International Negotiations and Trade Policy

• 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.

Trade Diversion – Good or Bad

Importing Country

- **Consumer Surplus**
  
  $$ + (a + b + c + d) $$

- **Producer Surplus**
  
  $$ - a $$

- **Govt. Revenue**
  
  $$ - (c + e) $$

- **National Welfare**
  
  $$ + (b + d) - e $$
Trade Creation-1

Importing Country

FTA with country a
- Consumer Surplus
  - + (a + b + c)
- Producer Surplus
  - - a
- Govt. Revenue
  - 0
- National Welfare
  - + (b + c)

Trade Creation (imports) from “0” to D2-S2 from country a

Trade Creation -2

Importing Country

Free Trade Area
Signed with country c, which has comparative advantage in producing the good.
Trade Create:
M1-M2=all the extra imports
Welfare analysis?
1 Antidumping and Trade Diversion

To demonstrate the concept of trade diversion in a partial equilibrium setting, let’s consider a case where a small importing country M\(^1\), with the following demand and supply for the good, imports \(D^1 - S^1\) from country A at price \(P_a\). After a complaint by the domestic producers in country M the govt. decides to impose an Antidumping duty "\(t\)" on imports coming in from country A.

Figure 2.1: Imposition of Antidumping duty in a Small Country

a) Case of no Trade Diversion: In the absence of Country C, that is any other foreign county that can export the good to country M. The imposition of AD duty of "\(t\)" amount, the domestic price in country M would increase by the amount "\(t\)" to \(P_a + t\). This would restrict the level of imports to \(D^3 - S^3\). So overall imports go down by the amount: \([D^1 - S^1] - (D^3 - S^3)\]

b) In presence of Trade Diversion: However, if foreign country C could export the good to country M at price \(P_c\), then we would see trade diverting to country C. As the price in the importing country starts rising, after the AD duty is imposed on imports coming in from country A, country C would start exporting the good to country M. The domestic prices in country M would then be \(P_c\) and new level of imports would by \(D^2 - S^2\)

\(^1\)We use a small country as an example just for the ease of the analysis. Since we are considering the small country, and change in the domestic policy would not influence the world prices. Trade diversion can also be shown in case of a large country.
Level of Import Restriction: \[((D_1 - S_1) - (D_2 - S_2))\]

Level of Import Diversion from country A to country C: \[((D^2 - S^2) - (D^3 - S^3))\]

In presence of trade diversion the domestic producers would not get the higher price \(P_a + t\) by \(P_c\). This reduces the benefit accruing to domestic producers. Also, foreign country C benefits from the AD duty imposed by country M, as it can now export goods to country M at price \(P_c\).

There has been earlier work that looks at the trade effect of AD protection for various countries. Prusa (1997) set forth to present evidence on the effectiveness of antidumping actions in the United States while Vandenbussche et al (1993) attempted to measure the effects of European antidumping measures on import flows so as to contrast their results with that of Prusa (1997). Utilizing U.S. data, Prusa (1997) concluded that (i) antidumping duties substantially restrict the volume of trade from countries named on the petition and particularly for those cases where ”high” duties were imposed and (ii) substantial trade diversion exists from named to non named countries with the diversion being larger the greater the duty. Accordingly, for the US data, antidumping laws have the peculiar side effect of benefiting countries and firms that were not named in the investigation through substantial price increases and volumes. In contrast, Vandenbussche et al (1999) find that little or no trade diversion exists in the European Union data. Their conjectures regarding this difference include (i) differences in concentration levels, (ii) the nature of antidumping legislation as well as the differences in the calculation of penalties and (iii) the lack of transparency and the extent of uncertainty with respect to protection offered in Europe. Niels (2003) shows that for Mexico there isn’t much trade diversion after AD duty is imposed on the named countries.