

THE PROS AND CONS OF A COMMON MARKET: THEORY AND REALITY

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1. Introduction

When we talk about a common market, we talk about international trade, about trading blocks, about free movement of factors of production and beyond. And there are many trading blocks in the world today. What brought them into the world? How do they affect world trade? How have they fared? Does it pay to form a customs union? What are the pros and cons of a common market? These are the basic question. In what follows, an attempt will be made to answer these questions. But first and by way of introduction we shall have a look at the historical background, if only to have some proper perspective.

One of the most striking features of the modern history of world trade is that over the last fifty years, there has been a tremendous growth in the volume of world trade, the pace of which is quite unprecedented in human history. From 1960 to 1980, for example, the value of world trade, measured in U.S. dollars, increased nearly tenfold. What may be the cause for such phenomenal growth? We shall argue that it is mainly the new pattern of international trade that contributed to this growth and it was Europe that played a central role for the emergence of this new pattern. For this reason, we will take a close look at Europe first as a stepping-stone for our historical perspective.

To begin with, in Europe foreign trade is not a new economic activity. Indeed, foreign trade was an important part of many ancient European economies. But before 1500, modern nation states did not exist in Europe. Trades among distant communities were largely confined to some exotic commodities. The markets were small and without the nation states and central governments, there were no policy of any kind to push for more trade or market expansion. Even internal trading within a community was unable to flourish due to the imposition of tolls or tariffs that a trader had to pay at each city or river crossing. Only with the emergence of modern nation states, the influence of mercantilism and then the establishment of empires and colonies by some European nation states during the 16th and 17th century that foreign trade took on a new meaning. The basic tenet of mercantilism was that the wealth of a nation is measured by the amount of precious metals it possesses such as gold and silver and it can increase its wealth by maintaining surpluses in the balance of trade, Thus a colonizing county could export to the colonies as much as it wanted while deny these markets to its competitors and at the same time it can extract mineral and other natural resources from the colonies as much as it was possible. Its control of the markets was absolute. The notorious Navigation Act introduced by England in 1601 restricted all of English colonies in America, Asia and Africa to trade solely with the mother country, Goods imported or exported by the colonies had to be shipped in vessels constructed by English shipbuilders and at least three quarter of the ship's crews had to be English. It was natural that this type of economic injustice would lead to strong resistance and revolt. Strong resistance and revolt resulted in the loss of some colonies to independence but they did not bring about a fundamental change in the pattern of world trade. It was the intellectual revolt against mercantilism, which spread the doctrine of free trade that caused the major change, albeit the change was gradual and slow. For some two hundred years, economist of all persuasions in their support of free trade. But politicians and men in power continued to embrace protection. The growing trade between the colonies and former colonies and the mother countries, however, helped to create a trend toward the formation of preference trading clubs, leading the way for the creation of customs unions. The

first fifty years of the last century was a period of many great upheavals and large conflicts and many parts of the world were still under colonial rule and economically still very underdeveloped. Trade was not possible between political enemies and industrial production in many countries was geared toward the war effort. Consequently it was not a period conducive for economic cooperation or for the expansion of world trade. It was only when the second war ended, with many countries productive infrastructure virtually destroyed and many other countries succeeded in their struggles for independence that the need for rapid economic recovery and development had opened the way for the growth of international trade to take off. Three European countries, Belgium, The Netherlands and Luxembourg, which were on the same side during the Second War, took the first initial step. They formed the first Customs Union in 1948. Benelux was an association of three sovereign states which agreed to eliminate or reduce trade barriers among themselves. The main purpose of the association is to lower costs of imported goods and to enlarge markets. The next important step was taken by France and Germany, two countries that were on the opposite sides during the second war and for many years had been the worse of enemies. Jean Monnet, a French civil servant who had been concerned with the production of goods during the war and who was involved in the implementation of his plan for French Economic recovery through systematic increase of production and Robert Schuman, the French foreign minister, shared a common belief that long standing antagonism between France and Germany can be put aside if there is enough economic gain from cooperation. Economic cooperation could begin first at the industry level. The two industries that stood out as the most important for the reconstruction after the war were the coal industry and the steel industry. Thus Schuman made a proposal in May that France and West Germany should have a common authority to regulate these two industries. The advantage of having a common regulatory authority is the increase in production efficiency and the benefit of economies of scale. The proposal was not only welcome by the German but also four other countries. Belgium, Italy, Luxembourg and The Netherlands also wanted to join in. This resulted in the signing of the Treaty of Paris in by the six countries and the ECSC – the European coal and Steel Community – was established in August. The initial success of this modest economic cooperation led the six countries to examine the possibility of further economic cooperation. This effort resulted in the two treaties of Rome in March, which created the European Atomic Energy Community (EURATOM) and the European Economic Community (EEC). The treaties of Rome called for the elimination of trade barriers among member nations over a twelve-year period, the setting of common tariff for imports from the rest of the world and for the creation of a common policy for managing and supporting and supporting agriculture.

As a reaction to the EEC, seven other European countries, Austria, Denmark, Norway, Portugal, Sweden, Switzerland and the UK formed the European Free Trade Area (EFTA) in 1960 and shortly after, in 1961, the UK began to negotiate with the EEC for membership. But the French President general De Gaulle vetoed this application.

In July 1967, EEC, ECSC and EURATOM merged into one and became the European Community (EC). Two years later, the election of George Pompidou as the new French President, made it possible for the re- negotiations for the UK membership. EC membership was then extended to include the UK, Ireland and Denmark (1973), Greece (1981), Spain and Portugal (1986). In December 1991, the heads of the twelve member nations met in Maastricht and a treaty was signed in February 1992. After the ratification by each of the twelve members nation, the European Community became the European Union on November 1993. The Maastricht treaty took the integration process a step further: there would be joint policies in regard to defense, citizenship and the protection of the environment. Under the treaty, European citizenship was granted to citizen of each member state so as to enable a citizen of a member state to live or to work anywhere in the union. The integration would be complete when there is a single currency and a single market. Following the establishment of the European Union, three other European nations, Austria, Finland and Sweden also became members in 1995.

Since then several east and central European nations and Turkey, which has only about 0% of its land in Europe, also have applied for membership or for the establishment of a customs union with the European union.

2. 2. The monetary Aspect

One of the main economic objectives of forming an economic block is to expand trade. If trade does expand and liberalized then the economy of each member of the block would become more open. The degree of openness of an economy is generally measured by the ratio of its foreign trade, that is the sum of exports and imports, over its GDP. This ratio in the early 90s, for example, was 70 for Germany, 40 for France, 49 for the UK, 99 for the Netherlands, 66 for Denmark, 136 for Belgium, 117 for Ireland ... whereas it was only 18 for Japan and 22 for the United States. This means that the member countries of the EC rely much more on foreign trade than does, say, Japan. Fluctuations in the exchange rate would have much larger impact on these more open economies. Depreciation in the exchange value of an EC member country's currency would have greater effect on its domestic inflation rate than a similar depreciation of the dollar on the US inflation. With a large volume of imports relative to its GDP, depreciation in the exchange value of the domestic currency would make imports more expensive, causing higher inflation. By the same token, an appreciation of the exchange value of its currency would have a greater effect on its employment level than a similar appreciation of the dollar on the US employment level. With a large volume of exports relative to its GDP, an appreciation in the exchange value of the domestic currency would make its export industries become less competitive, causing their contraction and resulting in higher unemployment. On the other hand, more than half of the total trade of EC countries is with other EC countries. It is therefore very important that the exchange rates among EC members be stable. This realization led to the creation of the European Monetary system (EMS) in March 1979 after a long period of exchange rates volatility following the 1973 oil crisis. All members of the EMS, with the exception of the UK, agreed to participate in its Exchange Rate Mechanism (ERM) whereby member countries were required to limit the fluctuations of their bilateral exchange rates to within 2.25% (1% for the Italian Lira). Each central bank must intervene whenever the market force pushes the exchange rate beyond this specified band. Under the terms of the ERM agreement, members agreed to provide one another with credit facilities and to institute the Ecu as the formal unit of account and the exchange ratios of the participating countries of the EMS were formally defined with reference to the Ecu. Since this was not strictly a fixed exchange rate regime but one with some allowance for adjustment, there were some 11 alignments during the period from 1979 to 1987, mostly involved a revaluation of the Deutsche mark and the Dutch guilder against the other EMS currencies.

These realignments were necessary due to the differences in inflation rates among EMS members. Germany economy was the strongest economy and one with the most consistent record of low inflation. Since 1971, with the abandonment of the Bretton Woods system, European countries could no longer use the dollar as an anchor currency.

The Deutsche mark was the natural replacement for the dollar for the ERM countries. By pegging with the Deutsche mark, the ERM members with inflation rates many times higher than that of Germany were able to bring down their inflation. Besides these alignments, the exercise of capital control by most ERM countries also helped to make the EMS a success during the 1979-1987 period. After 1987, with every ERM member inflation rates came down to less than 0%, no more alignments were made and capital controls were removed. The ERM became a *de facto* fixed exchange rate regime. Under a fixed exchange rate regime and with free capital mobility, a country would lose its ability to use monetary policy to achieve its domestic objectives. Unless there was full convergence of inflation, exchange rate stability could not be maintained fully recognized this fact. Member nations in the EC agreed in 1989

to transform the EMS into a full monetary union with a single currency within a fixed timetable.

The path toward full monetary union was not without occasional hitches or snags. First there was the unification of Germany in 1990. The German government chose to finance the cost of unification by borrowing. As a result, Germany went from a budget surplus to a budget deficit. Since she needed foreign capital to finance unification, Germany also went from a surplus to a sizable deficit in the balance of trade. This necessitated an alignment for the Deutsche mark. But no EMS member would agree to such alignment. The unification also led to German monetary growth as well as expansionary fiscal policy, resulting in higher inflation. The Bundesbank then responded by adopting a restrictive monetary policy, causing interest rate to increase substantially. To maintain parity of the exchange rate, other EMS countries would have to raise their interest rates as well. But some were in the middle of a recession and would not want to increase their interest rates. On the other hand, two countries, Italy and the UK, under intense pressure by speculators, had to withdraw from the ERM in 1992. Then in 1993, as unemployment increased, recession deepened in most EMS countries and with massive intervention by the Bank of France, by the Bundesbank and by other EMS central banks failing to stabilize the exchange rates, currencies in the ERM was allowed to fluctuate to a range of 10%. This made the ERM turned into a *de facto* flexible exchange rate regime!

3. 3. Trading Blocks in other parts of the world

The EU is the first, the most ambitious and currently the largest common market in the world. But there are several others in other continents as well. Many countries in America, Africa and Asia have followed the lead of Europe and set up several regional trading blocks in the form of free trade zones or customs unions with various degrees of success. The first trading block in America, the Latin America Free Trade Area was established in 1960 following a treaty signed by Mexico and six South American countries (Paraguay, Uruguay, Brazil, Argentina, Chile and Peru). In the same year, the Central American Common Market (CACM) was also established, which included all Central American countries, except Panama and Belize. A decade later, in 1969 the Andean Pact which consisted of Bolivia, Chile, Colombia, Ecuador, Peru and Venezuela, was formed and in 1973 the Caribbean Community and Common Market (CARICOM) was created by 12 Caribbean nations. In 1980 the Latin America Free Trade Area became the Latin American Integration Association (LAIA). In 1990 Colombia, Mexico and Venezuela formed the group of three, and in the same year Argentina, Brazil, Paraguay and Uruguay jointly created the Southern Cone Common market (MERCOSUR). The establishment of the Association of Caribbean States by Colombia, Surinam and Venezuela followed this. The main objective in forming these trading blocks was to protect south and central American markets from outside competitor while enlarging the internal markets for the local products. Since 1960, military dictatorship has begun to give way to democratically elected government in these regions. But in most cases, for several decades the elected government only served the upper class and other small elite groups and did not do much to eradicate income and wealth staggering inequality or to help the rural areas to develop. Poverty, government neglect, corrupt policies and hyper inflation all contributed to political unrest, without political stability, economic cooperation could not be consolidated in any long term basis.

In North America, the concept of trading block did not take root until the mid 80's and even then, opinion in Canada and in the United States was sharply divided. Trade flows between Canada and the United States have been the largest bi-national flow in the world and yet not until 1988 that the two countries signed a free trade agreement to establish the two countries as a Free Trade Area (FTA) that would take effect the following year. Five years later, with much debate in the US, this free trade area was extended to include Mexico and NAFTA was born. With NAFTA came into effect, a Summit of the Americas meeting was

held in 1994 with the participation of 34 American countries to dedicate to tariff – free trade for the whole American continent by the year 2000.

In Asia the south East Asian Association (ASEAN), which have been in existence since 1967 as a political and joint – defend group, began to take steps to expand to include other South East Asian nations after the end of the Vietnam war and to embark on regional economic cooperation. The Asian Free Trade Area (AFTA) came into being by declaration in 1992. Each nation member pledged to reduce tariffs on most imported goods from other member nation to 0% by 2003.

In other part of Asia, there is a customs union formed in 1990 by Belarus, Kazakhstan and Russia, which was joined by Kyrgyz Republic the following year. And then of course we have the gulf Cooperation Council established in 1981 in the Middle East which consisted of six Gulf States, namely Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and united Arab Emirates. The Council had the mandate to eliminate customs tariffs by 1982 and to liberalize trade and services by 1983.

The potentially largest trading block in the world is perhaps the group of nations that border in the Pacific Ocean. At the initiative of the Australian government a forum called the Asia Pacific Economic Cooperation (APEC) was formed in 1989. This is a forum for all the so – called pacific nations in Asia, America and Oceania, dedicated to regional economic integration and free trade. By 1996 it already has some 18 nations as members and is continually expanding. Member of APEC includes Asian countries such as Japan, China, South Korea, Taiwan, Malaysia, and Thailand etc. Oceanian countries such as Indonesia, Australia, New Zealand and the American countries such as Chile, Mexico Canada and the United States. Currently these countries together produce more the half of the world total output. Foreign ministers from these countries have met annually since its inception and the first meeting of Heads of States took place in 1993 Besides regional security, the most important topic of discussion in these meeting has been the reduction of tariffs and the removal of trade barriers, in 1994 the industrialized nations in the group pledged to remove all trade barriers by 2010 and the developing nations in the group pledged to follow by the year 2020. These are the first steps toward a Customs Union with such diversity in culture, religion and political system; it would be a long hard road before such trading block can become a common market.

In Africa there exist also several trading blocks. The Central African Economic and Monetary Community (formerly, the Customs and Economic Union of Central Africa) is a customs union consisted of four central African nations: Central African Republic, Cameroon, Gabon and Republic of the Congo. The Southern African Customs Union is another African trading block whose member nations include Botswana, Swaziland, Lesotho, Namibia and South Africa. Other African customs unions include the West African Economic and Monetary Union. East African Community which consists of Kenya Tanzania and Uganda, the Economic Community Of West African States and the Community of Eastern and Southern Africa. Then there is also the Cross Border Initiative (Sub – Saharan Africa), which is not a customs union but a free trade area.

4. 4. The Gain and Loss From Joining a Trading Block

With so many trading blocks being formed in every part of the world in the last fifty years one must suppose that the driving force behind this movement must be the strong belief in the economic gain that would follow and that would not otherwise be possible without being member of a trading block. So what are the possible gains and what does economic theory have to say on this issue?

In order to see whether a country can gain from joining a trading block, we can begin with a simple static model and take a hypothetical case of three trading nations, one of which is the

home country. We shall assume that production is fixed in the short run and that when the three countries trade with each other for the first time they always begin with restricted trade rather than with free trade. The home country would impose a tariff on imported goods from the two foreign countries which we shall call A and B. Suppose all three countries can produce good y but the home country is the least efficient and B is the most efficient producer of y . If the home country impose a tariff in the importation of good y and if this tariff is sufficiently high it would make the home produced y to have the lowest price and good y will not be imported from either A or B. The home government receives no tariff revenue and the home consumers are forced to buy the most inefficiently produced y . The home country might as well close its door to foreign trade. The only justification for this high tariff, which would curtail imports, is when the y industry is in its infancy therefore it would need protection for some period in order to mature and be able to compete with foreign producers. Beyond this specific case, we can thus suppose that the tariff is not high enough to curtail the importation of y but that it is low enough to make the price of imported y lower than the price of home produced y . If the tariff on the importation of y from A or from B is the same then the price of y imported from B would be the lowest. Total consumption of y would be imported from B if the supply of y from B were sufficiently inelastic. The home government would receive some tariff revenue from the importation of y and y industry at home will close down releasing resources for other perhaps more efficient production. Thus there is a gain in resource allocation and in government revenue. Now suppose the home country forms a customs union with A removing all tariff on imports from A. but keeping the same tariff on all imports from B, which now represents the "outside world". This could make the price of x imported from A the lowest. Home consumers now buy y imported from A instead of y imported from B. Trade had been diverted from B to A. Since there is no tariff on the importation of y , the government loses all the tariff revenue with respect to the importation of y but for the home consumers. Since y is now cheaper than before there is a gain in consumer surplus. There would be a net gain or net loss, depending on whether the gain in consumer surplus. There would be a net loss, depending on whether the gain in consumer surplus is greater or less than the loss in government revenue, if only part of the total consumption of y is imported and part is produced at home, then the fall in price of y following the formation of the customs union would also mean a loss in producer's surplus at home. This loss must also be taken into account in this case. We illustrate this case graphically in Appendix 1b.

In the long run, the home country needs not remain at the same point on its production frontier. Now consider the case of forming a customs union, with A. As a result of this union, the country may move resources to produce more x s and less y . The fall in the price of y may cause a large increase in demand if demand is sufficiently elastic, so that more y would be imported and more x s would be exported. In other words, not only trade is diverted but also more trade has been created. Furthermore, if the home country is large, the curtail of import from the outside world B would improve the terms of trade with the outside world. But the terms of trade with the custom partner would worsen. We make use of a simple graph to illustrate this case in Fig. 1 in the Appendix.

Now consider the case where the home country joins B to form a customs union and A is now the outside world. Since the home country has been buying Y from B, it will continue to buy Y from B after a customs union has been formed. But now that the tariff on the importation of y from B is removed, price of y paid by the home consumers is lower and more y will be imported and bought in the home market. Trade expands because more trade has been created. The gain in this case is the increase in the home consumer's surplus. If some of y consumed were produced by the home country before the customs union, the removal of tariff which lowers the price of y will also reduce the amount of home produced y in total consumption resulting in a reduction of producer's surplus. And then there is a loss of government tariff revenue. However the gain in consumer's surplus is always greater than these two losses combined by the mere fact that both home produced y and imported y is but a portion of the total home consumption. We illustrate this case graphically in Appendix 1a.

Again these calculations are based on a static short run framework where production is assumed to be fixed. If this assumption is relaxed, the removal of tariff and the formation of a customs union would move the home production toward producing more x and less y resulting in a large increase in both export and import. The creation of trade is thus much greater in this more robust framework if the supply of y from B is inelastic, there would be no change in the terms of trade. But if it were elastic, the home country's terms of trade with B would worsen. This case is illustrated graphically Fig. 7 in the Appendix.

In practice, there are of course more than one imported good and more than one exported good. To calculate the gain and loss we would have to combine all the gains and all the losses in order to derive the total net gain or the total net loss. The calculation can be quite complex. From the point of view of the customs union as a whole, however, the picture is quite simple. The creation of a customs union clearly expands intra-block trade and the block, as a whole would gain. Furthermore if the block is sufficiently large it could affect the world terms of trade and move it in its favor. We learn in the theory of tariff that if a country is small. It only does itself harm by imposing a tariff on imports.

However if the country is sufficient large it can affect the terms of trade and can gain by imposing a tariff on imports. Indeed there exist an optimal tariff where the gain is largest. Therefore if the trading block is sufficient large, it could maximize the gain from trading with the outside world by adopting a common tariff against the outside world and setting this tariff at the optimal level. How high is this tariff depends on the elasticity of the demand of the outside world for the block's exports? The lower is this elasticity; the higher is the optimal tariff. Thus in general, the common tariff levied against the outside world tends to be higher than that of any individual country in the block. A movement in the terms of trade in favor of the block is a movement against the outside world. So a gain by the trading block is a loss of the outside world.

Furthermore, the expansion of trade following the creation of a customs union would also bring about the enlargement of markets. Here the trading block can also gain in productive efficiency and competitiveness. This gain can even be more important in the long run than those we have mentioned above, particularly for those markets that are basically oligopolistic and are subject to economies of scale.

• • Theory and Reality

Although it is easy to see the economic gain from joining a customs union, but in practice this is not the only nor the most important consideration, with the exception of APEC, which is not yet a customs union and may never be one, all trading block in practice are regional in character, this is due to the fact that in most cases. A substantial amount of trade of a country is with its neighbors. To begin with, transportation cost would be lower. Also countries within a region tend to share similar history and culture even at any given moment in history they may not have similar political system or are in the same side of a conflict. Sharing the same economic vision may bring neighboring countries together initially to discuss the economic pros and cons of forming a trading block. But to succeed they must also share the same political vision. This is vital since there will be the problem of distributing the gain among members of the block and the consensus required for the common commercial policy with the outside world. Customs union cannot be viewed as an end product but as an intermediate product, a first step toward complete integration. This implies that a country will have to consider the next step and to decide whether it can go all the way. For example, in order that trade flows can grow smoothly, exchange rates among members of a block must not be too volatile.

This can be achieved with a fixed exchange rate regime. But in practice it is not an easy policy to carry out, as the European experience has shown. Each country in the block might have its own economic, social or political problem to deal with. One country might have a

large government deficit and another might have a serious unemployment problem. They may have different fiscal responses to these problems and as a result their price movements are not similar. One country may have high inflation while another may have low inflation. These situations would make it extremely difficult to maintain fixed exchange rates. So should member be required to eliminate budget deficit and to agree to a common fiscal policy? And if free capital movement is to be allowed, how much independent a member nation can conduct its monetary policy? Should there be only one currency when the block becomes one market? Would a member nation be prepared to forgo its pride and sovereignty and accept a common money unit and the dictation of a common central bank or common monetary authority? A common monetary policy in the America is impossible in the present climate and will remain impossible for the foreseeable future. Even between as geographically close as England and the continental Europe, the English still resisted strongly to the idea of abandoning the pound sterling and replace it with the euro. The new trading blocks will likely have to deal with the same kind of economic problems and difficulties that the European Union had to face in the early years of the union and perhaps with some other even more serious.

A customs union is of course not yet a common market; the latter refers to a customs union where there are free movements of factors of production. This implies that labor must be allowed to move freely. A worker may reside and work in any country within the block and a citizen of any country within the block can open a business in any country within the block. It is only then that one can hope to reap the benefit of improvement in resources allocation. But then there would be problem of citizenship, national border, immigration and migration, and the like that a trading block has to face. These are not economic problems and they are a lot more difficult to solve than any economic problem. In some regions these problems are in fact insurmountable in the short or medium term. But given the fact that there are so many trading blocks that is already in existence and if they do make economic gain, some of these gains would be at the expense of the outside world. For that reason alone no country can afford to be standing alone. For a nation that does not belong to any trading block in the world today the economic future cannot be very good.

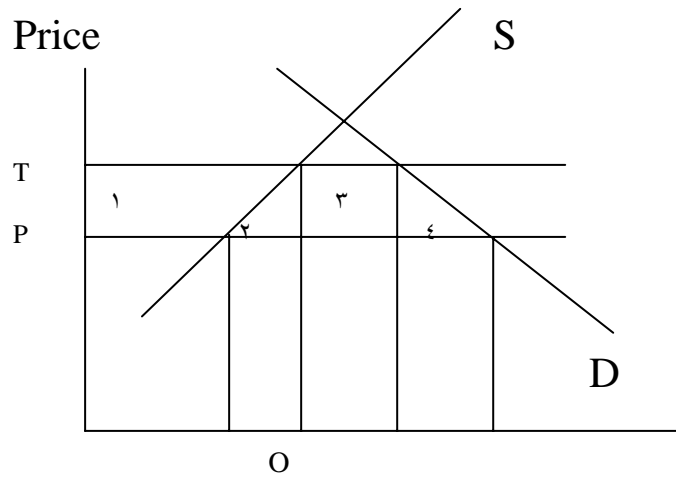
6. 6. Half Loaf and Whole Loaf

Since the end of the Second War, besides the general movement toward the formation of regional trading blocks, there is also a movement toward freer trade for all countries in the world. This is the movement that started with the General Agreement on Tariffs and Trade in 1947 between 23 countries and by 1994 when it became The World Trade Organization there were 123 member nations, since then some 30 more nations have applied for membership. GATT and its successors had been able to foster large tariff cuts and to help to settle serious disputes over commercial policy. These efforts clearly also contributed to the expansion of trade among nations. In fact the agreements that WTO will administer are expected to increase annual world trade by some \$770 billion by the year 2002. So we can attribute the phenomenal growth of world trade to both movements. From the pure economic viewpoint, for the world as a whole, the best situation is when there is free trade everywhere. If trade everywhere is free then the whole world would gain, every one would be better off and no one would be worse off. Trading block on the other hand, would enable nations within a block to gain at the expense of those that are not member of the block. It has the so – called *beggar – thy – neighbor* effect. If the world is divided into a number of trading blocks instead of one world block, then it is like having a half loaf instead of a whole loaf. But of course from a single nation point of view, having a half load is better than having none. If this half load is enough to overcome regional differences and hostilities then all the better. The movement toward the formation of trading blocks may thus compliment the movement toward freer trade for all. When all trading blocks have been formed, and if they are membership-wise mutually exclusive, tariff war would lead to bilateral negotiations and external tariff would tend to be reduced. If they are membership-wise not mutually exclusive, tariff war would be unlikely and bilateral negotiations would be easier. In either case the

WTO would have a role to play. So the future of world trade is very good indeed, provided every nation of the world would strike to be a member of some customs union or some common market.

APPENDIX

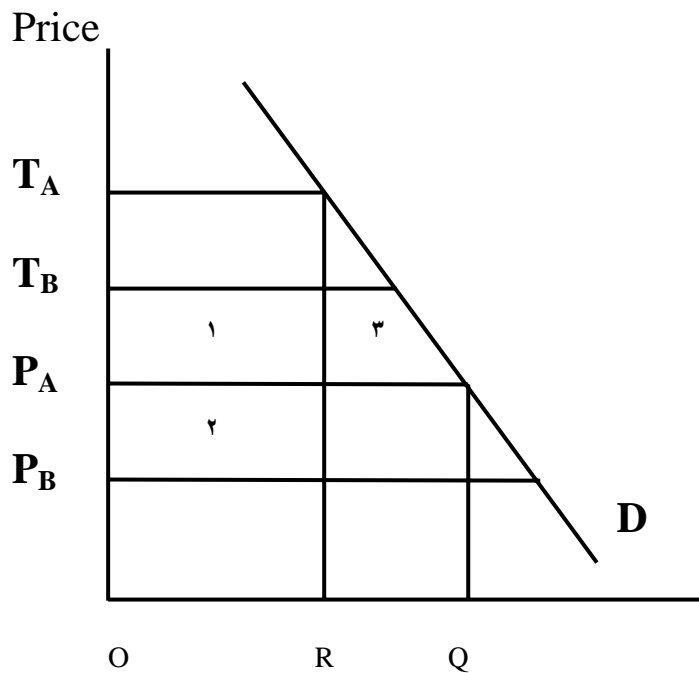
\a. Trade Creation: Short run



The short run demand and home supply of a good y are drawn as line D and S in Figure 1 a. Country B can produce this good more efficiently and can supply y inelastically at price P . if a tariff PT was imposed on importation from B then home production will be OR and import will be RM and home consumer pays the price OT for the good. If A and B forms a custom union, tariff on importation from B will be removed and price will fall to OP . Home production will be reduced to OQ and import from B will rise to QN . More trade has been created. What are the gains and losses in this case? A fall in price from T to P increases consumer's surplus and the area $1, 2, 3$ and 4 measures this. Home producer surplus is reduced, and this is measured by area 1 . The government also lost tariff revenue equal to area 3 . So the net gain is 2 and 4 .

APPENDIX

\b. Trade Diversion: Short Run



exportation NE_1 of good x. if tariff is removed. Domestic relative price would be the same as world relative price more of good y would be imported. Domestic production would move to E_1 and the home production of good x is now further reduced to QE_1 . With the removal of tariff, home consumption can now move further beyond the production frontier to C_1 . Importation of y is now MC_1 and the exportation of x is now ME_1 . Thus more trade had been created.

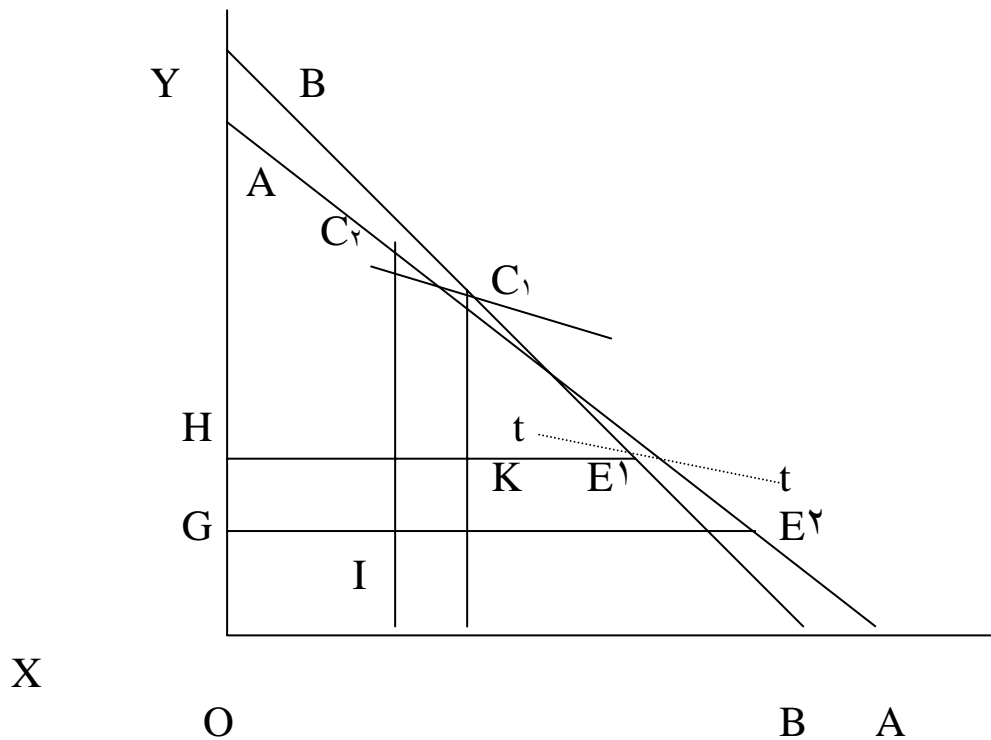


Fig 2

The case of *trade diversion* is illustrated in fig.2 to avoid crowding the graph the production possibility curve is not drawn. Relative price in country A is given by the slope of the line AA and that of country B is given by the slope of the line BB. With tariff imposed on the importation of good y the home country would choose to be at the point E_1 and the slope of the line tt gives trade with B. the domestic relative price after the imposition of tariff. A quantity KC_1 of good y would be imported from B in exchange for a quantity KE_1 of x exported. If a customs union is formed with country A, production in the home country would move to E_2 and a quantity IC_2 would be imported from A in exchange for a quantity IE_2 of x exported. Trade would be diverted from B to A. since the price of y is lower, the demand for y is higher, this is indicated by the fact that $IC_2 > KC_1$. So more trade would also be created since both imports and exports are larger than before. Is the home country better off? In term of social Welfare, as We can see from the graph, if C_2 is sufficiently higher than C_1 then the social indifference curve at C_2 would be higher than the indifference curve at C_1 in other words, the demand for y has to be sufficiently elastic to bring out this result. On the other hand, with the formation of the customs union, the outside world B can no longer sell nor buy x from the home country. Consequently, the home country's term of trade with the outside world would improve and that with the customs union partner A would deteriorate.

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