

Lecture 18 Preferential Trade Areas

Preferential trade areas, refer to liberalization agreements applying to a subset of all countries. So the models require at least 3 countries. Generally, at least three goods are needed to make the question interesting.

The difficulty with this topic is that it is inherently a second-best topic, and it is never clear ex ante that a liberalization by a few countries benefits either them or the whole world (the general theorem of the second-best).

The second difficulty is that the analysis generally proceeds by using fairly specific special cases. But there are many possible cases to consider, and it is not very clear what we learn from them overall.

Here is some old, but still used terminology.

Trade Creation - creation of trade from when there wouldn't be any.

Trade Diversion - diversity of imports from a genuinely low-cost source to a high-cost source.

Suppose that we are country A, and can produce a good ourselves, or import it from B or C

<u>Country</u>	A	B	C
Price	35	26	20
100% Tariff	35	52	40
50% Tariff	35	39	30

Suppose that we form a customs union with B, eliminate tariff against B, but not against A.

Initial Situation 1: 100% tariff

Initially no trade, home price is \$35. With a FTA we buy from B at a price of \$26. This is trade creation.

