

TRADE POLICY

Lecture 4

Regional integration and bilateral trade agreements

Fulbright School of Public Policy and Management
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Ari Kokko

Copenhagen Business School

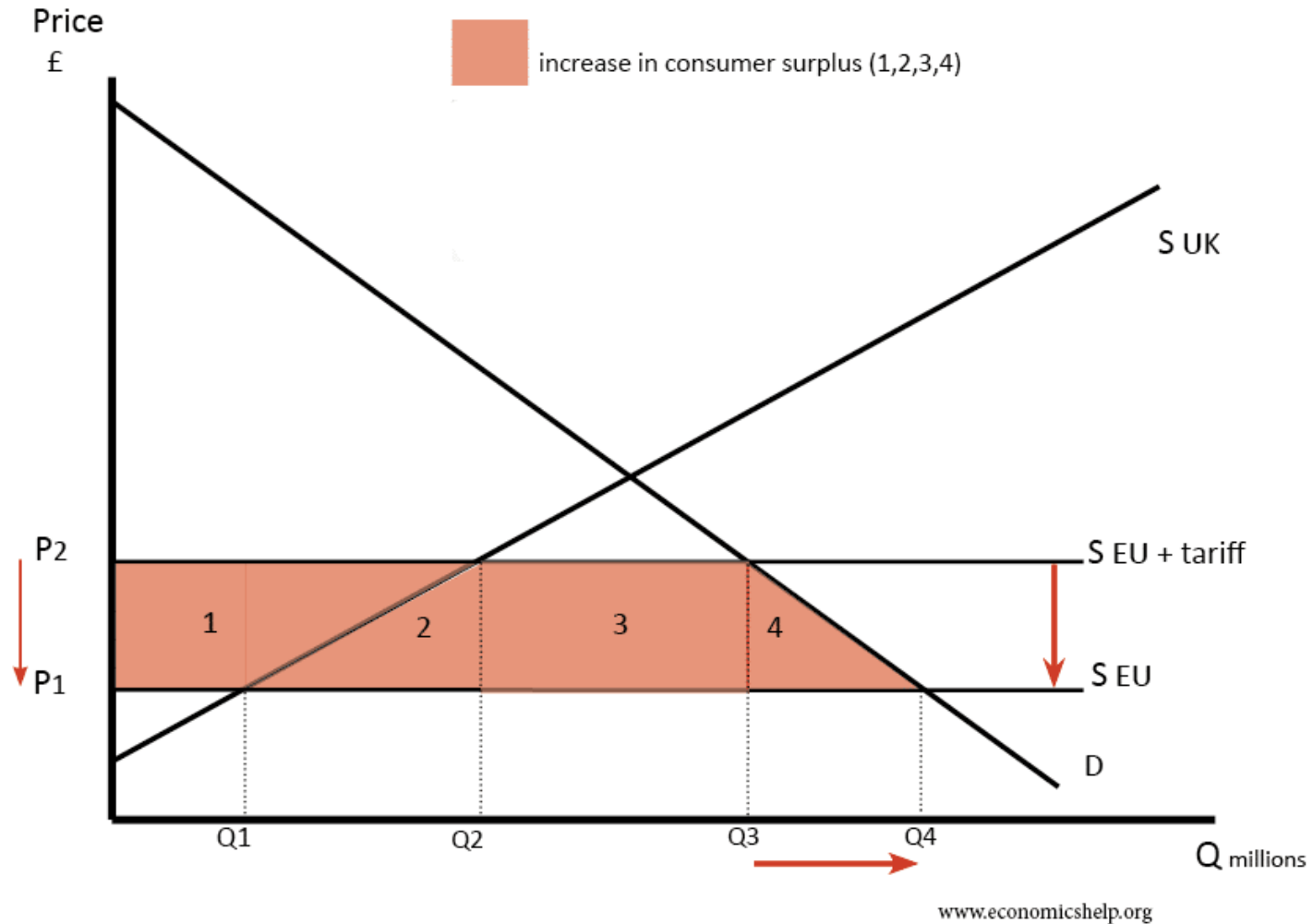
Regional integration

- Big difference between *old* and *new* integration
 - *Old* integration based on neoclassical trade theory. Small gains from simple agreements.
 - *New* integration based on modern trade theory. Economies of scale create big effects, but agreements become more complex

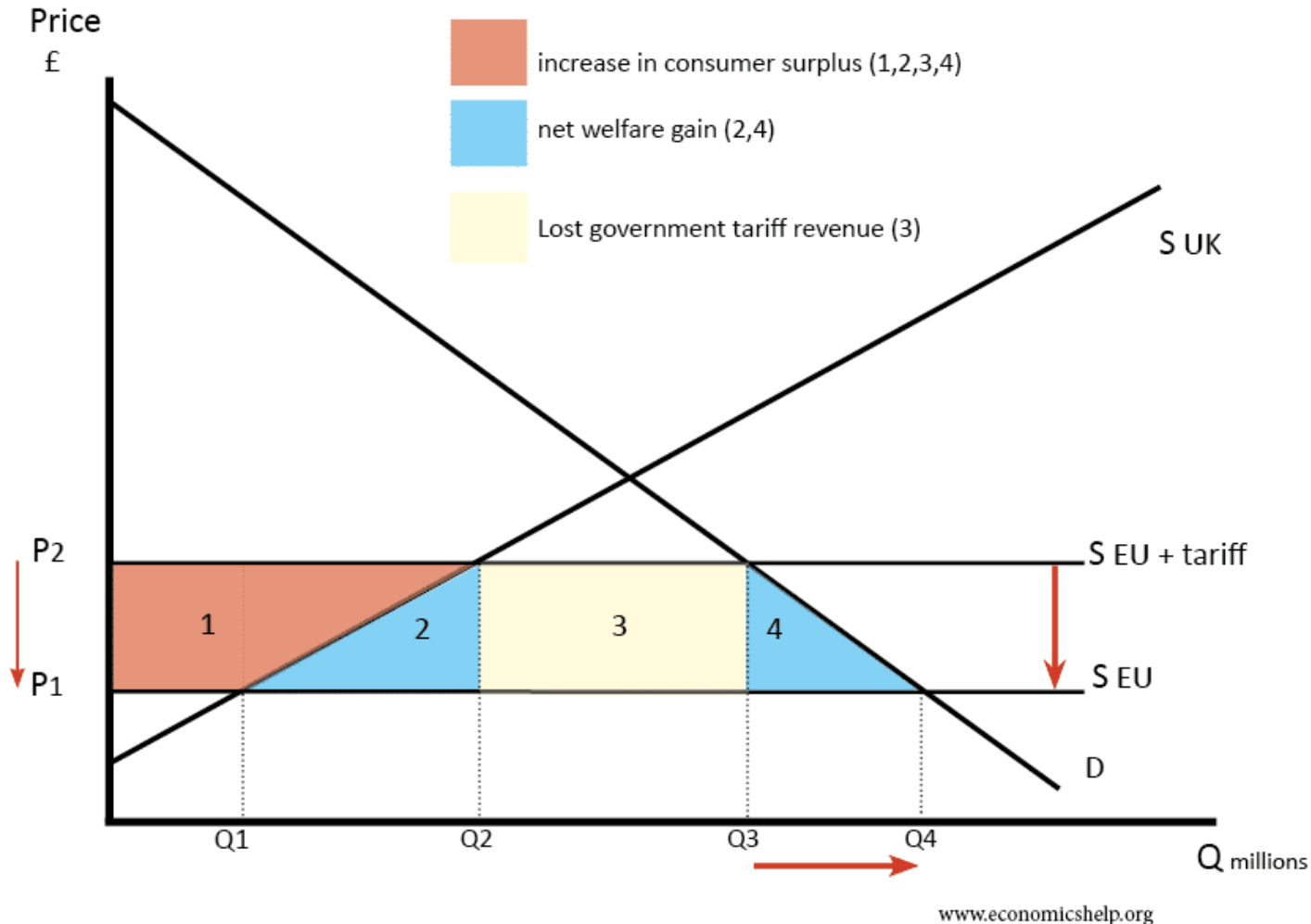
Effects of *old* integration

- Trade creation
 - Reduction of tariffs leads to new trade flows from other members of the regional integration agreement (RIA)
 - Always a positive result
- Trade diversion
 - Tariff reductions for some (= other members of the RIA) but not for others (= countries outside the RIA) may mean that trade is diverted to countries that are not best in the world, but best in the RIA
 - Can be harmful for individual countries in the RIA as well as for the world
- Overall
 - Estimated effects of RIAs are small.
 - Not rational to spend resources on large changes in rules and regulations

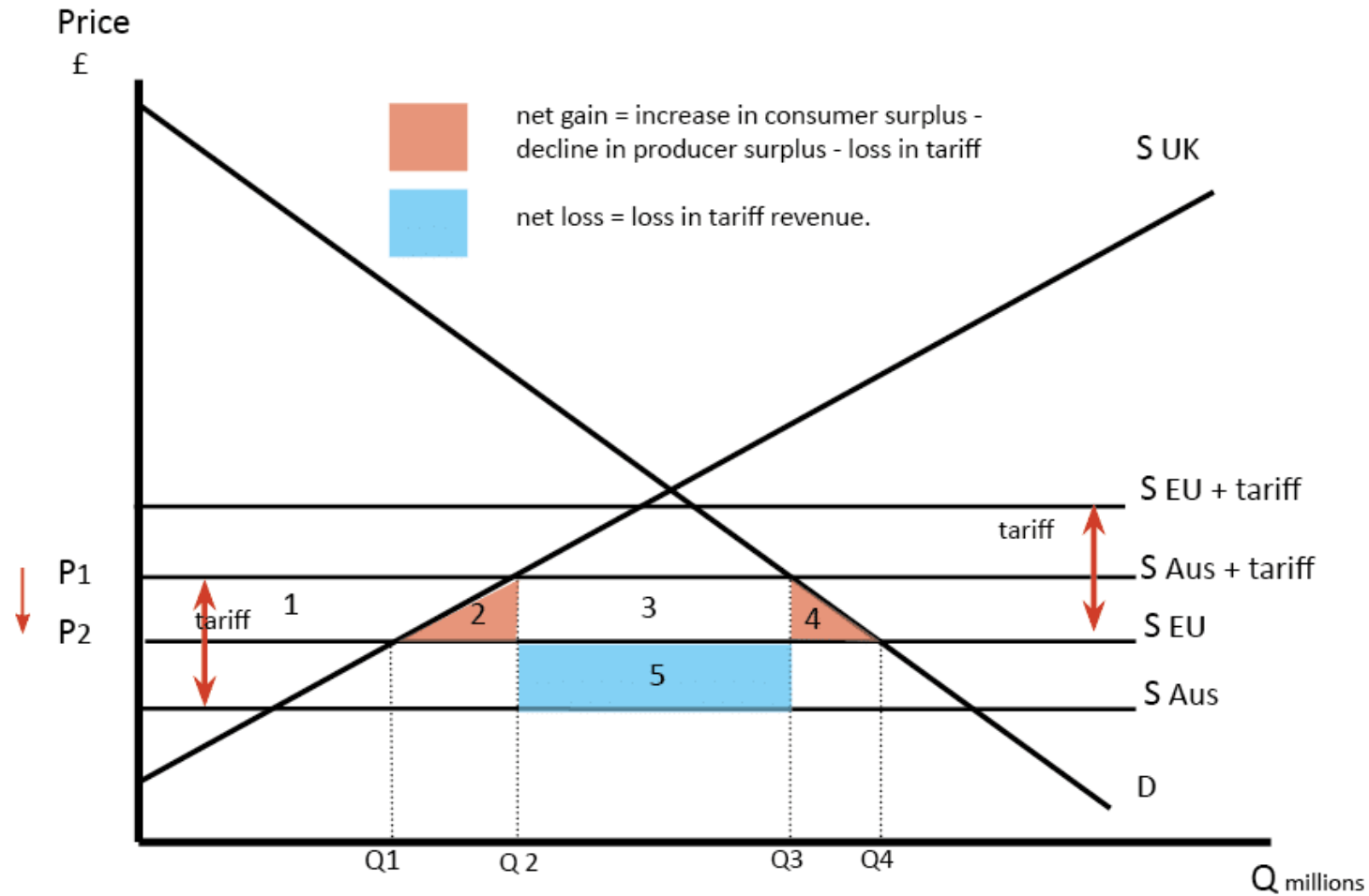
Trade creation: increase in consumer surplus



Trade creation: effects when reductions in tariff revenue and producer surplus are deducted



Trade diversion



Effects of *new* integration

- A larger home market means tougher competition and structural change
- The number of firms will diminish, but those that survive – the regional champions – will be larger and stronger thanks to economies of scale
- The overall gains can be very large, especially if the more competitive RIAs becomes more innovative
- Politically sensitive process: who will get the regional champions, and who ones will lose?
- Need to create *level playing field* (and worth to spend substantial resources on harmonizing rules and regulations).

Stages of regional integration

- Preferential Trade Area
- Free Trade Area
- Customs Union = all above + common tariffs
- Common Market = all above + harmonization of product standards + factor mobility
- Economic Integration = all above + fixed exchange rate + policy coordination
- Economic and Monetary Union = all above + single currency and central bank + unified economic policy

How far will harmonization continue?

- Some factors cannot be "homogenized"
 - Geographical location: center vs periphery
 - Population density
 - Weather, climate
- Some diversification necessary to compensate less advantaged (peripheral, sparsely populated, cold and rainy) locations

And what happens if integration is really, really successful?

- So far, integration has been seen as a reduction in trade costs, and trade has unambiguously increased as a result
- Full integration, however, could mean that we move towards *the law of one price*
- If transport costs and national preferences still survive, trade volumes could actually go down

At the same time, a multitude of bilateral free trade agreements

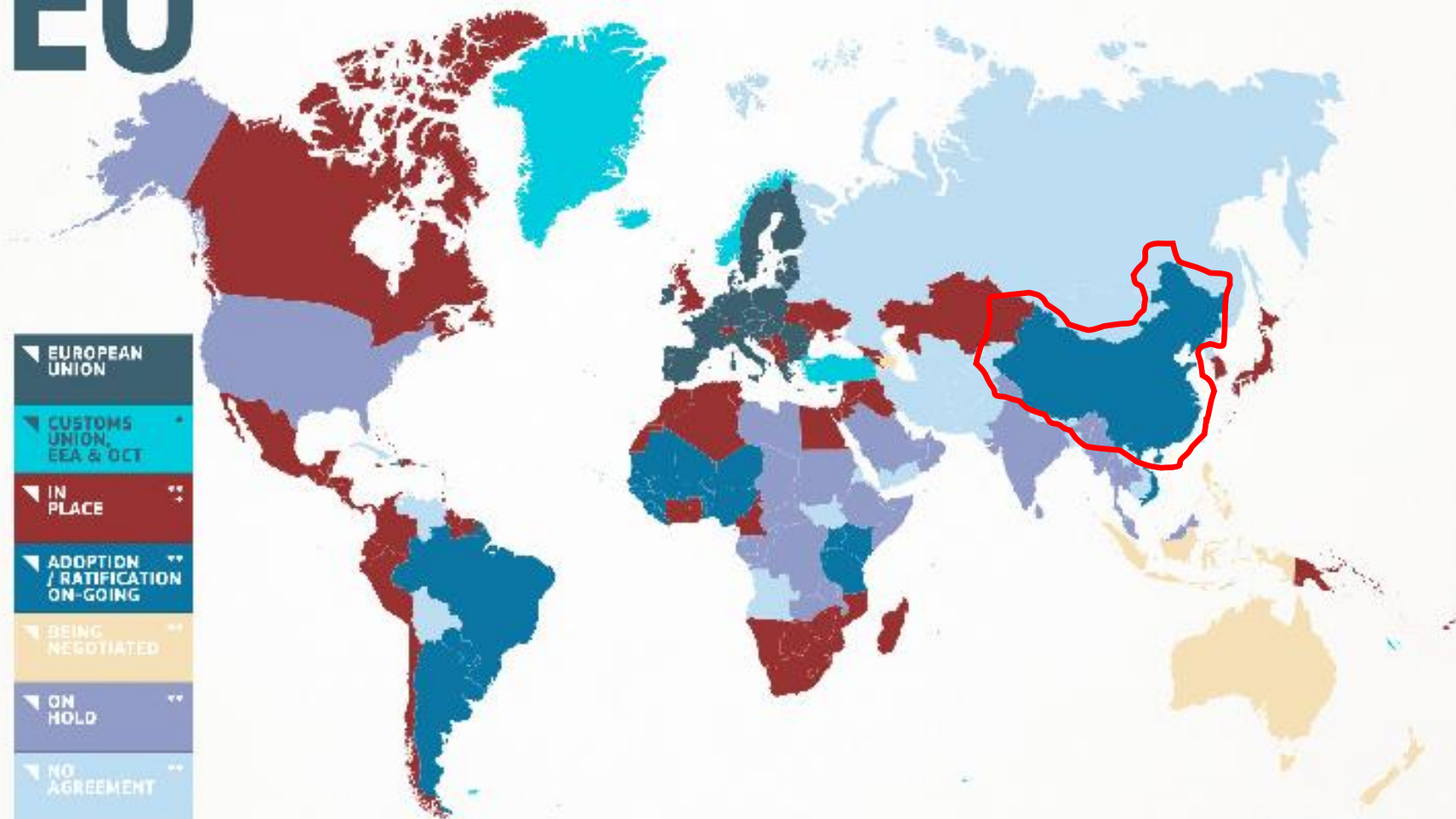
- Bilateral free trade agreements (FTAs) mean that countries reduce tariffs on trade from FTA partners
- No customs unions, which means that rules-of-origin (ROIs) are important: free trade only applies to goods produced in partner countries
- Mainly *old* integration, often with a twist
 - May include areas not covered by WTO (such as FDI)
 - More tariff reductions than in WTO
- Still hard to understand why so much energy is invested in FTAs with countries that are far apart

Example: EU's trade agreements in Asia

- EU-South Korea FTA (2015 / 2011)
- EU-Japan Economic Partnership Agreement (2019)
- EU-Singapore FTA (2019)
- EU-Vietnam FTA (2020)

- *EU-Indonesia FTA (negotiations)*
- *EU-Philippines FTA (negotiations)*
- *EU-Thailand FTA (negotiations)*
- *EU-India FTA (on hold)*
- *EU-Malaysia FTA (on hold)*

EU trade agreements 2021



* European Economic Area (EEA) + Overseas Countries and Territories (OCT)

** Free Trade Agreement (FTA), Deep and Comprehensive Free Trade Agreement (DCFTA), Investment Agreement, Enhanced Partnership and Cooperation Agreement (EPCA), Partnership and Co-operation Agreement with preferential elements (PCA).

† The agreements with Chile, Tunisia, and Eastern and Southern Africa are currently being updated; the updated agreement with Mexico is under ratification. The DCFTA with Georgia does not apply in South Ossetia and Abkhazia. The agreement between the EU and the United Kingdom is applied provisionally, pending ratification by the EU.



A Grand Strategy?

Is EU trying to encircle China?