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Preferential Trading Arrangements: Gainers and Losers from Regional Trading Blocs

**C. Parr Rosson, III, Extension Economist, Texas A&M University;
C. Ford Runge, Professor, University of Minnesota;
Kirby S. Moulton, Extension Economist, University of California-Berkeley**

Trading blocs, or preferential trading arrangements (PTAs), are relatively new in U.S. trade policy, but other nations have used and participated in various forms of preferential trade for decades. PTAs normally include one or more of the various types of economic integration, such as a free trade area, a customs union, a common market, or an economic union. More than 23 forms of PTAs have been identified among the 119 countries that account for 82 percent of world trade (Fieleke 1992). The use of PTAs to achieve both domestic and international trade policy objectives clearly is increasing.

Since 1985, the United States has negotiated preferential trade treatment with Israel and regional free trade agreements with Canada and Mexico. The United States has announced that Chile is the next country likely to join NAFTA. Several countries in Central and South America have joined new trading bloc initiatives.

The interest and concern of observers, analysts, and policy makers have been raised regarding the implications of PTAs for U.S. agriculture. The threat that U.S. firms will re-locate offshore and take jobs with them, and the ability of the United States to compete with low-wage economies have been focal points of debate. The environmental consequences of making common national borders more open, increased industrialization, and the prospects of the world economy fracturing into openly hostile trading blocs, are other policy issues related to the formation of trading blocs and their increased use as a policy option.

Large economic gains may be achieved with PTAs, as reduced trade barriers create new markets for U.S. goods and cheaper products for consumers. The purpose of this leaflet is to discuss the importance of PTAs, reasons for their increasing use, and potential gainers and losers as PTAs become a more common trade policy instrument

Forms of Economic Integration

Preferential trading arrangements can incorporate many types of economic integration. Various forms of economic integration have occurred within the framework of the General Agreement on Tariffs and Trade (GATT). Although Article I of GATT prohibited the use of preferential tariff rates, an important exception was allowed by Article XXIV. This latter Article specifies the conditions under which signatories may form PTAs. PTAs entered into by the United States have taken the form of free trade areas. A free trade area consists of provisions to reduce or remove both tariff and nontariff barriers to trade between member nations, while retaining barriers to

trade with nonmembers. Barriers to trade between individual PTA members and nonmember nations can vary and are determined by each member's policy makers. The North American Free Trade Agreement (NAFTA) is an example of a free trade area.

A customs union requires members to eliminate trade barriers with each other and takes economic integration a step further by establishing identical barriers to trade against nonmembers, most often in the form of a common external tariff. For many years the European Community, now the European Union (EU), was the world's most well-known customs union. The European Community created a common agricultural policy (CAP) for all member states. The CAP was (and still is) characterized by a variable levy system which limits most agricultural imports from nonmember countries by applying a common import duty.

A common market includes all the aspects of a customs union, but takes integration further by permitting the free movement of goods and services, labor, and capital among member nations. In January, 1993, the EU moved closer to full common-market status by implementing the Single European Act, which consists of provisions to remove some or all tariff and nontariff barriers to trade in goods and services, labor, and capital.

Finally, an economic union represents the most complete form of economic integration. Member nation social, taxation, fiscal, and monetary policies are harmonized or unified. Belgium and Luxembourg formed an economic union in the 1920's. The EU has adopted regulations creating a full economic union with common banking laws, coordinated macroeconomic policy, and a common EU currency by the year 2000.

Motivations for Preferential Trading Arrangements

The emergence of the United States as a major player in the formation of regional trading blocs has raised questions about the popularity of PTAs and the reasons for aggressively pursuing this policy option. Several reasons may be cited:

1. PTAs foster political stability and economic prosperity, thereby supporting the continuation of the democratic process and reducing the likelihood of political and social disruption in those countries that are economically or politically important to the strategic interests of the United States.
2. PTAs hasten the progress of multilateral trade negotiations, such as GATT; the achievement of timely, substantial reduction in barriers to trade, particularly agriculture, intellectual property rights, services, nontariff barriers, and dispute settlement procedures; and stimulate economic growth and development.
3. PTAs counter the economic and political power created in Europe by further expansion and integration of the EU and the prospects for trade and economic cooperation with former Soviet and Eastern bloc nations.

Foster Political Stability and Economic Prosperity. A major motivation of the United States in liberalizing trade with Mexico was to support a democratic government and the more market-oriented policies introduced in the 1980s. More open markets and the ensuing economic growth

may be one of the most effective means of improving the standard of living in Mexico and ensuring that economic prosperity leads to a stable political environment.

PTAs may also encourage member nations to undertake economic, social, or political reform. For instance, in the long term, NAFTA should help create an economic environment where Mexican workers can seek employment in Mexico, rather than in the United States. It is doubtful that any other policy action taken by Mexico could have, or would have, been as instrumental in stemming the flow of the more than 300,000 illegal Mexican immigrants annually to the United States. This could have other consequences for the United States, such as reducing the poverty in border colonias (unincorporated rural subdivisions) and eliminating the strain on border health care, water, sewage, and other facilities required to accommodate a near doubling of population over the last decade. It also could result in a reduction in the availability of low cost labor in some sectors of the U.S. economy and a decline in border retail trade.

Other possible outcomes might include an increased effort on the part of the Mexican government to control air and water pollution in its major cities. Evidence existed well before NAFTA was implemented that remedial environmental efforts were underway in Mexico to construct sewage treatment facilities in border cities, which previously had dumped untreated sewage into the Rio Grande and its tributaries. Some meat packing facilities were also being relocated outside of major cities in order to improve air quality and reduce problems with disposal of animal waste.

Although various reasons may cause the United States to participate in PTAs, it is likely that strong domestic economic and political interests will be the driving force behind such efforts. In the future, leverage may be needed to negotiate continued or additional access to major markets. Negotiating from the strength of an economic bloc may prove to be the most effective means of achieving the desired outcome.

Encourage More Rapid Progress Toward Trade Liberalization. Since 1947, average world tariff rates for manufactured goods have declined from approximately 40 percent to about 4 percent, largely as a result of agreements negotiated through GATT (Runge 1992).

The Uruguay Round (UR) was convened in an attempt to liberalize trade in these more highly protected sectors. Rising farm program costs, the inability to separate international agriculture from domestic farm programs, and trade distortions caused by government intervention in agriculture all contributed to the complex set of policy issues facing trade negotiators as the Uruguay Round opened. As Runge (1988) points out, "If farm policy is to be liberal, rather than protectionist, it must reflect greater market orientation both at home and abroad, and reduce the distortions that now separate the domestic from the global markets."

Even though the recently ratified Uruguay Round Agreements is an important first step to reducing trade-distorting agricultural policies, its slow and limited progress, along with the prospects for failure, led the United States, Mexico, and Canada to negotiate and ratify NAFTA. However, NAFTA liberalized trade without providing for substantial reductions in domestic support to agriculture. GATT-UR and NAFTA are discussed in more detail in Leaflets 7 and 9, respectively.

Counter Economic and Political Power in Other Parts of the World. The NAFTA created the world's largest free trade area. However, the EU expanded to 15 members on January 1, 1995 when Austria, Finland, and Sweden were admitted, and has extended preferential market access to Poland, Hungary, and the Czech and Slovak Republics. As economic and political integration in Europe continues, it is likely that the United States will feel more pressure to form a larger and stronger PTA.

In 1991, Argentina, Brazil, Paraguay and Uruguay initiated the Southern Cone Common Market, MERCOSUR, to foster economic growth and mutual interests among the member nations. Although smaller in economic strength than NAFTA, MERCOSUR has stimulated interest and concern among many publics. Some analysts speculate that the Enterprise for the America's Initiative, designed to stimulate investment and reduce debt in the Caribbean and Latin America, may be a key first step to linking all the economies of North and South America through trade.

Though less-well organized than the EU or NAFTA, five Asian nations are attempting to strengthen trade ties. Japan, Singapore, Hong Kong, South Korea, and Taiwan have developed plans to extend preferential trading terms to each other. While this does not constitute a formal trading relationship, it may create a basis for the formation of a free trade area or other trading arrangement in the near future.

Economic and political interests of the United States may dictate that, as economic blocs emerge around the world, steps be taken to ensure existing and future trading relationships are maintained, and even strengthened, by participation in one or several forms of economic integration. As Salvatore (1993) points out, any free trade area or customs union acting as a single unit in international trade negotiations will likely possess much more bargaining power than the total of its members acting separately. Further, reaching a compromise with a unified group of nations may sometimes be easier than dealing with each nation individually.

Do Preferential Trading Arrangements Create Trade?

Regional trading bloc formation can both create and divert trade. Countries excluded from a trading bloc often argue that PTAs lead to increased trade within the bloc, but less trade outside the bloc. Arguments in support of PTAs state that they may eventually lead to the merger of regional blocs and therefore, multilateral trade liberalization more quickly than through other means, such as the GATT. While both arguments have merit, the effects of PTAs are largely empirical and depend upon several important conditions, which will be discussed in this section.

With the growing importance of PTAs, a question of critical importance is whether or not the United States will become better-off as the economies of North America become more closely integrated. Each case of PTA creation must be examined on its own merits. Given that agricultural trade is less than free, the creation of a PTA may or may not result in large overall economic gains, but member nations are unlikely to be worse off. Because trade barriers are lowered, PTAs do expand each member nation's opportunities for trade.

Short Term Effects. The short term effects of creating a PTA are measured in terms of trade creation and trade diversion. In the case where there is full employment of domestic resources,

trade creation increases the economic well-being of member nations because it leads to greater specialization in production and trade, lower consumer prices, and higher disposable incomes. PTA members may import from one another certain goods not previously imported at all due to high tariffs.

Trade Creation. Trade creation occurs when domestic production of one member nation is replaced by lower-cost imports from another member nation. The trade creation effect causes efficiency gains for member nations, because some countries shift from a higher-cost domestic source of supply of an item to a lower-cost foreign source. Member countries eventually specialize in producing those items, for which they have a comparative advantage.

A trade-creating PTA may also increase the economic well-being of nonmembers, since some of the increase in its economic growth will produce real increases in income that will, in turn, translate into increased imports from the rest of the world.

Gains from a free trade area are expected to be large if the tariff to be removed is large and if domestic supply and demand are more responsive to price changes over the long-run.

Trade Diversion. Trade diversion occurs when lower-cost imports from a nonmember nation are prevented from entering the PTA by tariff or nontariff barriers, and are replaced by higher-cost imports from a member nation. Trade diversion reduces world economic well-being since it shifts production from more efficient producers outside the PTA to less efficient producers within the PTA. The international allocation of resources becomes less efficient, and production shifts away from the pattern suggested by comparative advantage. In reality, most attempts to create PTAs contain both trade creation and trade diversion effects and may increase or decrease member welfare depending on the relative strength of the two opposing forces. PTAs will most likely lead to trade creation and increased economic well-being of member nations under the following conditions (Tweeten):

1. High pre-PTA trade barriers increase the probability that trade will be created among members, rather than diverted from nonmembers to members.
2. The more countries included in the PTA and the larger their size, the more likely that low-cost producers will be found among member nations.
3. A PTA formed by competitive, rather than complementary, economies is more likely to produce opportunities for specialization in production and trade creation.
4. When member nations are in close proximity to one another, transportation costs become less of an obstacle to trade creation.
5. If the free trade area contains countries with the lowest cost source of goods and services consumed by members nations, trade diversion is less likely to occur.

Long Term Effects. PTA formation can be expected to have major long term benefits that are important to participating nations. In fact, it has been recently estimated that the long term gains from forming a PTA often exceed the short term gains by a factor of five or six (Salvatore 1993). The more important long term gains include: increased competition, economies of scale, stimulus to investment, and more efficient use of economic resources.

Increased Competition. Possibly the most important single gain from a PTA is the potential for increased competition. Businesses, especially those in monopolistic and oligopolistic markets, may become sluggish and complacent when protected by barriers to trade. With the formation of a PTA, trade barriers among members are greatly reduced or eliminated, and producers must become more efficient to effectively compete with foreign firms. Some may succeed; some may merge with other firms; others will go out of business. The higher level of competition is also likely to stimulate the development and adoption of new technology and new products. The end result will be lower costs of production and, therefore, lower consumer prices for goods and services, new products, and improvements in product quality. It is important that member country governments enforce the new trade rules if these competitive forces are to operate effectively.

Economies of Scale. Another benefit of PTAs is that substantial economies of scale may become possible in the enlarged market area. If firms were previously serving only the domestic market, the expanded market with the PTA may create export opportunities. If the production process possesses economies of scale, the increase in output lowers per unit costs and the price charged to consumers. For instance, it has been determined that many firms in small nations, such as Belgium and the Netherlands before joining the EC, enjoyed economies of scale by producing both for the domestic market and for export. However, after becoming members of the EC, significant additional economies of scale were gained by individual firms reducing the range of products manufactured and increasing the output of the remaining products.

Stimulus to Investment. The formation of a PTA is likely to stimulate outside investment in production and marketing facilities to avoid the discriminatory barriers imposed on nonmember products. In order for firms to meet the increased competition and take advantage of the enlarged market, investment is likely to increase. In most cases, investment in a PTA area is an alternative to the export of products from nonmember countries. The large investments made by U.S. firms in Europe after the mid-1950s, and in the years and months leading up to the Single European Act, were fostered by their desire not to be excluded from this large potential market: investing ensured that their products would not be restricted by tariff and nontariff barriers.

Efficient Resource Use. Finally, if the PTA is a common market, the free movement of labor and capital is likely to stimulate more efficient use of the economic resources of the entire bloc. Overall efficiency of industries and individual firms will likely increase with increased access to lower-cost capital and additional labor. Lower consumer costs and higher real incomes should follow.

Summary

Preferential trading arrangements have been growing in importance in recent years. Trading blocs account for about three-fourths of world trade. By their nature, PTAs favor trade among member nations and discriminate against nonmembers. Trade among members grows at the expense of the rest of the world. PTAs function legally within the framework of previous GATT rules. Because of the vague nature of these rules, nations have been able to discriminate rather freely against nonmember nations with little fear of retaliation. Whether or not this situation is allowed to continue under the new World Trade Organization remains to be seen.

Trade theory provides only ambiguous conclusions regarding the consequences of PTA formation. Free trade is certainly more efficient than discriminatory trade, but in a world of less-than-free trade, PTAs may permit major economic gains under certain conditions. Long term gains, such as increased competition, economies of scale, and greater investment may far exceed the short term gains from trade creation. Consumers often gain from PTA formation as restrictive trade barriers are lowered and finally eliminated. Government and taxpayers bear the cost of this gain, however, since tariff revenue also declines.

PTAs will likely take on added importance as policy tools for negotiating fewer barriers to trade among groups of nations. Strong economic and political interests will be the driving force behind these actions. In the future, it may become more important to negotiate access to major markets, using the additional leverage provided by nations acting together.

For a more complete discussion of preferential trading arrangements see Rosson, Runge, and Hathaway.

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