Preferential trade liberalization

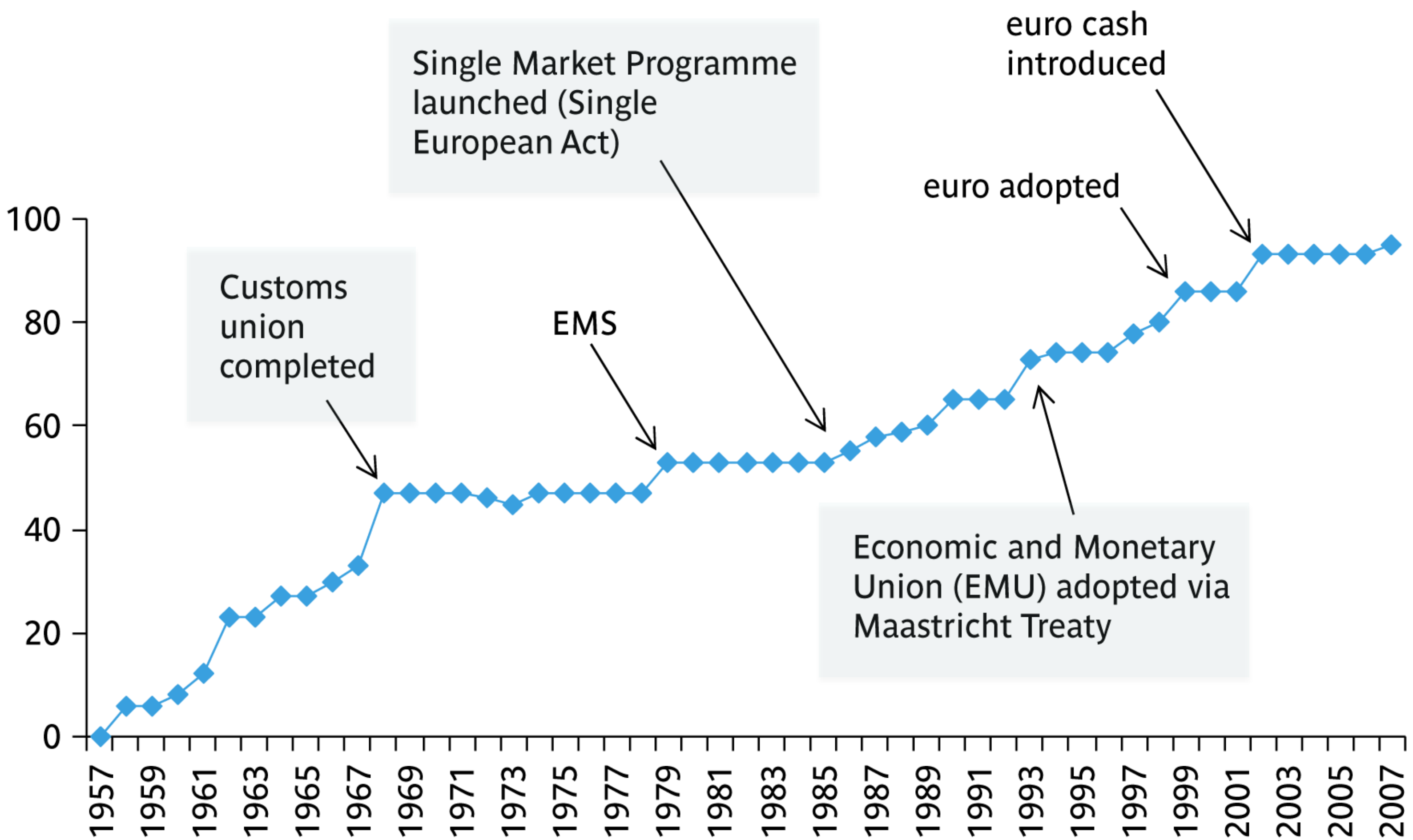
Class overview

1. Treaty of Rome
2. Domino effect I
3. Single Market Prog.
4. Domino effect II

- Slides are largely based on Baldwin-Wyplosz's ones (textbook)

Quantifying economic integration

- Economic historians have quantified the extent of integration.



Economic integration in the EU

- The **Treaty of Rome** was a far-reaching document.
- It laid out virtually every aspect of economic integration implemented up to the 1992 Maastricht Treaty.
- The Treaty's intention was to create a unified economic area based on "four freedoms":
  - Goods
  - Service
  - Workers
  - Capital
- Common policies where necessary.

Main elements

- Free trade in goods: eliminate tariffs, quotas and all other trade barriers.
- Common trade policy with the rest of the world: Customs Union to trade deflection.
- Ensuring undistorted competition (to avoid "deals" that offset trade barrier removal):
  - State aids are mostly prohibited
  - Anti-competitive behavior regulated by Commission
  - Approximation of laws (i.e., harmonization);
  - Taxes (weak restrictions but no explicit harmonization).
- Unrestricted trade in services, but implementation has been hard.

Main elements

- Common policy in agriculture: set up in 1962, agriculture was much more important than it is today (e.g., about a third of French population was involved in agriculture in 1950s; today less than 5%). However, still 40 % of EU Budget are devoted to agriculture
- Exchange rate and macroeconomic coordination.
- Labor and capital market integration:
  - free movement of workers;
  - free movement of capital in principle but many loopholes; very little capital-market liberalization until the 1980s .

Omitted elements: Social policy

- Social harmonization very difficult politically:
  - very different opinions on what types of social policies should be dictated by governments;
  - it is not as an exchange of concessions.
- Not clear that European economic integration demands harmonization of social policies: national wage would adjust to offset any unfair advantage.
  - Lower social standards (lower production costs) →, higher long-term wages that offset the advantage.

Omitted elements: Tax policy

- Similar to Social policy, tax policy directly touches the lives of most citizens and it is the outcome of a national political compromise. Thus, EU leaders have always found it difficult to harmonize taxes.

Preferential trading agreements

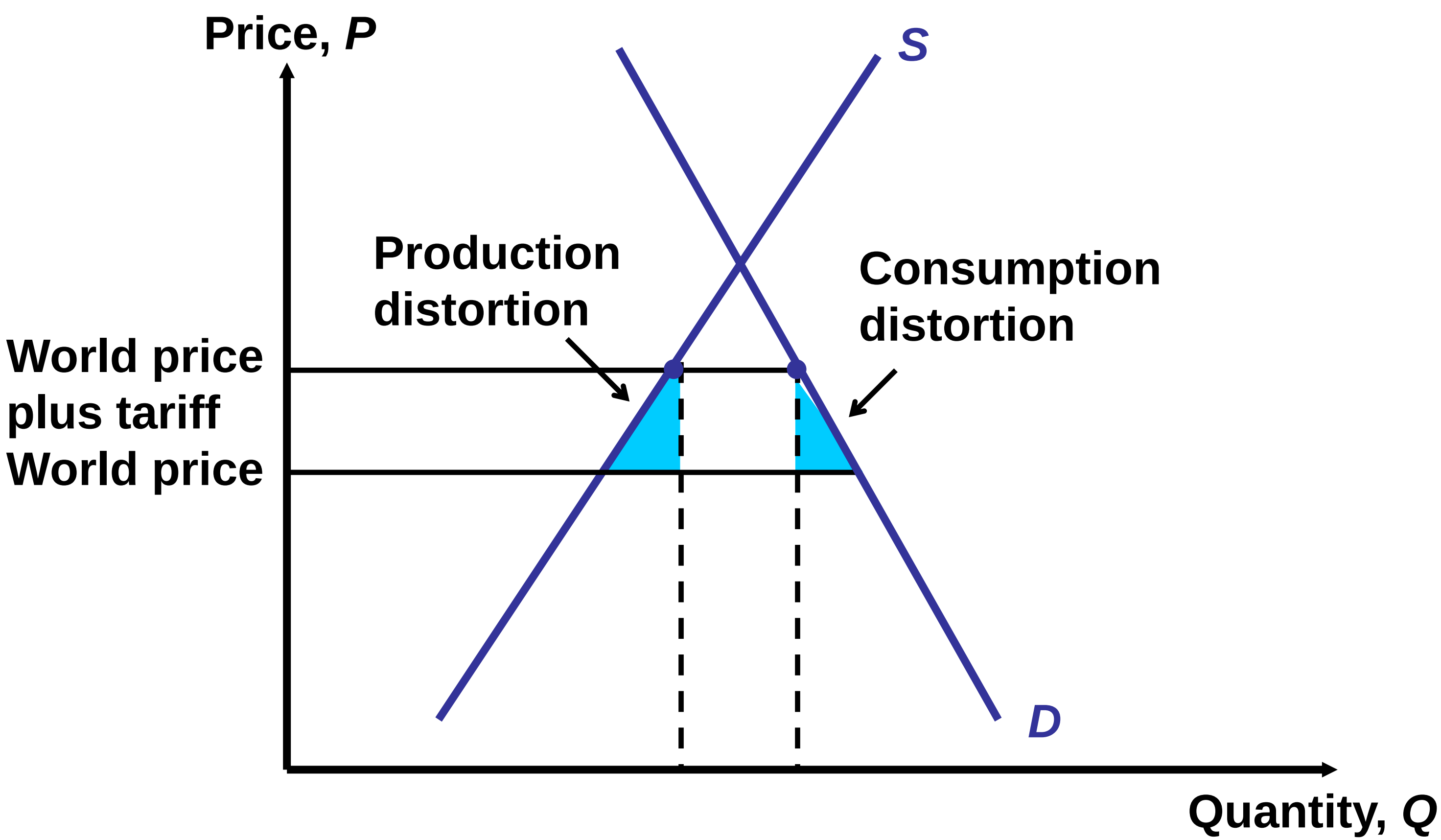
- A **free trade area** allows free-trade among members, but each member can have its own trade policy towards non-member countries.
- A **customs union** allows free trade among members and requires a common external trade policy towards non-member countries.
- A **common market** is a customs union with free factor movements (especially labor) among members.

Unilateral discriminatory liberalization

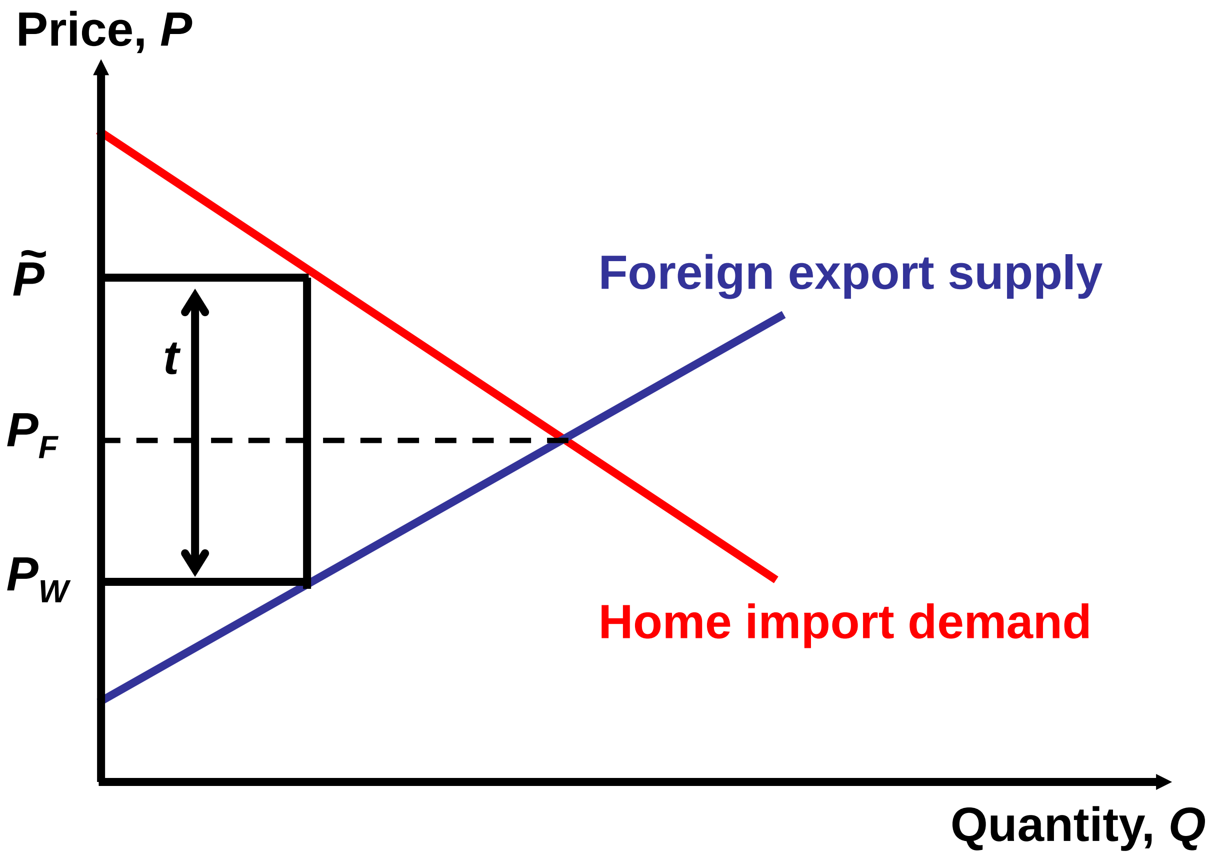
- **Smith's certitude** by Adam Smith: foreign firms gain (i.e., higher price and more exports) when tariffs against them are eliminated;
- **Haberler's spillover** by Gottfried Haberler: third nations – those excluded from the preferences – must lose;
- **Viner's ambigüita** by Jacob Viner: preferential liberalization might harm the preference-giving nation because .discriminatory liberalization is both liberalization – which removes some price wedges and thus tends to improve economic efficiency and home welfare – and discrimination – which introduces new price wedges and thus tends to harm efficiency and welfare.

Effects of a tariff

- Small-open economy



Effects of a tariff



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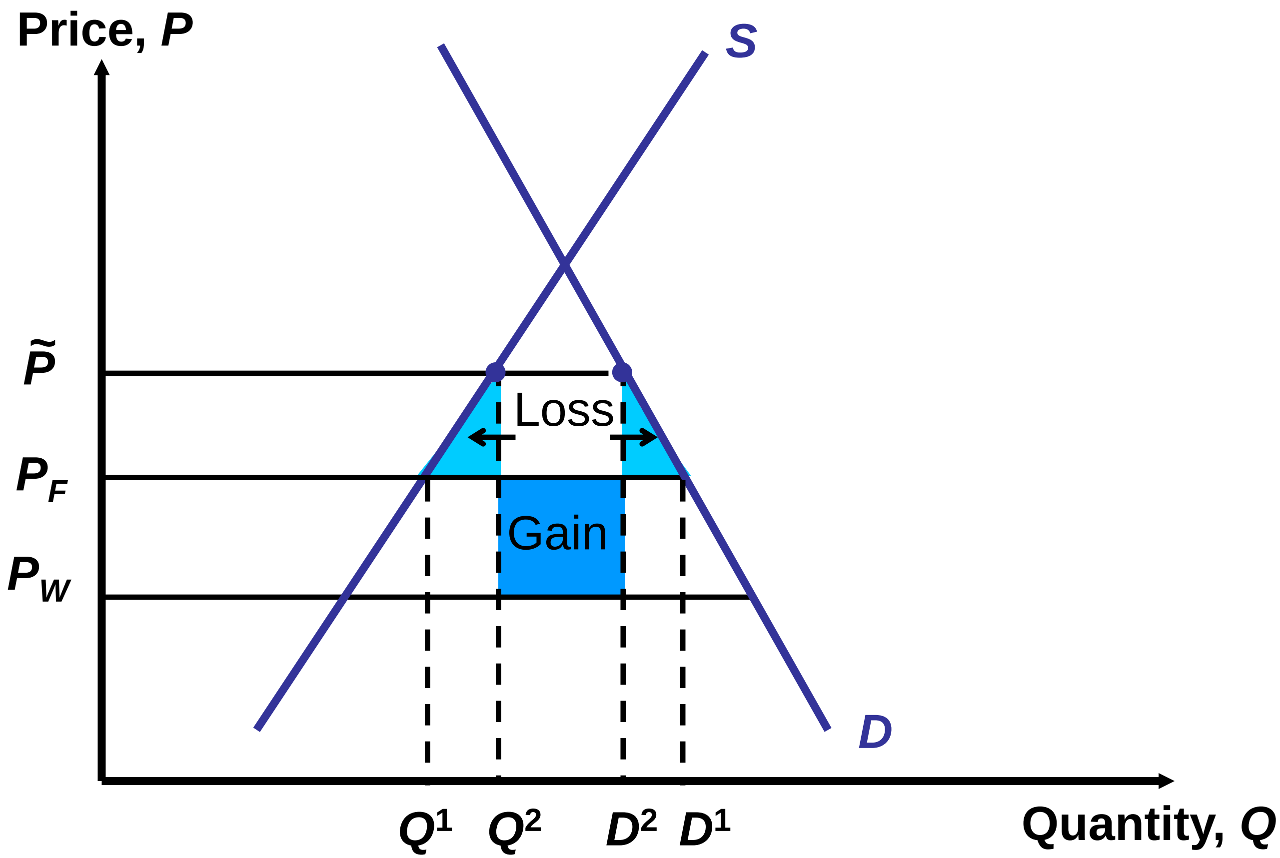
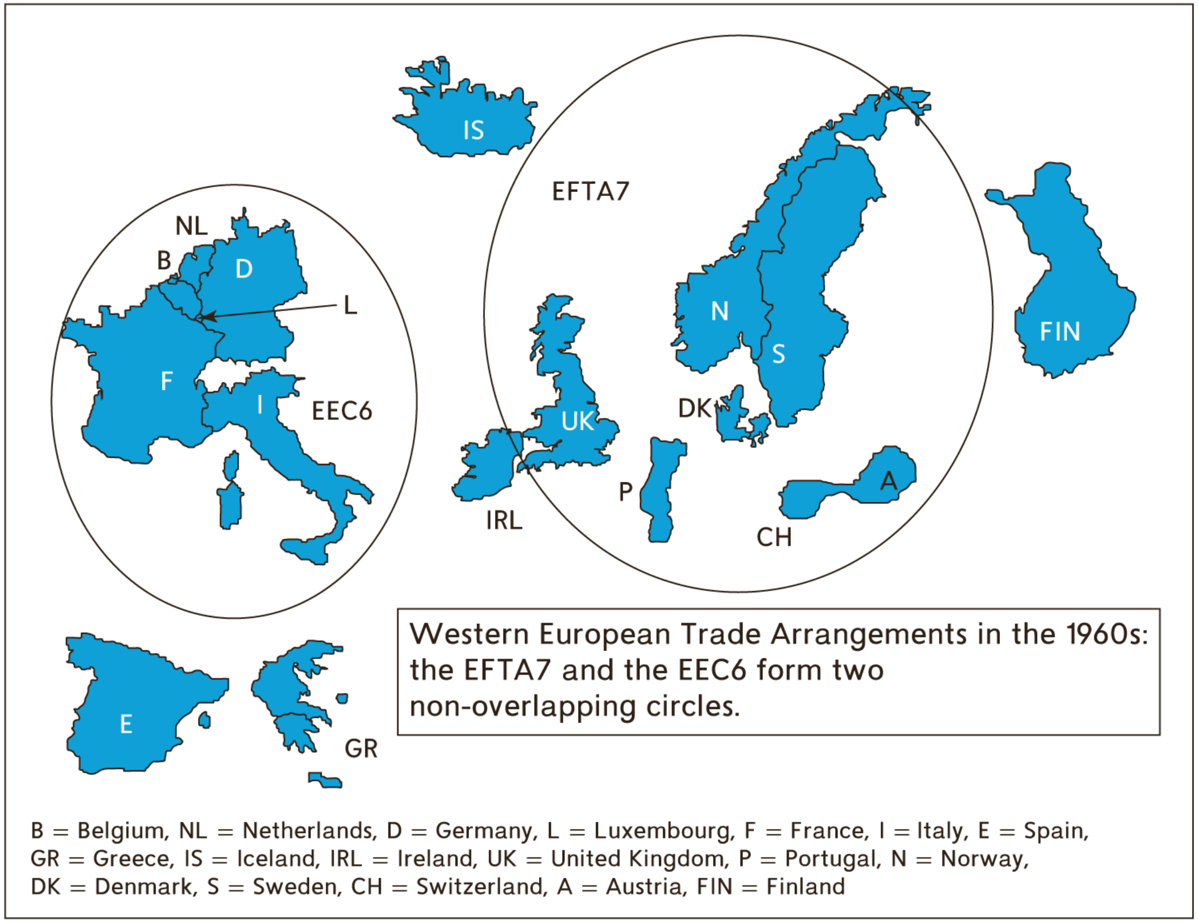


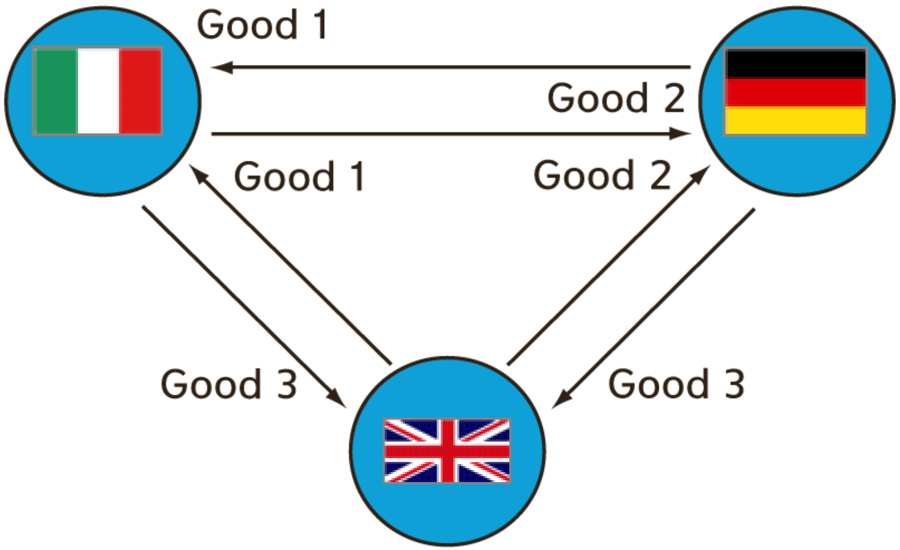
Two non-overlapping circles

- Situation by the late 1960s



Are preferential trading agreements good?

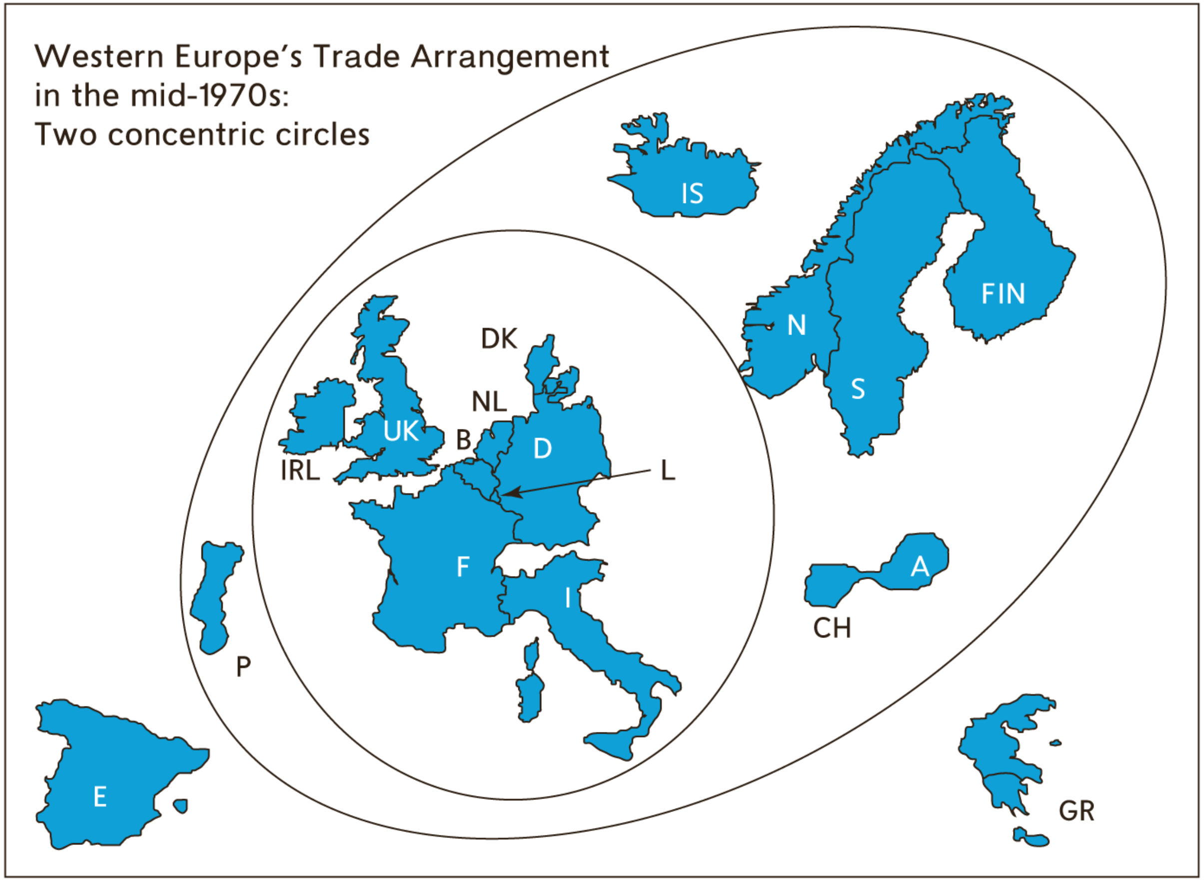
- It depends on whether it leads to
  - **Trade creation**
  - **Trade diversion**



Are preferential trading agreements good?

- It depends on whether it leads to trade creation or trade diversion.
- **Trade creation**. Occurs when the formation of a preferential trading agreement leads to replacement of high-cost domestic production by low-cost imports from other members.
- **Trade diversion.** Occurs when the formation of a preferential trading agreement leads to the replacement of low-cost imports from non members with higher-cost imports from member nations.

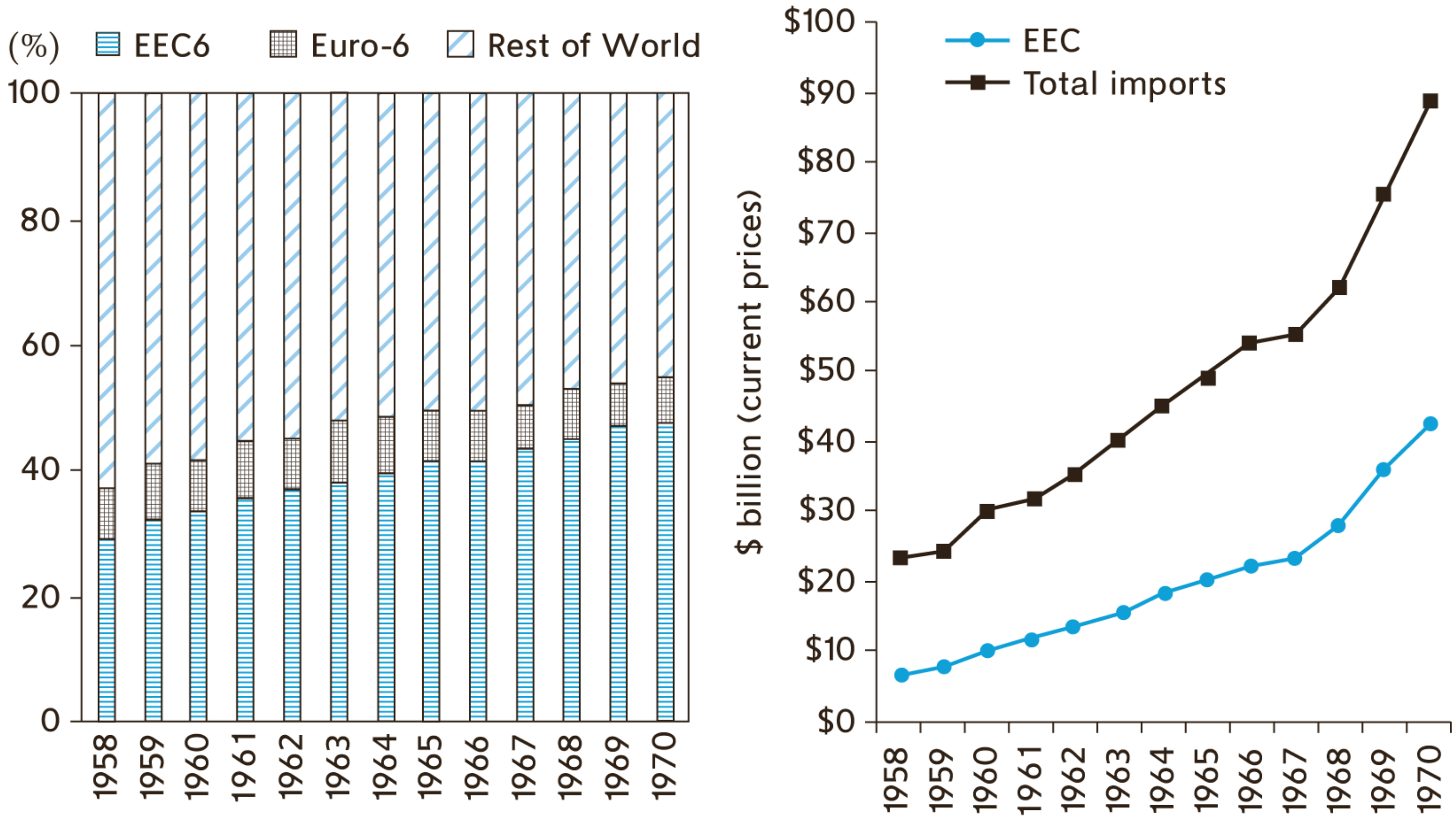
Evolution to two concentric circles



Domino effect I

- Falling trade barriers within the EEC and within EFTA lead to discrimination. The GDP (i.e., potential market size) of the EEC much larger than that of EFTA (and EEC incomes were growing twice as fast)
- Thus, the EEC club was far more attractive to exporters and this lead to new political pressure for EFTA nations to join the EEC.
- The UK applied for membership in 1961. Denmark, Ireland, and Norway also followed since they would otherwise face stronger discrimination (other EFTA nations did not apply because of political reasons).
- Charles De Gaulle stopped UK membership twice. Denmark, Ireland, and UK join in 1973 while Norwegians said no in a referendum.

Supply-switching effects of EEC



Note: The left-hand panel shows shares of the EEC6's imports from the three regions. The 'Euro-6' are the six countries that had joined the EU by the mid-1980s: the UK, Ireland, Denmark, Spain, Portugal and Greece.

Source: http://epp.eurostat.ec.europa.eu/portal/page/portal/international_trade/introduction © European Union, 1995–2014

Frictional barriers: the 1992 Program

- Since the mid-1970s and especially since the 1986 Single European Act, most economic integration has involved the removal of frictional barriers to trade.
- Frictional barriers can be conceptualized as tariffs where the tariff revenue is thrown away. For such barriers, Smith's certitude and Haberler's spillover still hold, but Viner's ambiguity disappears.
- Reciprocal preferential frictional barrier liberalization leads to: lower Home's domestic and border price; higher price received by Partner exporters and lower price received by RoW exporters.
- Thus, Home imports rise and Partner exports rise while RoW exports fall. Supply switching still occurs.

Deeper circles: Single Market Program

- 1970s Euro pessimism began.
- Jacques Delors launches completion of the internal market.
- The Single European Act (SEA, 1987) aims to create "an area without internal frontiers in which the free movement of goods, persons, services and capital is ensured" (i.e., the four freedoms promised by the Treaty of Rome).
- It also implemented important institutional changes: majority voting instead on unanimity on issues related to the Single Market.

Single Market Program

- Basic elements:
  - Goods trade liberalization
    - Streamlining or elimination of border formalities;
    - Harmonization of VAT rates within wide bands;
    - Liberalization of government procurement;
    - Harmonization and mutual recognition of technical standards in production, packaging and marketing.
- Factor trade liberalization
  - Removal of all capital controls;
  - Liberalization of cross-border market-entry policies, including mutual recognition of approval by national regulatory agencies.

Deeper circles: Domino effect II

- Deeper integration in EC12 strengthened the force for inclusion in remaining EFTA nations.
- New ‘forces for inclusion’ lead to a domino effect:
- EEA initiative (1989) to extend single market to EFTA
- Membership applications by all EFTA nations except Iceland and Liechtenstein; Norwegian rejected (again) membership in a referendum; Switzerland only adopted a EEA-like bilateral deal with EU.
- The fourth enlargement (1995) adds Austria, Finland, Sweden and leads to the EC15.
- In 1993, the EU sets the Copenhagen criteria for accession of CEECs. Copenhagen summit (2002) says CEEC nations plus Cyprus and Malta join in 2004 (5th enlargement).

Dynamic welfare effects

- In the long run, integration may increase a country's welfare because:
  - increased competition may occur, leading to lower prices,
  - larger markets may allow economies of scale to be realized,
  - more investment may be attracted,
  - increased factor mobility may lead to greater efficiency.