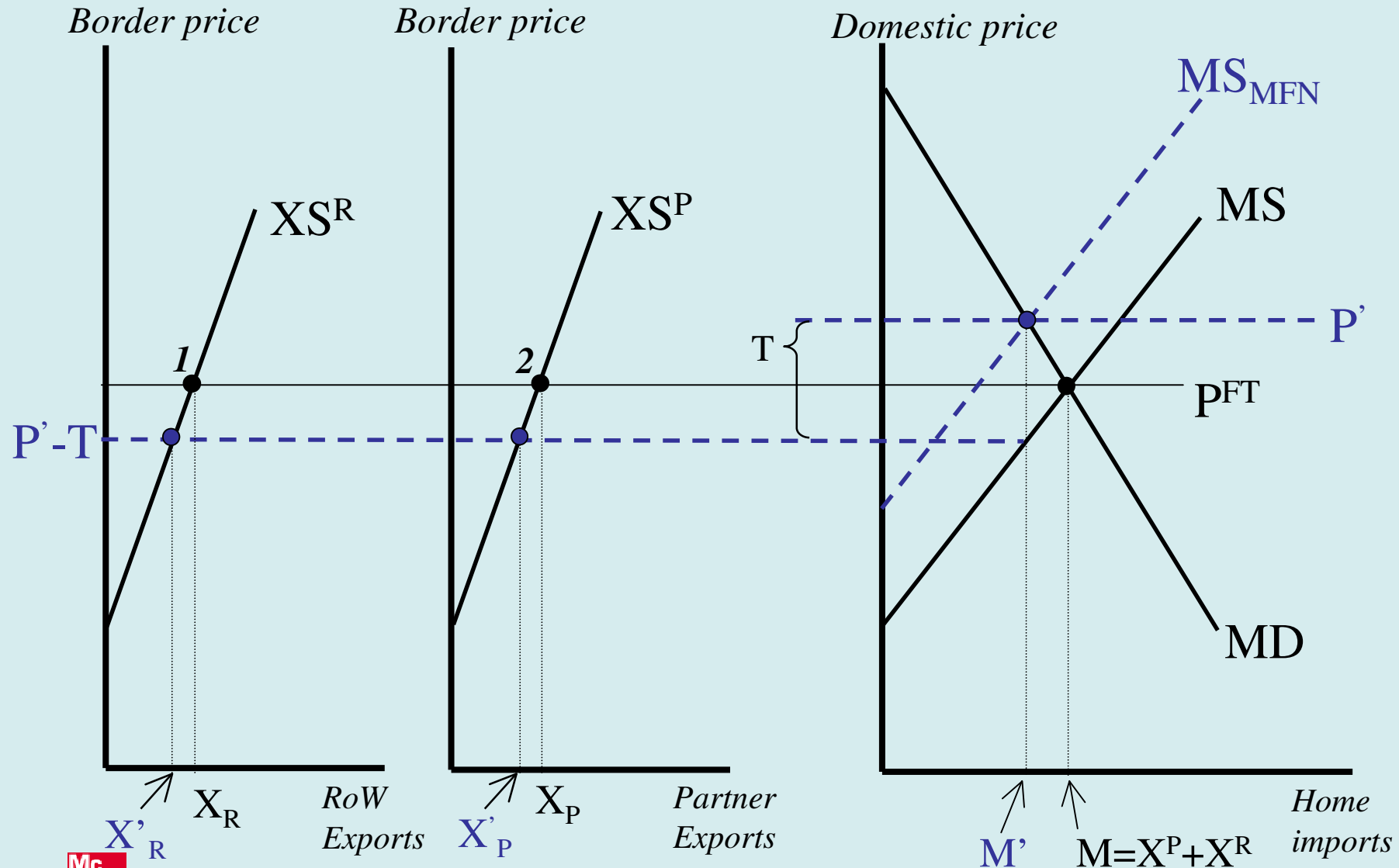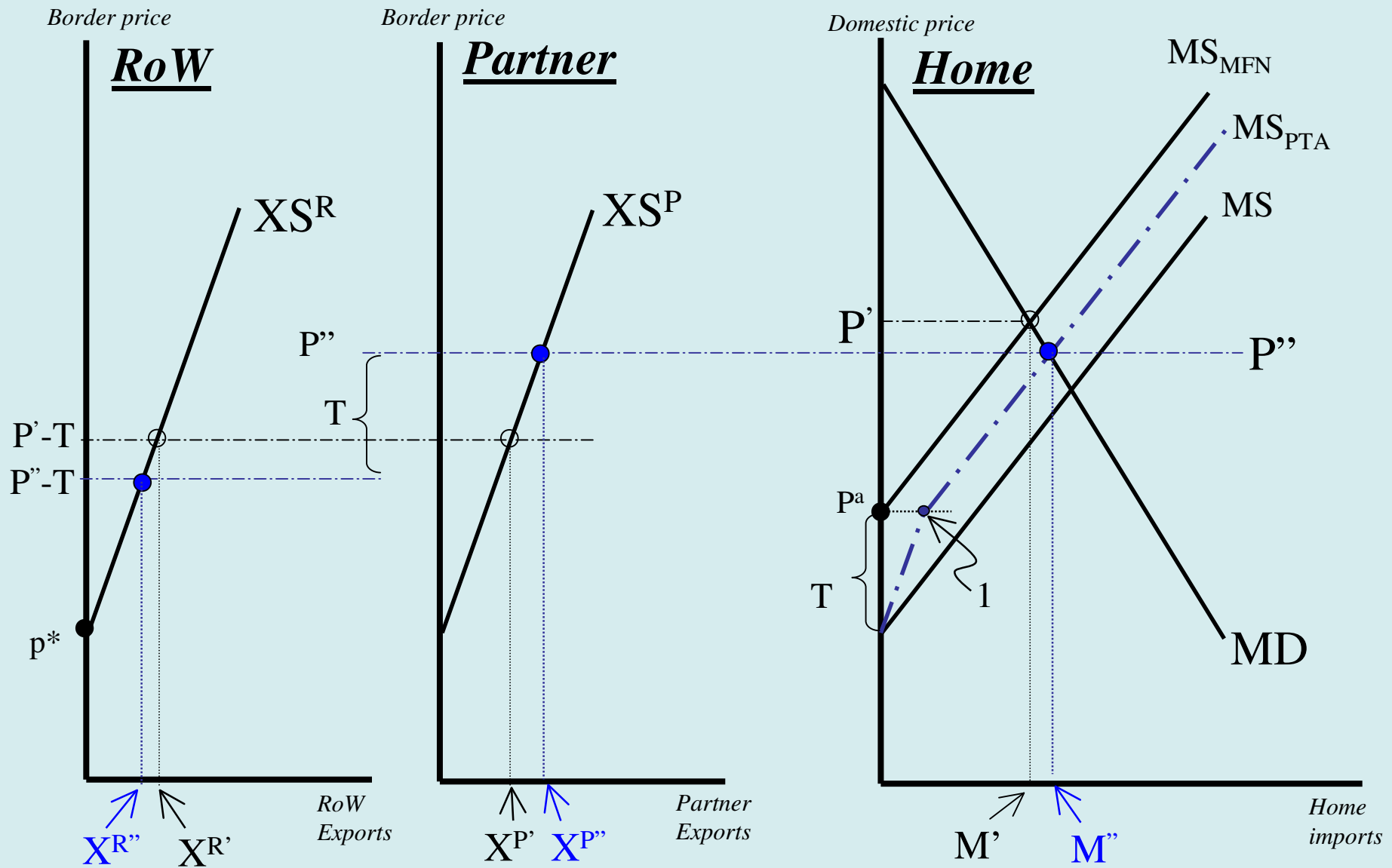
# Discriminatory, unilateral liberalization

- To build up to analysis of real-world policy changes (e.g. customs union):
  - Consider Home removes T on imports only from Partner.

- 1st step is to construct the new MS curve.
  - The liberalisation shifts up MS (as with MFN liberalisation) but not as far since only on half of imports.
    - Shifts up MS to half way between MS (free trade) and MS (MFN T), but
  - More complex, kinked MS curve with PTA.

Discriminatory, unilateral liberalization

Border price

RoW

XS^R

P''

P'-T

P''-T

p*

$X^{R''}$ $X^{R'}$

RoW Exports

Border price

Partner

XS^P

P''

T

$X^{P'}$ $X^{P''}$

Partner Exports

Domestic price

Home

MS_{MFN}

MS_{PTA}

MS

P'

P''

P^a

T

1

MD

M' M''

Home imports

Domestic price & border price changes

- domestic price falls to P' from P".
- Partner-based firms see border price rise, P'-T to P".
- RoW firms see border price fall from P'-T to P"-T.
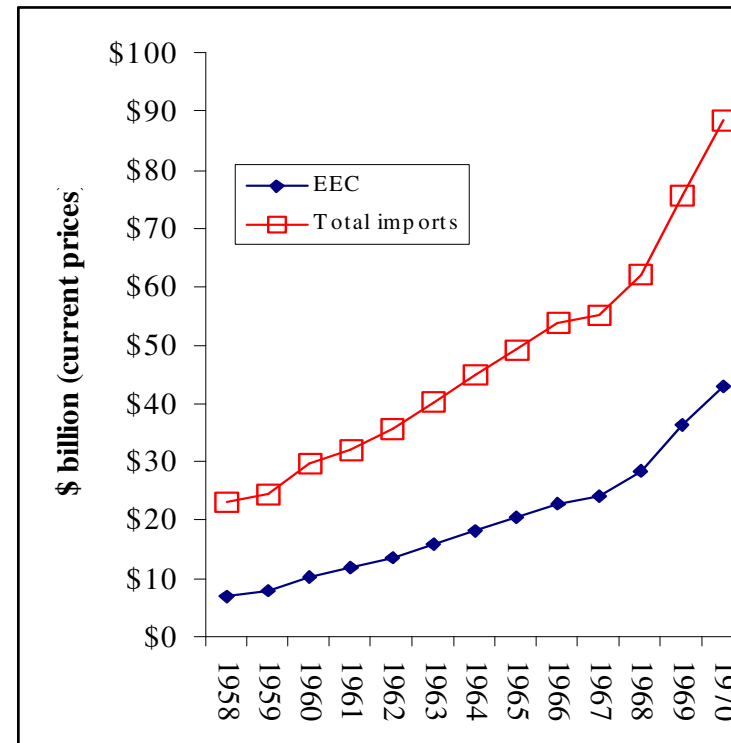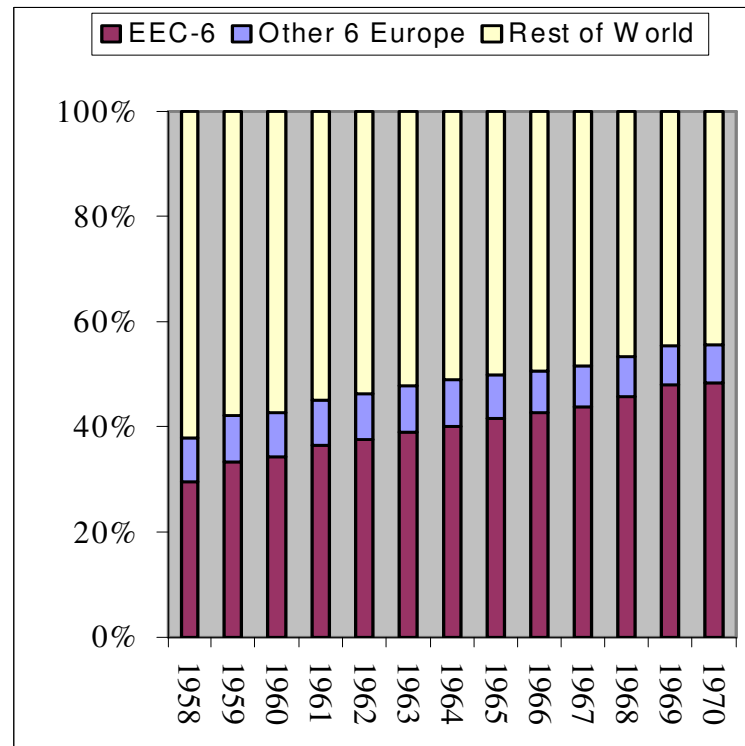

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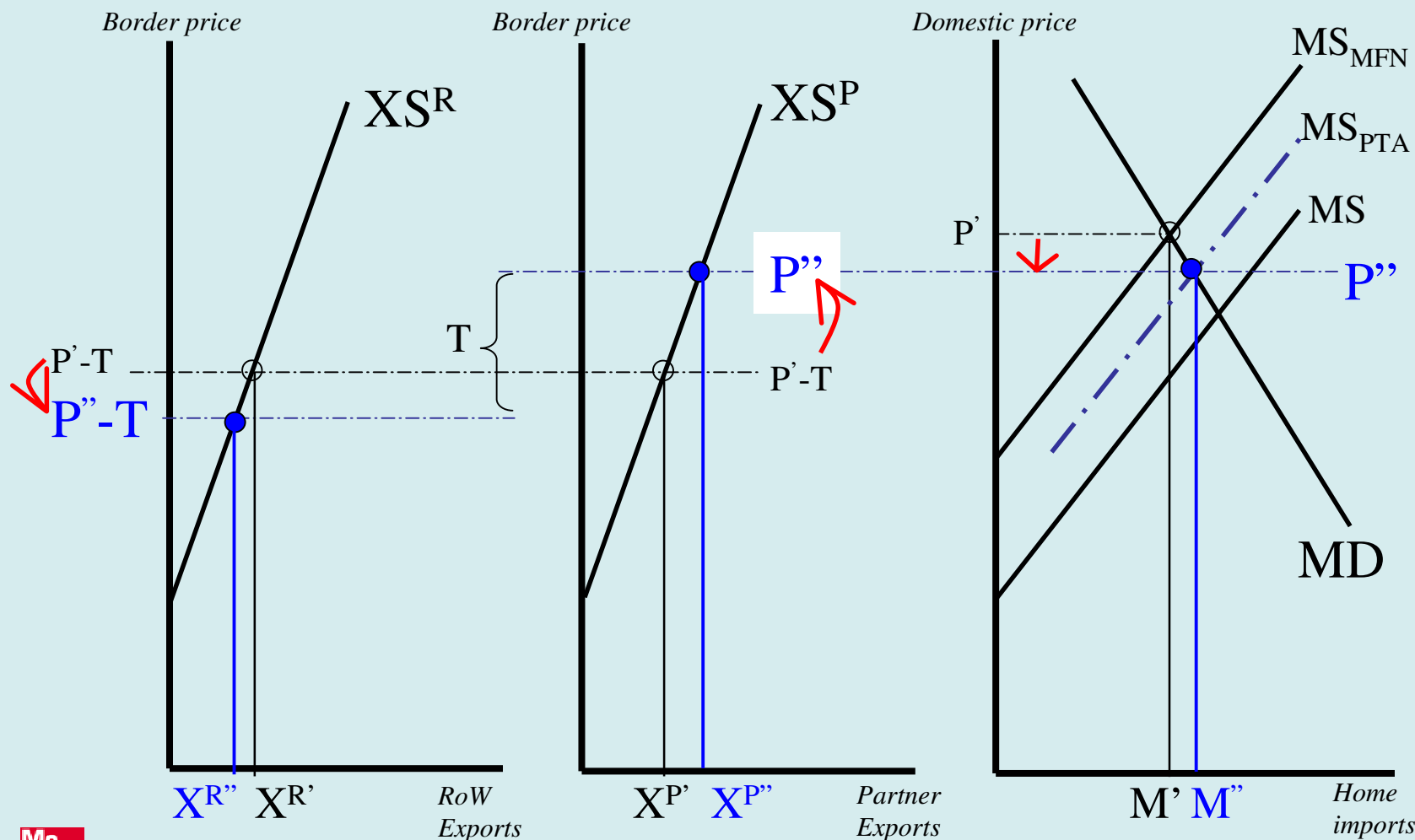
Quantity changes: supply switching

- RoW exports fall.
- Partner exports rise more than RoW exports fall, so
- domestic imports rise.
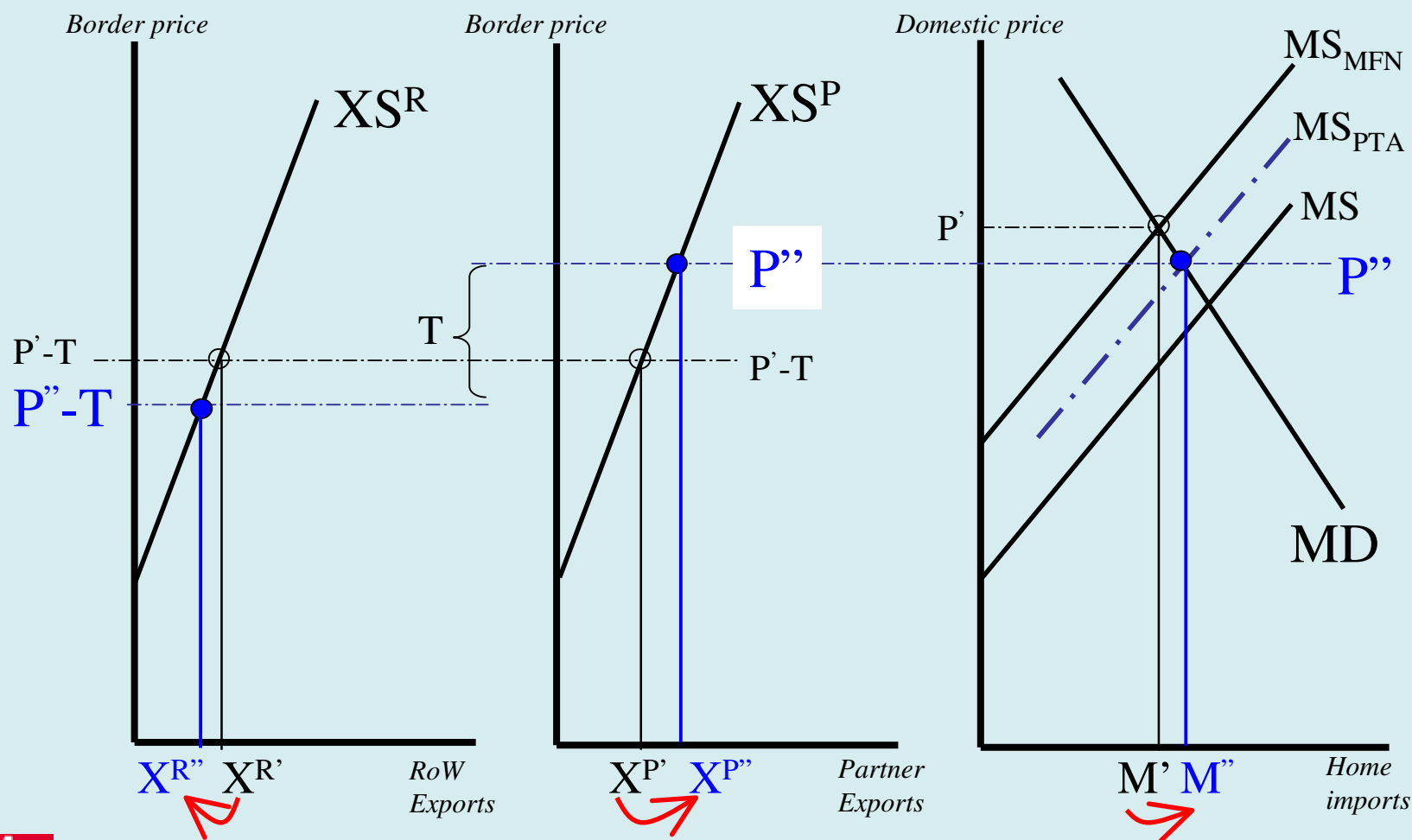
Impact of customs union formation

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,

Welfare effects

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

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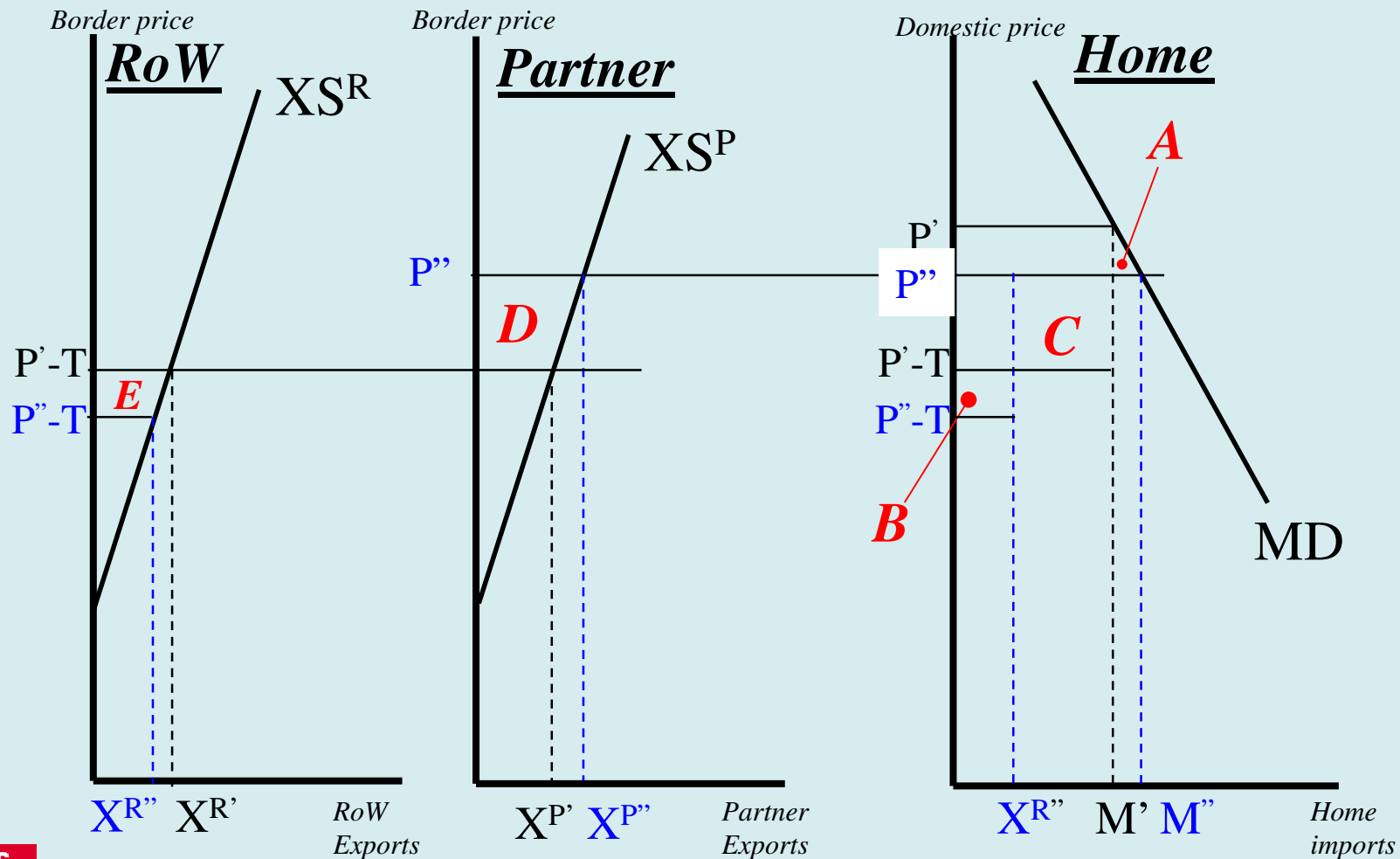
Analysis of a Customs Union

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

    – In example, both Home & Partner drop T on each other's exports.

- Need to address the 3-nation trade pattern.
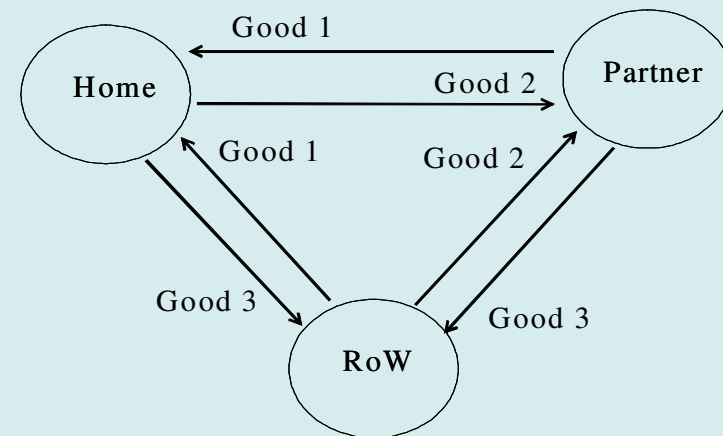
Analysis of a Customs Union

- FTA vs Customs Unions.
  - Given symmetry 3-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.
- 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.

Welfare effects of a customs union

- In market for good 1:
  - Home change = $A+B-C_1-C_2$.
- In market for good 2:
  - Home change = $+D_1+D_2$.
- NB: $D_1=C_1$.
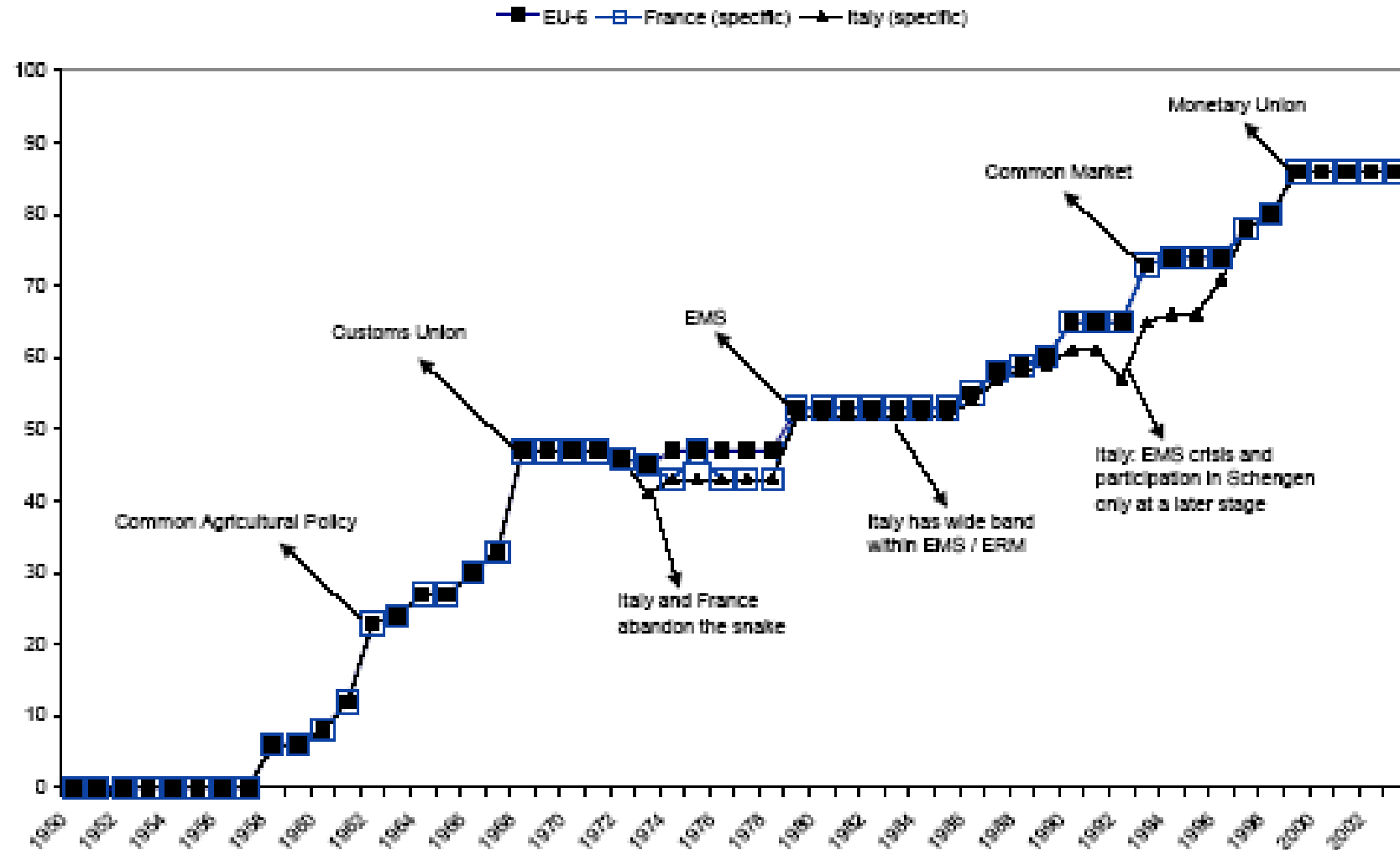- Net Home impact $=A+B-C_2+D_2$.
- Partner impact identical.
- RoW loses.
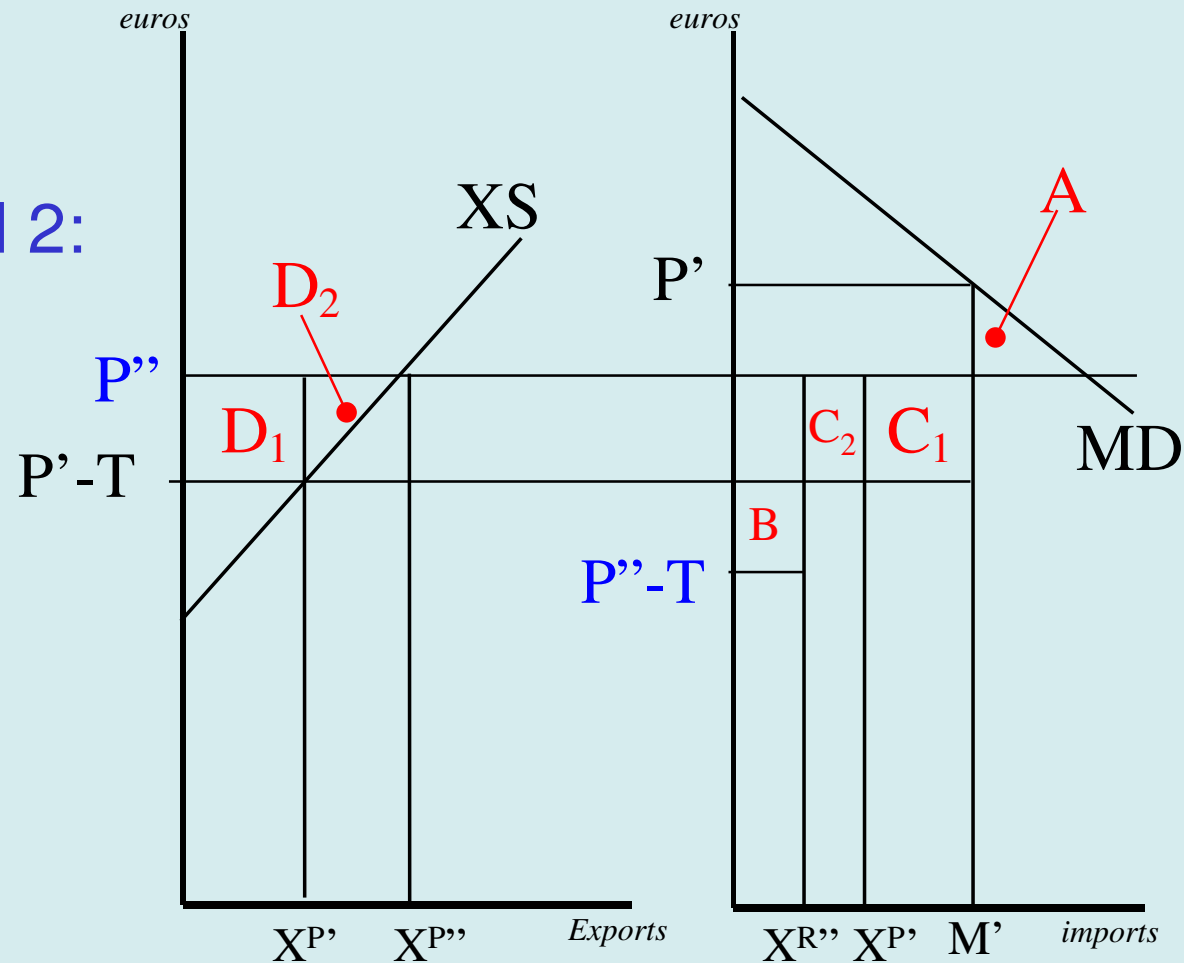
Trade creation & diversion

- Trade creation & diversion is jargon that is often used.
    - It is imprecise, but widely used.
    - Intuition for why it is so popular, despite its shortcomings.
        - It captures ambiguity of welfare gains in two words.
- "Discriminatory liberalisation".
    - Liberalisation
        - = tends to improve welfare ~ trade creation
    - Discrimination
   - -= tends to diminish welfare ~ trade diversion

Not just tariffs ...

Figure 1a   Index of institutional integration of the EU-6 (i.e., Belgium, France, Germany, Italy, Luxembourg, and the Netherlands) that started integrating in 1957

Legend: EU-6 · France (specific) · Italy (specific)

Annotations on chart:
- Monetary Union
- Common Market
- EMS
- Customs Union
- Common Agricultural Policy
- Italy and France abandon the snake
- Italy has wide band within EMS / ERM
- Italy: EMS crisis and participation in Schengen only at a later stage

Frictional barrier preferential Liberalisation

- **In market for good 1:**
  - Home change = A+F.
- **In market for good 2:**
  - Home change = +D.
- **Net Home impact: =A+F+D.**
  - Unambiguously positive.
- **Partner gains same.**
- **RoW loses.**
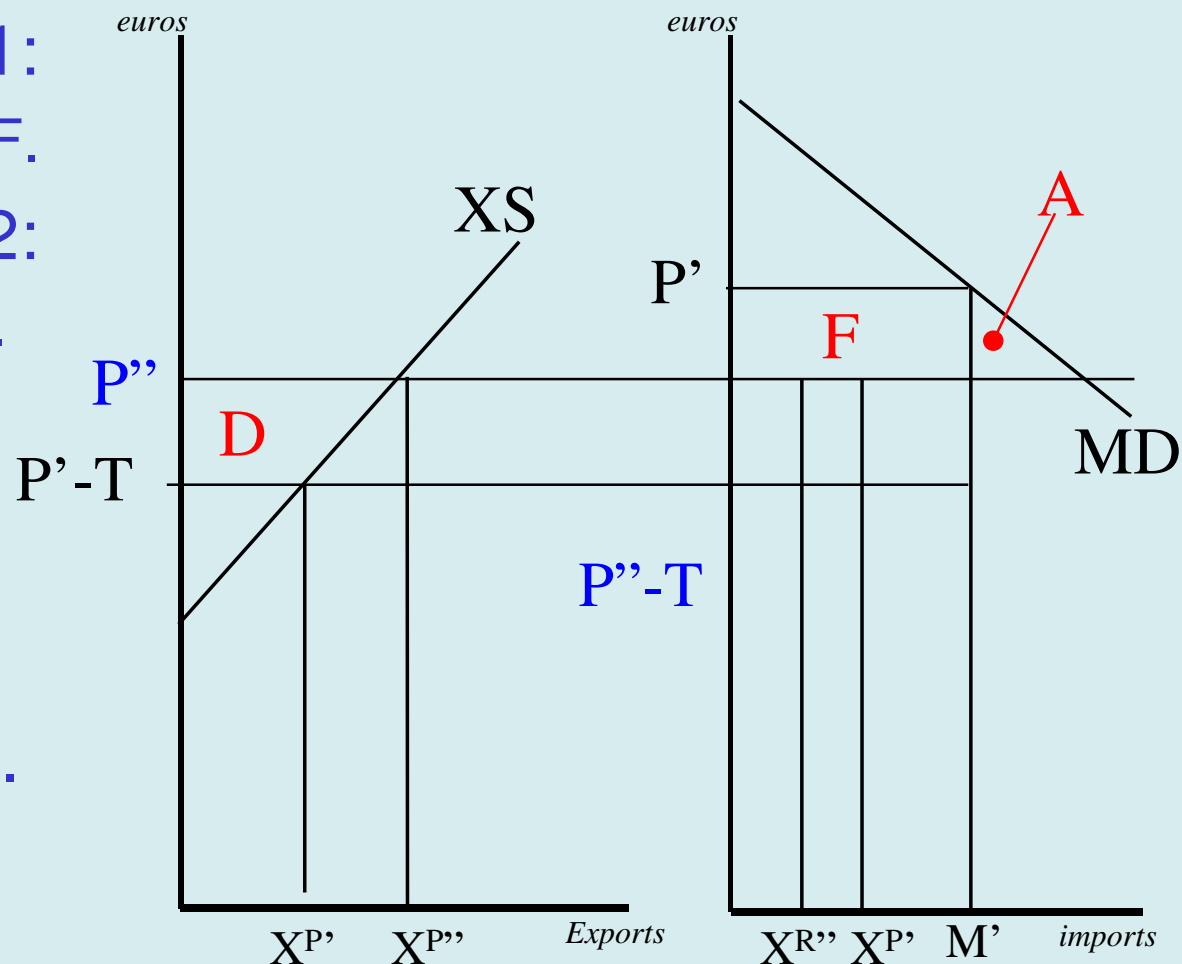
Customs Union vs FTA

- FTA like CU but no Common External Tariff.
  - Opens door to 'tariff cheats',
    - goods from RoW destined for Home market enter via Partner if Partner has lower external tariff, called 'trade deflection'.
  - Solution is 'rules of origin' meant to establish where a good was made.
    - Problems: Difficult and expensive to administer, especially as world get more integrated.
    - Rules often become vehicle for disguised protection.

- Despite the origin-problem in FTAs, almost all preferential trade arrangements in world are FTAs.
  - CU's require some political integration.
    - Must agree on CET and how to change it, including anti-dumping duties, etc.

WTO Rules

- A basic principle of the WTO/GATT is non-discrimination in application of tariffs.

- FTAs and CUs violate this principle.

- Article 24 permits FTAs and CUs subject to conditions:
  - Substantially all trade must be covered   .
    - Cannot pick and choose products.
  - Intra-bloc tariffs must go to zero within reasonable period.
  - 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).

Kemp Wan Theorem

- Possible to alter CET to get Pareto improvement.

- Form CU and adjust CET to ensure zero external trade effect (thus welfare impact on RoW is zero).

- Treat external trade vector as part of endowment vector & First Welfare Theorem tells us FT between partners achieves FB and so is better than distorted equilibrium.

- Not practical, but an intellectual landmark (FTAs need not be bad).