Topic 9: Preferential trade agreements (PTAs)

Introduction

One of the most important elements of trade policy in the world is the rapid growth of various forms of Free Trade Agreements (FTAs), more generally referred to as PTAs or Regional Trade Agreements (RTAs).

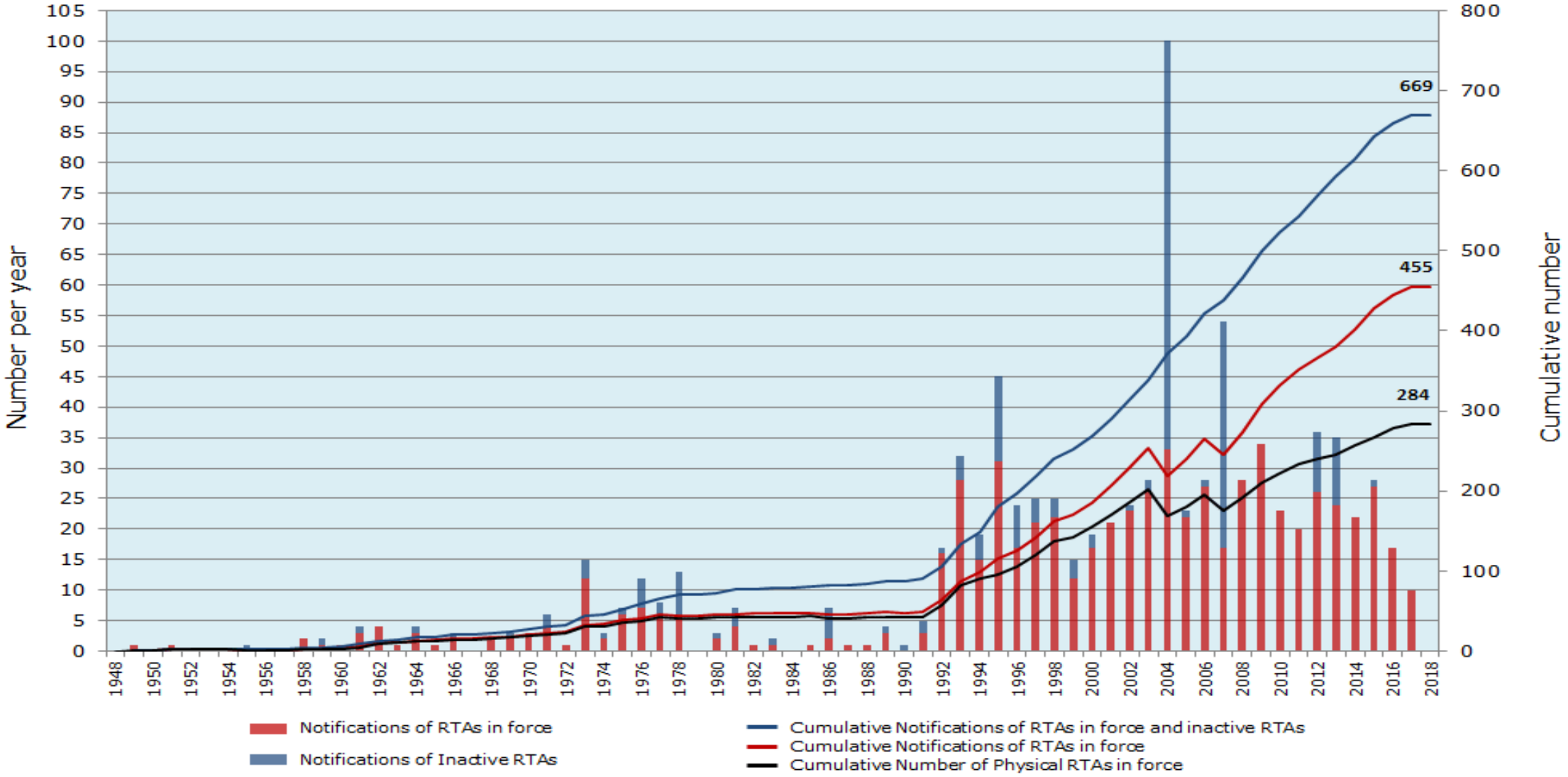
They have been in existence for many centuries in various forms, such as the Hanseatic League among northern German principalities and parts of Scandinavia in the 13th to 17th centuries and various trade agreements among Italian republics during the Renaissance.

The first major FTA after World War II was the European Coal and Steel Community (ECSC), which eventually became the European Community and now the European Union.

The first major agreement involving the United States was the North American Free Trade Agreement (NAFTA) with Canada and Mexico in 1994, which succeeded the Canada-US FTA.

PTAs really began to grow in number and scope after NAFTA and as of January 2018 there were 455 such agreements in place involving nearly all countries in the WTO (Chart).

Evolution of Regional Trade Agreements in the world, 1948-2018



Note: Notifications of RTAs: goods, services & accessions to an RTA are counted separately. Physical RTAs: goods, services & accessions to an RTA are counted together.
The cumulative lines show the number of notifications/physical RTAs that were in force for a given year.
Source: RTA Section, WTO Secretariat, 25-Jan-18.

US PTAs

In recent decades PTAs have become the primary way that the US and the EU try to manage their trade relations with specific countries or groups of countries. In addition to NAFTA the US has the following agreements (20 countries in total):

- Central America (CAFTA);
- Several nations in the Caribbean (CARICOM);
- Agreements in South America (Chile, Peru, Colombia);
- Australia;
- South Korea;
- Israel, Jordan, and numerous other small countries.

Other PTAs

The EU itself is a massive FTA with 28 current members (actually a Customs Union; see below).

The EU also has an FTA with the members of the European Free Trade Agreement (EFTA; Switzerland, Norway and Iceland) and a customs union with Turkey and some smaller states.

EU has recently concluded major PTAs with Mexico and Canada (separately).

The EU has also developed what it calls Trade Partnership Agreements (TPA's) with countries in Eastern Europe, Central Asia, the Middle East and North Africa. More recently ones include Chile, many Caribbean nations (CARIFORUM), numerous sub-Saharan African countries, and some Pacific Island states. It has ongoing negotiations with India, South Korea, the ASEAN nations, and several in Latin America.

Japan has generally chosen not to engage in PTAs, except:

- Japan signed a comprehensive one with EU in 2017
- Japan is one of 11 countries in the "Comprehensive and Progressive Trans-Pacific Partnership" (CPTPP)).
- A big reason for Japan's reluctance is concerns that agreements might force Japan to give up on some of its agricultural trade protection. China has not been involved in many either.

China has not been involved in many either but that is changing.

Other prominent agreements are MECOSUR (several countries in South America), ASEAN (Association of Southeast Asian Nations, which is not just about economics), and the South African Common Market.

Other attempts worth knowing about

The Trans-Pacific Partnership (TPP) was signed in 2016 but fell apart when Trump Admin pulled out in January 2017. It involved Australia, Brunei, Canada, Chile, Japan, Malaysia, Mexico, New Zealand, Peru, Singapore and Vietnam.

The Trans-Atlantic Trade and Investment Partnership (T-TIP) is also basically dead. It involved negotiations between the US and the EU over free trade and deep regulatory cooperation.

The Regional Comprehensive Economic Partnership (RCEP) is a proposed PTA involving China, India, Japan, S Korea, Australia, New Zealand, and the 10 ASEAN countries. Those negotiations (led by China) are completed and signature is scheduled for November 2018.

Comments on “mega-regional PTAs”

Because these last PTAs are so large in country coverage they are often called “mega-trade deals” or “mega-regionals”. So are NAFTA, the EU, and a few others (eg, MERCOSUR).

“Old TPP” and T-TIP are less about cutting tariffs and removing quotas and much more about reaching agreements on many regulatory issues that go beyond trade. Examples:

- Trade and FDI in services;
- Rules on investment;
- “Rules of origin” regarding what constitutes within-PTA production;
- Intellectual property rights (IPRs);
- State-owned enterprises (SOEs);
- Standards for recognizing product safety and quality;
- Data flows, privacy and e-commerce;
- Labor rights and environmental protection.

These are really important and interesting issues that we don’t have time for. But you should be aware of them. And they can be controversial, for example, patent protection for medicines.

General comments

Because they involve 2 or more countries giving each other policy preferences that they do not give to non-members, PTAs are explicitly *discriminatory.*

This means they violate the basic GATT and WTO principles of non-discrimination (most favored nation (MFN) and national treatment (NT)). But the GATT and the WTO have rarely tried to intervene and stop the formation of any such agreements.

PTAs are permitted under GATT Article 24.3, which states that such agreements are OK if:

- They cover the substantial majority of trade among members; and
- The PTA members do not raise their tariffs against other WTO members.

Types of PTAs (depth of integration)

1. A Partial Free Trade Agreement involves 2 or more countries offering each other lower (or zero) tariffs on a range of goods but not all goods.

2. A Free Trade Agreement (FTA) involves 2 or more countries offering each other zero tariffs and no quotas on all goods (though there are exceptions, usually in agriculture).

- A key point is that in a PFTA or an FTA each country keeps its own trade policy against non-member countries. In NAFTA for example, Canada, Mexico and the US all have different tariff schedules against countries outside of NAFTA.
- That situation raises the obvious problem that firms from other countries would choose to ship their goods to where the import tariffs are lowest, then ship the goods freely around NAFTA countries without paying additional taxes.
- To offset this, all FTAs have in place complex "rules of origin" (ROOs). To qualify for zero-tariff transshipment around Canada, US and Mexico, for example, products must have been produced with at least XX% of their value coming from one or more of those 3 countries. The percentage varies by product but ranges from 25% to 80%; the average is around 55%.
- The treatment of US domestic content is/was a central element of the renegotiation of NAFTA to get the "USMCA". It raises the % of regional auto content to 67%, has a minimum US content, and a minimum content produced for at least $16 per hour

Types of PTAs

3. A Customs Union (CU) is a FTA in which members give each other zero tariffs and also agree to have the same trade policy against non-members ("common external tariff").
   - The EU is a customs union and tariffs are set in Brussels and shared by all countries in the EU. This reduces the ROOs problem quite a bit.
   - Some countries are annoyed they can't set their own trade tariffs, a big reason for Brexit, which is currently being negotiated.
   - The EU countries negotiate as a group at the WTO or in any other trade agreements.

4. A Common Market is a CU in which labor and capital are permitted to move freely among member countries.
   - The EU is actually a common market in that most restrictions on capital and labor migration are removed. (Although when a new country joins there is usually a period of time before workers can go elsewhere in the UE legally.)
   - The free labor migration plank is the biggest reason for Brexit.

5. An Economic Union is a Common Market in which there is also a single centralized fiscal and monetary policy. There would be just one central government permitted to set federal taxes and expenditures, one central bank, and one centralized system for regulating financial markets.
   - The EU has hopes of getting there but is a long way from it.
   - In fact, *the United States is an economic union*. The EU is trying to get the same kind of integration, with considerable difficulty.

Basic economic analysis

In principle, PTAs have offsetting effects on economic efficiency:

- Because they cut tariffs among members, they seem to be a movement toward freer trade and more efficiency.
- But because they do so in a discriminatory way, they could be a movement toward more restrictive trade and less efficiency.

Thus, the basic question we ask in economics is this: does a PTA generate more welfare gains through *trade creation* or more welfare losses through *trade diversion*?

First, some definitions:
Trade creation **exists when a policy change (such as a PTA) causes output to move from a higher-cost location to a lower-cost location within the region. It is usually associated with an expansion of trade volumes within the PTA. This is an efficient change and generally raises welfare within the PTA.**

Trade diversion **exists when a policy change (such as a PTA) causes output to move from a lower-cost location outside the region to a higher-cost location within the region. It is usually associated with a reduction of trade volume with non-member countries. This is an inefficient change and generally reduces welfare within the PTA. (And it can make non-PTA exporters worse off because they lose an export market.)**

In any PTA both of these outcomes are possible, so member countries (and the world, if the PTA is large enough) could gain or lose welfare from forming a PTA.

Simple examples

To understand TC and TD consider the formation of the EU.

Trade Creation: When the UK joined in 1973 its domestic steel and automobile producers suddenly faced lower-cost competition from other members of the EU (e.g., Germany, Netherlands, and France). This was efficient trade creation, even if bad news for UK steel and auto producers.

But note that the UK also exported things it made efficiently to the rest of the EU, such as financial services; also TC.

Trade Diversion: But the EU also had a high-cost set of agricultural price and output supports, called the Common Agricultural Policy (CAP).

By reducing trade barriers within the EU on agricultural trade there was more output generated in France, Belgium, Spain, and other locations, much of it exported to UK, Germany, etc.

But this extra output and trade came at the cost of excluding cheaper wheat, corn, and so on from North America, South America, and Australia. This was inefficient trade diversion.

Basic graphical analysis

Here is a simple graphical example of how this works (this is just like text Figure 9.1).

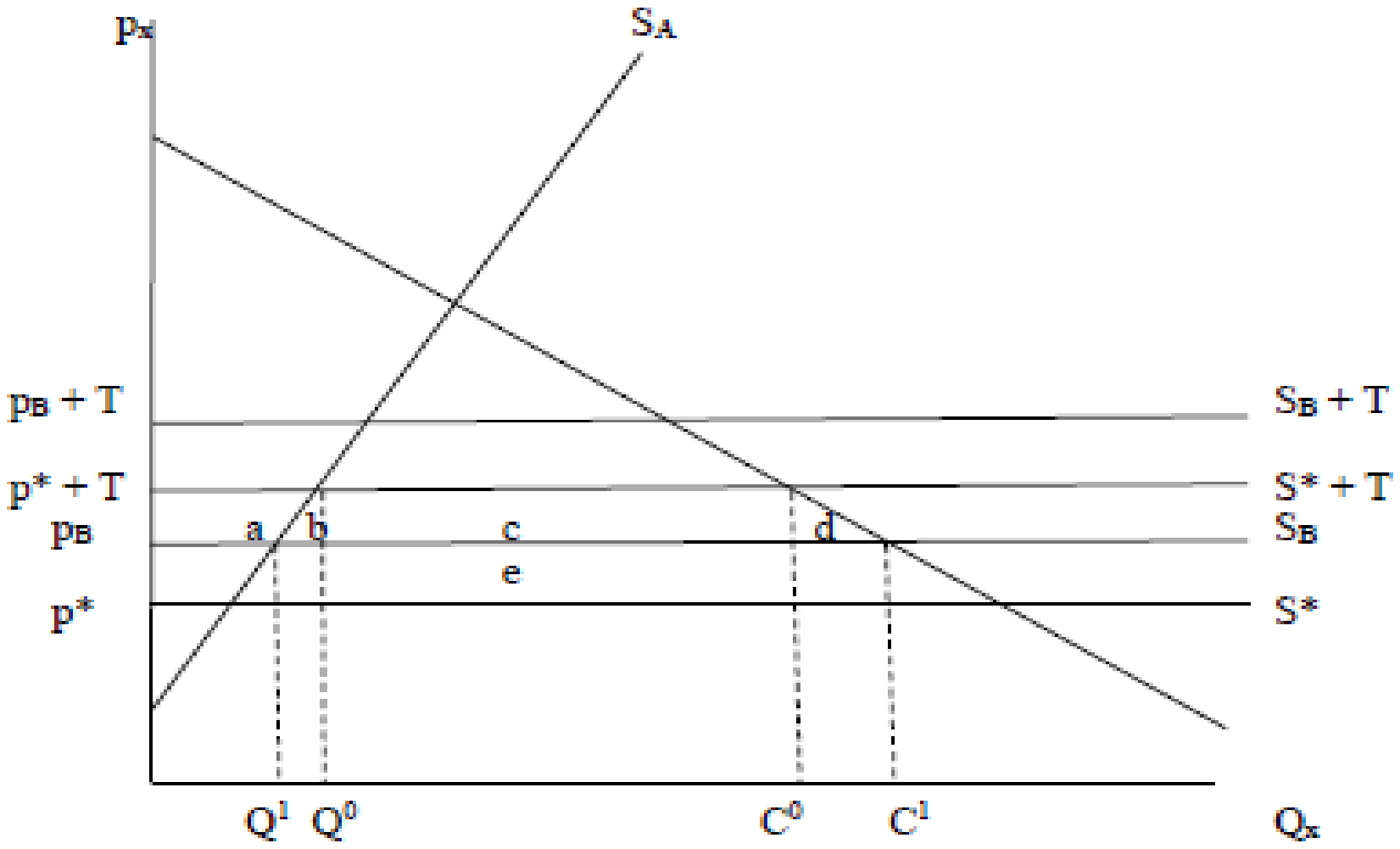
Let countries A and B be small relative to the rest of the world (which we'll call the World).

A imports good X and can choose between buying it from the world at price p* or from B at a higher price p_B. Because the price from B is higher it is a less efficient producer than is the world.

Suppose initially that A imposes the same ("most favored nation" or MFN) tariff against X coming from both B and the World.

In that case the lowest available price to the market in A is p* + T and that will be the initial domestic price in A. Domestic output in A is Q^0 and domestic consumption is C^0. In that case the initial import volume is Q^0C^0 *and all of those imports come from the World* (none from B).

PTA analysis: 2 small countries



Basic graphical analysis

Now let A and B form a FTA, eliminating tariffs between them.

This means that good X is now available in A's market at price p_B rather than p* + T. Since the price is lower the domestic price in A will fall to p_B.

- Domestic output falls to Q^1 and domestic consumption in A rises to C^1.
- Imports are now Q^1C^1 *and all of these imports come from B* (none from the World).

Note that there are 2 kinds of changes in imports here.

- First, there is an expansion of imports of X into A in the amounts $Q^1Q^0 + C^0C^1$. This really is new trade and is associated with trade creation. WHY?
- Second, the old volume of imports Q^0C_1 still exists but its source has changed from the efficient World to the less efficient partner B. This is associated with trade diversion. WHY?

Welfare analysis

Let's do the welfare calculations in country A:

- Loss in producer surplus = - a
- Gain in consumer surplus = + a + b + c + d
- Loss in tariff revenues = - (c + e)

Be sure you understand why there is this loss in tariff revenues. Before the FTA country A received the tax amount $T on each unit of imports from the World and that amounted to the boxes (c + e). Now all of that revenue has disappeared because there is no tax on imports from B.

The net welfare gain or loss in A = + b + d – e.

- The areas + b + d are the efficiency gains (the opposite of our usual deadweight losses) from having country A bring in imports from B, which are produced more cheaply than they would be at home in A. *These are the gains from trade creation.*
- The area – e exists because country A now buys those imports from B at a higher price (p_B) than the country had been paying to the World (p*). In essence this is a decision by A to worsen its own terms of trade by buying from a higher-cost source within the PTA. *This is the welfare loss from trade diversion.*

Welfare analysis

As for country B we would do a similar analysis on the good it imports to see if it has net trade creation or trade diversion.

In general, there are thousands of goods that FTA partners trade and the analysis would add up TC and TD effects across all of them in all partner countries to see what the overall effects might be.

And as for the World, since we've assumed A and B are small this FTA doesn't really matter in welfare terms.

But if it is a large FTA (e.g., NAFTA, the EU, or CPTPP) the world certainly would care about its implied welfare effects. If A and B together made a large FTA then their trade partnership would reduce demand for many goods exported to them by the World, even if A and B did not raise their individual tariffs against the world.

This likely would make the World worse off (though again it would require a careful accounting across many thousands of goods).

Trying to make such calculations for particular FTAs is a major job for trade economists around the world. They use sophisticated statistical and theoretical models of how entire economies work to make such calculations.

What factors affect TC and TD?

This analysis raises an obvious question: what are the characteristics of FTAs or PTAs that would make their formation more likely to generate more trade creation than trade diversion?

1. *There is likely to be more TC than TD the larger is the economic size of the PTA.* This is because larger PTAs imply less of the world is left out to suffer from TD. In the extreme, if the entire world had free trade among all countries there would be just TC in this sense.

2. *There is likely to be more TC than TD the more member countries in the PTA differ in their comparative advantage (relative cost differences).* Where this is true the price adjustments within the PTA will be larger and you'll get larger TC triangles (efficiency gains).

- (To see this in the diagram above, if p_B were quite a bit lower than the initial domestic price in A the expansion of trade within the FTA would be pretty big while the TD loss (area - e) would be smaller.

3. *TC is likely to exceed TD where the pre-FTA tariffs that get removed are high.* This simply means that the FTA partners reduce quite high tariffs, which likely generates a lot of within-FTA trade.

NAFTA and TC versus TD

Given these factors, we can ask whether (old) NAFTA is likely to have generated more TC or more TD.

NAFTA is very large (any FTA with the US in it is, almost by definition, but NAFTA has 3 big countries). This suggests significant net TC.

Although the US and Canada are similar in their cost structures, Mexico has quite different relative costs from the US and Canada. NAFTA encouraged Mexico to specialize more in labor-intensive and assembly operations. Mostly this would support net TC, and has done so in an extreme way with the emergence of supply chains in autos, textiles, and electronics.

Pre-NAFTA tariffs were high in Mexico but not in the US and Canada. So this one is not as clear.

Available estimates (from about 10 studies done by economists) suggest that NAFTA has generated considerably more TC than TD, when measured in ways similar to this analysis.

Other economic effects of PTAs

This analysis of TC and TD is important but it misses a number of arguments made about PTAs. Let's just describe other important impacts that PTAs may have.

1. *Lock-in effects*: One reason Mexico joined NAFTA was to commit itself to maintaining the required tariff cuts and other liberalizing policies.

- Because of that, future Mexican administrations (not to mention US and Canadian ones, at least until now) would be very unlikely to go back on these commitments and raise tariffs.
- The main reason is that firms (domestic and multinational) make large investments based on the rules of NAFTA and become effective lobbyists against changing the rules later.
- All this seems accurate: it is possible for countries to pull out of NAFTA but this was never seriously considered before now.

2. L*arger joint size and the terms of trade:* Individual countries may be too small to have much impact on world trade flows and the terms of trade. But by joining together a grouping of such countries might have more influence on prices and global trade policies.

- This is one reason why MERCOSUR (Brazil, Argentina, Venezuela, Paraguay and Uruguay) was formed. Certainly the EU as a bloc is a huge customs union with considerable ability to affect world trade.

Other economic effects of PTAs

3. *Greater economies of scale due to larger market size:* Smaller countries face the problem that their markets are not large enough for firms to modernize, grow, and take advantage of lower costs through increasing returns to scale.

- Such countries could just unilaterally cut tariffs. Being open to global trade can help make exporters in such countries more efficient by selling into large world markets. But then these firms would also face formidable global competition.
- A useful mid-step could be to form PTAs with preferential market access inside the regions. Then surviving firms from smaller countries may gain considerably in terms of economies of scale.
- Evidence suggests that a number of Canadian and Mexican manufacturing industries became more productive and grew as a result of NAFTA and competing in the large 3-country market, though a number of others became less competitive and shrank.

4. *Dynamic effects:* The larger markets and greater policy certainty of PTAs attract more foreign direct investment (FDI) by multinational enterprises.

- The amounts of FDI into Mexico from the US, Canada and non-member countries have been far larger than originally anticipated.
- This is especially the case for FDI from Japan and the EU to take advantage of producing cars and other goods for the North American market.
- And available estimates consistently suggest that there was considerably more FDI in the EU as a result of the single-market (free trade) program there.
- A collateral dynamic gain is that FDI brings with it new technologies that help make domestic economies more productive.

Other economic effects of PTAs

5. *An easier path toward regulatory harmonization:* One major reason that the US and the EU have increasingly turned to PTAs is that they find it easier to negotiate with a few countries than with many countries on making countries “harmonize” (make more equal) their regulatory approaches.

So recent PTAs have focused on IPRs, investment policies, services regulations, labor rights, environmental protection and other complex issues that can’t be easily negotiated at the WTO with so many countries involved.

This is an intensely controversial process.

Basic PTA analysis: summary

In theory PTAs can be a source of welfare gain or loss, which depends on the circumstances.

Whether they move the world closer or further away from global free trade is not altogether clear. However, the larger and more successful ones seem to generate more TC than TD.

They put in place larger markets for achieving economies of scale and dynamic gains in investment and technology transfer.

PTAs also facilitate negotiation of regulatory harmonization.

For these reasons, trade economists generally support the formation of PTAs, the larger the better.