

CHAPTER 8

REGIONAL TRADING AGREEMENTS

CHAPTER OVERVIEW

This chapter investigates the theoretical and empirical aspects of regional trading arrangements. The chapter begins by discussing the nature and stages of economic integration: (1) free trade area, (2) customs union, (3) common market, (4) economic union, and (5) monetary union.

Of particular importance are the economic effects of a regional trading arrangement. The chapter analyzes the short-run effects of trade creation and trade diversion. Next are the long-run effects, which include economies of scale, competition, and stimulus of investment.

The rise of the European Union (EU) is emphasized in this chapter. Of particular importance are the reasons for the EU, the path of economic integration the EU has followed, and the effects of the EU.

Next discussed is the North American Free Trade Agreement (NAFTA). Emphasis is placed on the case for and case against NAFTA and also the empirical evidence regarding NAFTA three years after its inception. The chapter concludes by examining the hurdles that the transition economies have faced in implementing market economies.

After completing this chapter, the student should be able to:

- Identify the stages of economic integration.
- Discuss the static and dynamic effects of a regional trading arrangement.
- Assess the nature and operation of the EU.
- Discuss the advantages and disadvantages of the NAFTA.
- Identify the reforms that the transition economies have implemented to improve their standard of living.

BRIEF ANSWERS TO STUDY QUESTIONS

1. The General Agreements on Tariffs and Trade represent trade liberalization on a nondiscriminatory basis. Participating nations acknowledge that tariff reductions agreed to by any two nations will be extended to all other members. Trade liberalization on a discriminatory basis occurs when nations form preferential trading arrangements in which tariff reductions are limited to member nations.
2. Economic integration refers to the process of eliminating restrictions on international trade, payments, and factor mobility. The stages of economic integration include free trade area, customs union, common market, economic union, and monetary union.
3. The formation of a customs union results in static, or once-and-for-all, welfare effects. Included is a welfare-increasing trade creation effect and a welfare-reducing trade diversion effect. A country's decision to participate in the customs union depends on

which of these effects is the most significant. Over the long run, the formation of a customs union affects national welfare via economies of scale, investment incentives, and the level of competition.

4. One major problem confronting the CAP is that agricultural efficiencies differ among members of the European Community. This has led to internal disputes over the level of support provided to member farmers. The export subsidies of the CAP have also been criticized by nonmember countries.
5. Empirical studies suggest that the static welfare effects of the EU's formation have generally been favorable for member countries. The benefits associated with trade creation appear to offset the losses associated with trade diversion.
6.
 - a. Germany exports gloves to Portugal. For Portugal, $Q_s = 4$, $Q_d = 14$, Imports = 10.
 - b. Germany exports gloves to Portugal. For Portugal, $Q_s = 8$, $Q_d = 10$, Imports = 2.
 - c. Trade creation effect = \$2, trade diversion effect = \$2. The overall welfare of Portugal does not change.
 - d. Trade creating customs union. The welfare of Portugal rises by an amount equal to the trade creation effect (\$8); there is no trade diversion effect since the customs union includes the world's lowest cost producer.