The WTO. The World Trade Organization. Where 50 member nations set the rules for international trade. In 150 years of lifting trade barriers the WTO and its predecessor the General Agreement on Tariffs and Trade or GATT have demonstrated that freer trade means more trade. So, why are more and more nations settling their trade problems not through the WTO but by forming regional trading blocs?

Trade Liberalization and Regional Trading Blocs.

What's the best way to liberalize trade? We'll find out when we look Inside the Global Economy.

NARIMAN BEHRAVESH:
Hello, this is Nariman Behravesh. In this segment of Inside the Global Economy we'll be talking about trade liberalization and the formation of regional trading blocs. To their credit, many policy makers around the world during the post-war period have absorbed the lessons of the advantages of free trade and the problems and costs of protectionism. And they have tried to institute a number of efforts to liberalize trade. We're going to try to answer a couple of questions about this. One, what is the best way to liberalize trade and secondly who are the winners and losers as we go through the process of trade liberalization. To answer these questions, we're going to look at a couple of case studies. One from North America, and the second from Australia. We'll also hear from a panel of experts who will discuss some of the issues raised throughout this discussion.

And in looking at the various attempts at trade liberalization, they tend to fall into two broad categories. The first is a multilateral/non-discriminatory attempt to liberalize trade. What are we referring to here? This is basically an attempt by a very large group of countries to all lower their trade barriers and not discriminate against any particular group and not favor any particular group. So that's a broad-based attempt to liberalize trade.

A second approach that has been taken, again a lot in the post-war period is a preferential attempt to liberalize trade which has a regional flavor to it, and which, in which has only a smaller group, not the whole world, but a smaller group of countries are lowering their trade barriers against each other but keeping them relatively high against the rest of the world. So this has the effect of building a trading bloc, that doesn't really encompass a very large group of countries.

Let's focus on the first approach and at the heart of the first approach or the multilateral approach is an institution called the WTO or The World Trade Organization, or its predecessor the General Agreement on Tariffs and Trade and under the WTO what's happened in the post war period has been a dramatic lowering of tariff barriers. Here we have the average tariff rates imposed by countries starting in the 1940's and ending in the year 2000. And we can see that at the end of the Second World War, average tariffs were about 40 percent worldwide, now they are close to about 5 percent. So this is a very dramatic lowering of tariff barriers. What was the impact of this on world trade? We can see a very dramatic impact on world trade in fact from 1950 to 1990 world trade volumes went up twelve fold as a result of this trade liberalization.

Let's contrast that with the experience in the 1920's and 30's in which there was a lot of trade friction, tariff barriers were high. They were raised, in fact, in the great depression in the U.S. under the Smoot-Hawley tariff law. And as a result of that trade stagnated during those decades. But notice after trade was liberalized after the end of World War II we saw this explosion in trade
volume. So clearly the impact of this multilateral approach to trade liberalization has been very positive.

Now at the cornerstone of the WTO is something called the most favored nation principle or MFN for short. It's a bit of a mouthful. The basic principle says that if country A, let's say, lowers its tariff barriers against country B it also has to lower its tariff barriers to imports from all other countries within the WTO. And the result has been basically that all tariff cuts have been fair in the sense that they have been lowered against every body. This non-discrimination is part of the success story of the WTO in that it has been done equally and fairly across the board.

There's another element of success in the WTO and that is that the tariff cuts have been reciprocal when we have cut tariff barriers, let's say, against Japanese imports they have cut tariff barriers against our imports. And vice versa with Germany, Korea and so forth. So this again has had the impact of being reciprocal, being fair, and so forth. And finally, the idea behind the WTO is also the tariff structure’s transparence, and everything's on the table and that there's nothing hidden in the way of protectionism and so forth. So from this perspective, these have been the guiding principles behind the WTO.

Now the basic rules of the WTO can be boiled down to really three areas. One is no export subsidies, in other words, no country is going can focus its subsidies on exports. Except agriculture. There's an interesting story behind this. And that is that it was the U.S. that asked for this exception and the WTO granted it largely because of the clout of the U.S. but what's interesting is that it hasn't been the U.S. but it's been Europe that has exploited this particular exception and taken advantage of it much to the consternation of the Americans. But by and large the WTO does not allow for export subsidies.

A second area where the WTO says is a no-no is import quotas. In other words, a country can't set a fixed number of goods in a particular category, let's say cars or VCRs or whatever to come into a country. With again the exception being if there is something called market disruption or specifically if there is some kind of an import surge. The concern here on the part of many countries was that was that there might be dumping as it were. Dumping occurs when a country, let's say like Korea, sells its VCRs for a lower price in the U.S. than it does in Korea. But again, this is an escape clause that would allow for countries to in effect retaliate if they sensed that there was some unfair trading or dumping going on.

And finally, and this is a very important part of the WTO, is that any new tariff or increased tariff has to be matched by a lower tariff somewhere else so, again, the point being that on average the tariffs don't go up, they actually go down so any new tariff has to be matched somewhere else or other by a lower tariff elsewhere.

Now by and large the WTO has worked very well as we saw in the initial graphics but there have been lots of criticisms of the WTO. To begin with the view is that it's been too slow. The latest round of tariff cuts under the WTO lasted almost seven years. And most people thought that it was far too slow. They became very impatient with the process. A second criticism is that the WTO cannot handle the changing nature of protectionism. We saw where the WTO has been very successful in lowering tariff barriers but at the same time that tariff barriers have come down so-called non-tariff barriers have been rising. These include things like voluntary export restraints, anti-dumping legislation, counter veiling duties, a number of activities that aren't classified as tariffs. And the WTO has not been very effective in dealing with these and controlling them.

To better understand the frustrations with the WTO and what three countries, the U.S., Canada and Mexico did to counter these frustrations let's turn to the first case study which looks at NAFTA or the North American Free Trade Agreement.
Shots of Congress, American factory workers.

NARRATOR: AS CONGRESS WAS CONSIDERING PASSAGE OF THE NORTH AMERICAN FREE TRADE AGREEMENT IN 1993, WORKERS IN THE UNITED STATES GREW INCREASINGLY APPREHENSIVE ABOUT LOSING THEIR JOBS.

Anti-NAFTA demonstration

NARRATOR: A FIERCE DEBATE RAGED IN THE U.S. OVER THE IMPACT OF FREER TRADE BETWEEN THE UNITED STATES, MEXICO AND CANADA.

Clinton statement,

Good jobs, rewarding careers, broadened horizons for the middle-class Americans can only be secured by expanding exports and global growth.

Ross Perot statement:

Pay a dollar an hour for your labor. Have no health care: that’s the most expensive single element in making a car, have no environmental controls, no pollution controls, and no retirement and you don’t care about anything but making money, there will be a giant sucking sound going south.

Mexican farmers demonstrate against NAFTA:

NARRATOR: IN MEXICO FARMERS FELT THREATENED, BUT MOST MEXICAN WORKERS WERE HOPEFUL THAT THEIR LIVING STANDARDS WOULD BE IMPROVED.

President Clinton signing NAFTA, being applauded.

NARRATOR: SINCE NAFTA WAS SIGNED INTO LAW IN 1993, HAS IT FULFILLED ITS PROMISE OF JOBS AND PROSPERITY?

Trucks crossing border, ships being loaded, trains with cargo.

NAFTA PROVIDED THAT OVER A TEN TO FIFTEEN YEAR PERIOD, VIRTUALLY ALL OF THE TARIFF BARRIERS AND MOST OF THE NON-TARIFF BARRIERS WOULD EVAPORATE.
Amb. Jim Jones on-camera:

So, what you’re going to end up with as we go forward is basically a, an economic region, an economic trading unit between Canada, United States, and Mexico which will be one of the most powerful ones in the whole world.

NAFTA train in Kansas City, Bimbo truck in Mexico:

NARRATOR: WHAT HAS NAFTA ACCOMPLISHED SINCE ITS INCEPTION? TWO COMPANIES, ONE IN THE UNITED STATES…AND ONE IN MEXICO, SERVE TO ILLUSTRATE NAFTA’S EFFECTIVENESS.

Oil portrait of train in KCS offices, portrait of founder, shots of present day railroad.

KANSAS CITY SOUTHERN RAILROAD WAS STARTED IN THE LATE 1800’S BY ARTHUR STILLWELL. STILLWELL’S VISION WAS TO BUILD A LINE FROM THE HEARTLAND TO THE GULF COAST AND EVENTUALLY TO MEXICO. BEFORE NAFTA, KANSAS CITY SOUTHERN WAS UNDER CONSTANT THREAT OF HAVING TO MERGE WITH THE MORE POWERFUL RAILROAD GIANTS IN ORDER TO SURVIVE. WITH THE IMPLEMENTATION OF NAFTA, THE COMPANY SAW ITS OPPORTUNITY.

Michael Haverty on-camera:

With our north south orientation we believed that if we could make an investment in Mexico and tie it into our line that we could develop what we called the NAFTA railroad.

Train shot.

NARRATOR: KANSAS CITY SOUTHERN STARTED OPERATIONS TO MEXICO IN JUNE OF 1997, TRANSPORTING AUTO PARTS, GRAIN, CONSUMER PRODUCTS AND AUTOMOBILES.

Michael Haverty on-camera:

We have not hired more people, but you have to remember that had we not made that investment in Mexico, we would have probably had to lay off hundreds of people. We probably wouldn’t be here today if, if it had not been for NAFTA. So, even though we haven’t increased jobs we’ve certainly protected those jobs that we had in our company.

NAFTA rail shots: (Replaces 1st part of Luis de la Calle)

NARRATOR: THE NAFTA RAILROAD IS AN EXAMPLE OF THE KIND OF INVESTMENT IN INFRASTRUCTURE SO SORELY NEEDED IN MEXICO. WHILE THE NAFTA RAILROAD DIDN’T CREATE JOBS FOR ITS OWN OPERATION, THE FACT THAT IT COULD PROVIDE EFFICIENT AND ECONOMICAL TWO-WAY
TRANSPORTATION OF GOODS, INDIRECTLY GENERATED JOBS IN OTHER SECTORS ON BOTH SIDES OF THE BORDER.

Luis de la Calle on-camera and v.o.:

The choice in many sectors is do you want to produce a particular good with Mexican workers in the US or would you rather produce the same product with Mexican workers in Mexico, with US components. In order to allow for those sort of operations you need a frictionless border. The challenge of course is to build that transportation infrastructure system that will allow for the true benefits of NAFTA really to flourish and to then spread around the continent.

Old photo of original Bimbo bakery –dissolve - Zoom in Bimbo building:

NARRATOR: BIMBO BAKERIES WAS FOUNDED 57 YEARS AGO IN A SMALL MEXICO CITY STOREFRONT. IT IS NOW THE LARGEST BAKERY IN MEXICO.

Bimbo facilities in the U.S.

AT ABOUT THE TIME NAFTA WAS IMPLEMENTED, BIMBO DECIDED CONDITIONS WERE RIPE TO HAVE A STRONGER PRESENCE IN THE U.S., INVESTING HEAVILY IN NEW FACILITIES AND ACQUIRING SUCH PRODUCTS AS ENTEMANNNS PASTRIES, THOMAS’S ENGLISH MUFFINS AND BOBOLI PIZZA KITS…

Shots of imports from U.S. to Mexico:

BIMBO’S RELATIONSHIP TO THE U.S. MARKET IS MUTUALLY BENEFICIAL AS IT IMPORTS MUCH OF ITS MAIN INGREDIENT SUPPLIES AND EQUIPMENT FROM THE UNITED STATES.

Daniel Servitje on-camera:

In our case I think that jobs have been created on both sides of the border because of NAFTA. We now have close to almost 10,000 people working in the US.

Daniel Servitje v.o.

In Mexico we now have a much more stable economy because of NAFTA. So, certainly our standard of living and the employment opportunities of our associates are much broader now then they were before.

Luis de la Calle on-camera:

I think Bimbo is leading the way for other Mexican companies to invest in the US and I think that is one of the counter intuitive results of the NAFTA.

Mexican stock exchange: (Replace Luis de la Calle on-camera)
NARRATOR: BECAUSE OF NAFTA MEXICO IS A LARGE RECIPIENT OF DIRECT U.S. INVESTMENT, BUT ALSO BECAUSE OF NAFTA, MEXICO IS BECOMING A LARGE INVESTOR IN THE UNITED STATES, AVERAGING EIGHT HUNDRED MILLION DOLLARS PER YEAR.

Loading, unloading ships: (Replace Luis de la Calle from end)

IN ADDITION, MEXICO NOW BUYS 14% OF GOODS THE U.S. EXPORTS TO THE WORLD. 35% OF U.S. TRADE IS WITH CANADA AND MEXICO, A REMARKABLE AND DEEP INTEGRATION. BUT LABOR REPRESENTATIVES HAVE CONCERNS ABOUT THE IMPLICATIONS OF FREE TRADE FOR WORKERS.

Shots of workers in U.S. plants. Thea Lee voice-over and on-camera:

I think the point is not so much that trade between Mexico and Canada and the United States is bad or that investment between those countries is bad but it’s the question of what is the set of rules that NAFTA put in place and how has that impacted average working people in the different countries. So we look at a couple of different yard sticks, one is certainly here in the United States, we’ve lost over half a million jobs according to the labor department just as NAFTA went into effect, jobs that have moved to Mexico or Canada. You look at Mexico which was supposed to be the big winner from NAFTA and their poverty is growing, inequality is growing and real wages are actually lower then they were before NAFTA went into effect.

Jim Jones on-camera:

There has not been a net loss of jobs in the United States because of NAFTA. We have lost some jobs, but we have created far more jobs so the net increase in jobs, by anybody’s standards, has been proven to be true. We have kept the higher paying jobs, on average jobs in the United States that are related to producing goods and services for export, in this case NAFTA, pay about 15% higher than jobs where the goods and services are consumed inside the United States.

Robert Lawrence:

When people look at international trade they tend to focus on the very short run. They think about what happens if we buy more products from abroad at the expense of buying them at home. There’s likely to be some job loss. So, that’s what people look at. But, what they often ignore is the fact that once the economy adjusts, once people move out of jobs which are not competitive in the global economy and actually find jobs which are, once they make those adjustments they can earn higher wages and indeed can be more secure then they were originally. So over the long run, the benefits from trade basically come in the form of giving better jobs rather then just creating employment opportunities.

Luis de la Calle:

Now, you had some sectors that had experienced job losses both in Mexico and in the US but these job losses in my view, are more related to the globalization then, then the NAFTA. Let me give you a couple of examples, you have for instance in the US losing jobs in steel or textiles or apparel some of those jobs have actually come to Mexico and Mexico would manufacture to find the goods that we re-export
to the US under the NAFTA. Those jobs, the US was going to lose anyway. The question was whether those jobs would divert to China or Taiwan or they would come to Mexico. The beauty of the NAFTA was that if they came to Mexico then they will come with U.S. components.

NARRATOR: PROONENTS OF NAFTA SAY THAT SINCE OPENING U.S. MARKETS, PARTICULARLY AFTER WORLD WAR TWO, THE COUNTRY HAS EXPERIENCED ITS GREATEST GROWTH, ITS GREATEST IMPROVEMENT IN JOBS AND ENJOYED A HIGHER STANDARD OF LIVING.

Amb. Jim Jones:105910

I think NAFTA’s been a great success no matter how you measure it. It’s been a success in improving the standards of living and creating political stability and openness in Mexico. It’s been a success at creating a net, new increase in jobs in the United States. It’s been a great success in improving understanding between our two countries. Now, where NAFTA and many of these free trade and open market reforms have fallen short, is that it has not tangibly benefited enough of the people. Somewhere between 30% and 60% of the people have received no tangible benefits from open markets and from democracies and that is not sustainable.

Shots of NAFTA rail & Bimbo:

NARRATOR: SO, WAS THERE A GIANT SUCKING SOUND OF JOBS GOING TO MEXICO AS ROSS PEROT HAD PREDICTED? NO...DID IT CREATE SOME NEW JOBS ON BOTH SIDES OF THE BORDER? YES...THE EFFECTS WEREN’T HUGE BUT THEY WERE POSITIVE. IS THERE MORE WORK TO BE DONE? PROBABLY...THE DEBATE CONTINUES.

NARIMAN BEHRAVESH:
Some time ago, some of my economist colleagues got together in Melbourne, Australia to discuss regional trade agreements such as NAFTA. They are: Richard Snape of Monash University in Australia, Gerver Torres of the International Monetary Fund, Rachel McCulloch of Brandeis University and Magnus Blomstrom of the Stockholm School of Economics. Let's hear what they have to say.

BEVERLY:
Richard Snape, why do countries get into trade agreements in the first place?

RICHARD:
Well, one can ask why if a government wishes to reduce its trade barriers why doesn't it just go ahead and do it? Why does it need to enter into agreements with other countries? And I think that there are two categories of reasons. One is so that it can constrain the trade policies of other countries by entering into an agreement with them. And the other is for its own domestic political reasons and domestic, political and economic reasons. Obviously, if a country can get other countries to reduce the barriers at the same time then that’s much better than just reducing their own. As to their own political reasons, there will always be pressures within a country not to reduce
barriers. And, of course, if a country can get...if a group can in fact enter into commitments to other
countries then it can resist those political pressures too.

BEVERLY:
And those political pressures are interesting. Rachel, how much of a factor do those political
pressures play when it comes to trade agreement?

RACHEL:
Political factors are enormously important. And in industrialized countries we have elected
governments and the, uh, top issues in elections can often be trade issues. So they certainly can't be
ignored. One of the real advantages of the trade agreement as opposed to unilateral move to open
up markets is that it appears to the public that we are getting something extra. The gains from trade
are sometimes slow in showing up and may show up in unexpected places. And, yet the gains from
having new markets instantly available are clearly apparent on day one. So that makes it from a
political point of view, much more attractive.

But there's another advantage that's really an economic advantage and that's that when we open up
our markets, we must go through an adjustment period in order to fully take advantage of the new
situation. That adjustment is eased when others are opening up their markets to our goods at the
same time. So that at the same time that resources have to be pushed out of our liberalized sectors
in order to make room for imports, those same resources are being pulled into the expanding export
industries into those new markets that have been opened up by the agreement.

GERVER:
Regarding the political concerns, it is very interesting to know that some years ago, let's say twenty
years ago, people in developing countries were very...umm...they, they fear going into free trade
zones with other countries especially developing nations. So in Mexico, for example, people didn't
want to be part of a trade agreement with the United States and then...now it is the opposite. Or it
was the opposite in some way.

BEVERLY:
So is it directly linked then to, in terms of becoming part of trade agreements, actually opening up
your economy to the world?

GERVER:
That's right. And, it's a global tendencies, it's a global trend, which every nation is now in a way
obliged to follow. As you have bigger trade zones other countries may be in a situation of
a...disadvantaged situation if they don't do it because then they have more restrictions then the other.
This is why there is a kind of competition all around the world everyone trying to create a greater,
bigger trade zone. You have that going on in Europe, in North America, South America, Asia,
everywhere.

RICHARD:
That's a problem, isn't it? With, uh, with agreements which are only on a regional basis, that they
are in fact tending to discriminate against other countries. And countries maybe feel forced into
these regional trade agreements even if they would perhaps rather not be in it simply to stop being
discriminated against. And we've got this tension here between a sort of global, multilateral
liberalization on the one hand and these regional restricted agreements on the other. And we know
that the best thing for the world as a whole is probably to have open trade

BEVERLY:
Does time play a part though as well in actually...if multilateral agreements are taking such a long
time to get going is that another reason why bilateral agreements died out?
MAGNUS:
Well, time is certainly...and as Rachel said...that is certainly a very important thing. That you do it both, both sides so, uh, because if you face these tremendous structural adjustments that is necessary and you have nowhere to outlet for your products then you will be in deep trouble.

GERVER:
But, regarding the political motivation of a free trade agreement. It may be pull out, it may be, uh, pursue because of political reasons as it may have been the case of Europe as Magnus said. But you are not going to succeed if economics are not right. And we have examples, in Latin America, we for many years try to have a pact, try to have a trade agreement yet because of political reasons we wanted to be part of a very big nation, of a very big area...the South American big country. But the fundamentals were not right so the pact agreement didn’t work. In order to work, you may need political consensus, of course, but you also need the economies moving in the right direction, also.

BEVERLY:
Gerver, thank you very much.
To summarize what we saw in this case study, the U.S., Canada and Mexico came together and formed a free trade area. What do we mean by a free trade area? And more generally, let's look at the various ways in which economic integration can occur. We'll look at four different ways in which economies can do this. The first is a free trade area like NAFTA. This basically means that countries, such as the U.S., Canada and Mexico, agree to lower and eventually eliminate all trade barriers for goods being traded between them. Now what also stays in place here of course is the trade barriers that the U.S. Canada and Mexico have with the rest of the world. So those don't change but what gets eliminated are the trade barriers among these countries.

Now countries can take this one step further and form what is called a customs union. And the difference between this and a free trade area is that the participating countries agree that the barriers around this bloc with the rest of the world are going to be uniform so now they agree on a uniform trade barrier around this customs union. So that's the next level of integration.

The third level of integration is something called a common market. This is like a customs union with the added benefit that it allows for the free movement of factors of production like labor, capital and technology. So it provides even more integration among the participating countries. And the final kind of economic union is indeed something called an economic union in which not only do all the other forms of integration take place but the economies participating agree to coordinate their fiscal and monetary policies and other socioeconomic policies.

The most well known example of a common market is the European Union. Again to remind you, the common market not only lowers tariff barriers and imposes a uniform barrier with the rest of the world but also allows for the free movement of capital, labor and technology among the countries.

Finally, there are a couple of examples of an economic union. The first is the economic union formed by Belgium, the Netherlands, and Luxembourg, the so called Benelux countries. And a second one is the U.S.A. Of course, and the U.S.A. is not only an economic union it's also a political union in the sense that the fifty states function together. They have the same monetary policy, the same fiscal policy and so on.

Now it's interesting to reconcile especially the customs union and the common market and economic union with the rules of the World Trade Organization, or the WTO. If you remember, the most favored nation clause said that if you lower your tariff barriers against one country, you have to lower them against all other countries, in fact all of the WTO countries. But there is an opt-out for customs unions and common markets and the opt-out says that in a customs union and a common market the external tariff barrier, the tariff barrier for the rest of the world, has to be no higher than the average barrier of the countries in that union. So it's a way of trying to get this customs union or common market to keep its tariff barriers low, but obviously it can't force them to eliminate these barriers completely with the rest of the world.

Now, as we look at trade barriers and the removal of trade barriers in trading blocs, the formation of trading blocs, clearly there are benefits and losses. We are going to focus first on the benefits of joining a trading bloc. And we are going to do that using this analysis here of the supply and demand for automobiles in Sweden. Now, a couple of caveats about this analysis. First, it's static in nature. It doesn't look at the time path of changes that might occur. And secondly, it's partial in the sense that it just looks at Sweden and not the rest of the world, but again, it can help us to illustrate some of the points we are trying to make.

And in this market, the demand curve slopes downward from the top left to the bottom right and basically it says that as the price of automobiles goes up in Sweden, the consumption of automobile
sales goes down. The supply curve slopes upward from the bottom left to the top right and that says as the price of autos goes up, the production goes up. Now in this example, if free trade were to work then indeed what would happen is that the Swedish auto manufacturers, SAAB and Volvo in this case, would produce 10,000 cars and the remaining amount of cars coming into Sweden or being bought in Sweden, 20,000 cars, would be imported from let's say Germany, BMW's, and Mercedes. So if free trade was allowed to function, many German manufacturers would actually be lower cost producers then Volvo and SAAB. So free trade would allow for the importation of 20,000 cars.

However, what this example is looking at is that a situation in which Sweden has imposed, before it joins the European Union, a $1,000 tariff on imports of cars from Germany. So in fact the price of cars is not 8,000 as it might be under free trade, but 9,000 which is the free trade plus the tariff. So in this instance, the imports of cars is reduced, the price goes up from 8,000 to 9,000. Production goes up because the price has risen so now producers in Sweden are willing to produce more. Demand has gone down because cars are more expensive and so the imports have actually shrunk as Sweden has imposed the tariff.

Now what we are going to look at is the impact of Sweden removing that tariff as it joins the European Union. And just as a reference point, let's just assume that the price of German cars coming into Sweden is lower than the price of any competing cars coming from other countries let's say like Japan. This clarifies the analysis and we'll come back to this in a couple of minutes.

So what happens in this instance? Well, as Sweden removes the tariff on German cars, what happens is the price of cars in Sweden drops by $1,000 which is the amount of the tariff so that the price goes down from 9,000 to 8,000. Consumers benefit tremendously, they can buy more cars at a lower price and their gain is shown in this shaded area on this slide here.

There are two losers in this situation. The first are the car producers, SAAB and Volvo. Prices dropped, they sell fewer cars, they produce fewer cars. And so clearly there's a loss here because they are earning less and so their loss is shown in the shaded area in this graph. There's another loser in this situation and that's the Swedish government. It's eliminated its tariff’s on autos so its revenues from tariffs have gone down or have completely vanished in this particular case. So there's a second loser. And that's what's interesting in this example is that the gains of the consumers from the lower prices and the greater volume is greater than the loss, the combined loss, of the producers and the loss of government tariff’s. And so the net gain is shown by the two triangles on this graph.

Let's see if we can explain what's going on here. This is the trade creation that occurs when tariffs are lowered. It means everybody gains on average. In other words the Swedish economy as a whole, gains. There are clearly some losers and winners but the net effect on the Swedish economy is very positive. This, is another way of saying that trade is a non zero sum gain so the net effect of lowering tariffs is to have a very beneficial impact on the Swedish economy and these two triangles on the slide measure that net gain. As we said earlier, there are some losers, in this case the government and the producers, the car producers SAAB and Volvo but Sweden as a whole gains because the consumer gain more than offsets the loss of the producers and the government.

So this gives you a sense here then of the static gains from joining a free trade area or a customs union. As I said, this is referred to as trade creation. So these illustrate some of the static gains from entering a trading bloc, in this instance, Sweden entering the European Economic Community. However there are also dynamic gains that come from a country like Sweden joining the European Economic Community. The first is increased competition. For example in our example here Volvo and SAAB, Swedish car manufacturers, as they become integrated into the European Community will have to compete more effectively, and this will make them more efficient, it will lower their production costs and there are tremendous gains that come from this. The other is that Volvo and
SAAB now will have a much larger market area and they can enjoy economies of scale with having access to a larger market. In fact that was a primary reason why Canada agreed to join NAFTA because it gave Canadian companies access to a huge market mainly the United States.

And finally entering a free trade area or trading bloc can provide tremendous stimulus to investment in so far as companies who are looking at the improved growth prospects will begin to invest heavily in terms of equipment and other aspects of research and development and it also has the added benefit that companies outside of the bloc, foreign companies, will start to invest in that country too as they look at the growth opportunities that let's say Volvo or SAAB can enjoy.

Now not everything is positive, not all the outcomes of joining a trading bloc are positive. In fact there is something called trade diversion that can occur when a country joins a trading bloc. And to illustrate this point, let's move on to our next case study which looks at how Australia suffered when the UK joined the European Union.

**VISION**

**AUDIO**

British streets and markets

In 1973 life in Britain changed. Prices of agricultural products increased sharply. It cost families more to keep food on the table.

Family eating

It wasn't an accident. A government decision pushed prices up.

Australian farming

Britain turned away from cheaper produce from its former colony, Australia. Instead, Britain increased rural output and bought rural commodities from its more expensive European neighbors.

Anti E.C. protest march

But why was that decision made? Was there a gain to compensate the pain?

**TITLE SHOT**

UNITED KINGDOM ENTERS THE EUROPEAN UNION

Australian apples arriving in U.K.

Britain's trading relationship with Australia was bound by the apron strings of empire. The former colony had long supplied food to the plates of mother England.
Fruit market

In 1950 a third of Australia's exports landed in Britain. But in 1973 those apron strings were cut.

Signing of E.C. Entry

Britain signed an agreement to join its neighbors in the European Community, or E.C.

Map Graphic

It was formed under the Treaty of Rome in 1957. It would progressively eliminate trade barriers between European countries. Goods could cross borders without trade restrictions. The increased trade would bring economic rewards. Britain couldn't afford to be left out.

Interview with:

Dr David Robertson
Australian National University

"It was the political aspect - that Britain wanted to be part of this community that was being formed, wanted to influence things from inside rather than being on the outside complaining. And people believed that this was, was a positive thing to do at the time. The economics was something that had to be accepted".

Australian crop farming

Those economics hit Australian farmers hard. Their traditional trade with Britain ended almost overnight.

Wheat harvest

In joining the E.C., Britain had to comply with its common agricultural policy - known as CAP.

The CAP set common barriers to agricultural products from outside the European Community.

Meat production plant

Tariffs and quotas raised the cost of non-E.C. produce. Australian farmers preferential access to British markets ended. It was shut out as the United Kingdom fell in line with its European partners. British imports of Australian beef fell more than seventy five percent.
Wheat loading into ship
The eight hundred thousand-ton annual import of Australian wheat stopped completely.

Graham Blight heads the Australian Farmers Federation.

Interview with:

Graham Blight
Executive Director
Australian Farmers Federation
Language: English

"We had to go back to square one virtually and say well now who are we going to do business with and how are we going to understand them and how will they understand us? So, yes, it was a cultural shock, and our industry suffered a lot during those times in financial terms too. Because we not only did we have, lose the market in the U.K., we had to then spend money to build up a market somewhere else".

British food market
British consumers were also paying the price for the change. Before joining the E.C., Britain's food bills had been the cheapest in Europe. The Australian product was efficiently produced, and comparatively cheap.

Vox pop
"I think we should keep with our colonies. Our colonies possibly keep together as a unit. This is all wrong".

British high street shops
Supermarket
Europe couldn't match Australia's prices.

More expensive produce from Europe pushed retail prices up.

Dr David Robertson saw the effects first hand.

Interview with:

(SYNC)
Dr David Robertson  
(2nd appearance)  
"Prices would be shifted up by about twenty five percent on average and that was going to mean an increase in the cost of living - the CPI index - by something like three to four percent".

Australian dairy farm  
Britain lost because trade was diverted from a low to high cost producer. It had to pay more for agricultural goods.

But that's only one side of the equation.

British Wharf, boxes on conveyor  
Trade in manufactured goods from Europe increased significantly. Removing inter-country barriers made them cheaper.

Andrew Stoeckal heads Australia's Centre for International Economics.

Interview with:  
(SYNC)

Andrew Stoeckel  
Centre for International Economics  
Canberra, Australia  
Language: English  
"There's an enormous growth in that intra-European trade. The trade between members and parties in that bloc has grown enormously and that tends to...that has an upward effect on the incomes of those countries. Against that, if they've diverted trade from other low cost exporters like Australia, Argentina or America - say of grain - well then that tends to retard income. So it's an empirical question - does the income expanding effect dominate the income retarding effect?"

Paris - E.C. scene setter  
Prior to joining the E.C. that question wasn't so easy for Britain to answer.

Street produce market  
The debate raged over whether union would be an economic cost or benefit. Much of the focus was on agriculture.

London streets  
Analysis later showed that British consumers and Australian farmers suffered through trade diversion.
But for Britain, the trade created with Europe in manufactured goods helped offset the negative effects.

Interview with: (SYNC)

Andrew Stoeckal (2nd appearance) "If you view the formation of the trading block and what happened on agriculture narrowly it was probably a minus. If you view it - and it definitely was a minus - if you view it in terms of where Europe has gradually been going as a step towards greater and greater harmonization, right? And there's been no real evidence on the external barriers to trade rising by Europe - well then that trade bloc has probably been a good thing".

The complex nature of the analysis means there are no hard and fast rules to determine if a bloc is economically good or bad. But an integral factor is what happens to the common external barriers, and what effect that has on trade.

Even if external barriers don't rise trade is diverted. But if they do rise that diversion is accentuated.

When Britain joined the E.C. British food shoppers and Australian farmers were clear losers.

But as Britain found, even if some trade is diverted trade created by the removal of internal barriers between bloc countries can compensate.

It becomes a question of weighing the good against the bad.

NARIMAN BEHRAVESHER: Let's hear what our panel has to say about the positive and negative effects of trading blocs.
BEVERLY:
Well, of course we've seen Canada and America enjoy a free trade agreement and we've seen the European community form a common market. Magnus, what are the differences?

MAGNUS:
Well, the common market is a more advanced form of economic integration. In the case of the U.S./Canada, it's simply that each individual country keeps their trade barriers toward the rest of the world as...but in the later case, the Europeans form a common trade barrier around to the rest of the world. But, in the European case, it's more than simply trade because as it has developed in the 1990's it has also allowed free capital mobility, free labor mobility, and free trading services and a few other...more things, but that's basically the four freedoms inside Europe right now.

BEVERLY:
So, what are the gains, Rachel?

RACHEL:
The gains can be allowing greater trade along lines of comparative advantage by eliminating barriers between members of the trading bloc or group and also to allow a fuller scope for exploiting economies of scale. In the Canada/U.S. agreement that was an important incentive because the Canadian economy is only one tenth the size of the U.S. and so Canadian firms, uh, were not able to fully exploit economies of scale unless they were guaranteed access also to the much larger U.S. market. On the negative side, any bloc or preferential trading arrangement discriminates against excluded countries and so, in the case of the Australian wheat exporters, that comes out very clearly with a higher external common tariff of the European community, the Australians were out in the cold, out with an important market having disappeared.

RICHARD:
But that's the key factor. If, in fact, they are in a liberal... generally liberalizing framework and if, in fact, they are intending to reduce their external barriers at the same time then it may be a step toward's a more liberal, general system. On the other hand, if we take the situation of the 1930's when, in fact, there were barriers going up all over the place and countries were forming trading blocs...preferential trading blocs...and then we had the British system established in 1932, British preferences for the commonwealth countries. We then had other trading bloc areas established around Germany and around Japan. And these in fact were retaliatory blocs which were in a situation of rising barriers anyway and fragmented world trade in a disastrous manner.

BEVERLY:
So tit for tat basically.

RICHARD:
It's all a question of what framework, whether it's...going either way.

MAGNUS:
I think that it is in a more liberal framework today than it was in the 30's. One way of looking at it is that all of these Latin American organizations have also applied for the North American Free Trade Agreement.

RACHEL:
That's right. So they want to be part of that bloc. But we should keep in mind that the ideal is a multilateral framework and so it's really a second best thing to go into these regional blocs.

RICHARD:
Can we be sure that, for example, that they won't be set up to discriminate against Japan?
GERVER:
But then you have to take into account that there is another phenomenon which is taking place. Is that, in global terms, barriers are going down because we have things like the GATT or the Uruguay agreement rounds. So, it's not the same context, we have a context today in which, on one hand, you have all these trade agreements which are regional blocs, but on the other hand you have made improvement in general barriers, lowering them. And I would say that as an important thing is that as a historical fact, protectionism has been declining over the time. If you look forty years ago, there were much more barriers, there were higher import tariffs than today.

RACHEL:
Well, Gerver, I agree with you about the tariffs, but the multiplication of non-tariff barriers in recent years has been quite alarming. And because they are less transparent it's not always so easy to say that protection has definitely been going down and we certainly can point to some industries where it's simply not true and protection is worse now than it was certainly twenty years ago. I don't want to say forty years ago.

BEVERLY:
So can we have one without the other? Just finally, Gerver, can you have, do they have to coexist together as with multilateral trading agreements as the ultimate goal?

GERVER:
I think that we are going through stages and I'm very optimistic about that and I think that the tendency is to a, you know, to a freer and global market.

BEVERLY:
And thank you very much.

NARIMAN BEHRAVESH:
Let's see if we can reinforce the basic message of this case study and that is that the UK diverted its imports away from the low cost producer, in this case Australia, to a higher cost producer, in this case the rest of the European community, and that was clearly a problem.

We are going to try to illustrate this point of trade diversion by going back to the example we had about Swedish cars. In this example, if you remember, we've got the supply and demand here for cars in Sweden. And in the example, Sweden has a $1,000 tariff on cars coming from the rest of the world and originally in our example we had talked about Germany being the low cost producer of cars outside of Sweden. So Sweden lowered its tariff therefore more cars from Germany came into Sweden and there was trade creation.

What if in this example Germany is no longer the low cost producer but Korea is now the low cost producer of automobiles. What happens in this instance is that as it enters the European Union, Sweden lowers its tariffs, and eliminates them in fact against German cars but does not do that with Korean car imports so the tariffs remain in place against Korean car imports. The impact of this is quite interesting because there is both trade creation and trade diversion going on.

Let's see if we can illustrate this. The triangles in this diagram show the gains that Sweden gets in terms of trading with the European Union as it lowers its tariff barriers against German car imports. However, because even without the tariff barriers, the price of German cars is higher than the price of Korean cars, there's a trade diversion effect in the sense that imports of cars from Korea are now discriminated against so there is a loss associated with that for Sweden. And that is measured by the rectangle here that you can see on the slide which shows the trade diversion that occurs when there is this kind of discriminatory tariff reduction.
Now this is a static analysis of the losses from a trading bloc that can occur if this kind of trade diversion occurs. There are typically other objections to trading blocs as well. One of them is that many countries are excluded from trading blocs. By their very nature trading blocs are exclusionary. For example in the case of the European Union, Turkey has been excluded from it, even though it has been trying to get in.

Another problem with trading blocs is they tend to undermine the multilateral efforts at tariff reduction, in other words, one way to say this is that many of the countries forming blocs, in Europe and North America are so focused on creating the trading blocs that that dissipates some of their energy that they might be putting into reducing tariffs on a multilateral basis.

Also trading blocs increase the likelihood of trade friction and trade wars because as blocs get larger they tend to exert their economic clout and can throw their weight around and that can create problems. In fact many people have suggested that part of the problem with the WTO and the fact that the WTO has been so slow in resolving some of the trade issues worldwide is the second and third points in the slide, namely that as blocs have developed that has undermined the WTO and has also increased trade friction worldwide.

Now, we've talked about trade creation. We've talked about trade diversion, it's worth it to ask under what circumstances will the formation of a trading bloc create more trade than it will divert? We're going to list six reasons, three of which show up on this screen. To begin with, the higher the pre-bloc barriers then the less trade will be diverted and the more trade will be created. The idea is that if the barriers among the countries in the bloc are high and they are lowered then the chances are there'll be a lot of trade creation which will probably more than offset any trade diversion with the rest of the world.

Second, if the external barriers around the bloc, in other words with the rest of the world, are relatively low then there's not going to be a lot of trade diversion in the sense that goods from the rest of the world outside the bloc can come in very easily.

Third, the larger the number of countries in the bloc, in the extreme let's say if the bloc took up the whole world then obviously there's going to be very little trade diversion. In other words, the less exclusionary the bloc is, the less trade diversion that's going to occur.

Fourth, the more competitive the countries and companies within the bloc means that the lower the prices will be within the bloc and so therefore the less exclusionary that bloc will be relative to prices outside the bloc.

Fifth, the closer the geographic proximity of the countries within the bloc then the more trade creation and the less trade diversion there will be. This has to do with transportation costs and also if you look at the map of the world and you look at the major trading blocs, you see that they are formed by countries that are neighbors so geographic proximity clearly has a strong influence in terms of how much trade creation takes place.

And then finally the greater the pre-bloc trade among these trading partners then the greater the trade creation and the less the trade diversion. This is certainly true in the case of Canada and the U.S. They were each other's largest trading partners before NAFTA and the assessment is that the formation of that free trade agreement in fact did very little in the way of trade diversion and did a lot in the way of trade creation.

So what's the bottom line, the WTO or blocs? Well, clearly from an economic perspective, the WTO approach or the multilateral approach, wins hands down because it provides the freest amount of trade for the largest amount of countries. However from a political perspective the formation of
 blocs has gained a lot of support in recent years because of the frustrations with the WTO process. It's been slow, it hasn't kept up with all the changes in the world economy.

Another way of saying this is that the best approach or the optimal approach to trade liberalization is the multilateral approach and that the most you can say about the formation of blocs is that it's a second best way to approach trade liberalization.

For Inside the Global Economy, this is Nariman Behravesh.

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