

European Economic Integration II

Lecture 5

21 October 2024

Objectives of Lecture

- 1 Understanding Trade Creation and Diversion of Custom Union
- 2 Analyzing Static Impact of Custom Union
- 3 Investigating Dynamic Impact of Custom Union

Trade Creation

- 1 The figure 3 illustrates the concept of **trade creation**.
- 2 When a customs union is formed (allowing tariff-free trade within member countries), consumers may gain access to goods at a price lower than the "US price + tariff" but possibly higher than the original US price.
- 3 Trade is "created" because consumers now buy more goods at the lower, tariff-free price from a customs union partner (e.g., Germany in this case) rather than the high tariff-adjusted price.
- 4 This increase in trade improves consumer surplus, as they pay less than they would with the tariff on non-union imports.

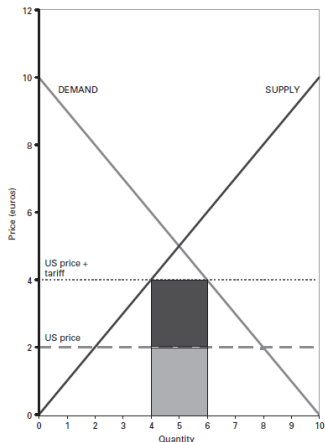
Trade Diversion

- ① The customs union can also lead to **trade diversion**, a less desirable outcome.
- ② Trade diversion occurs when imports shift from a more efficient, low-cost producer outside the union (like the US) to a higher-cost producer within the union (like Germany).
- ③ Although consumers face a lower price with the customs union than they would with the US tariff, they are not benefiting from the lowest possible price (the original US price without the tariff).
- ④ This diversion creates an efficiency loss, as trade shifts from a more efficient producer to a less efficient one due to trade policy rather than comparative advantage.

Welfare Impact of the Customs Union

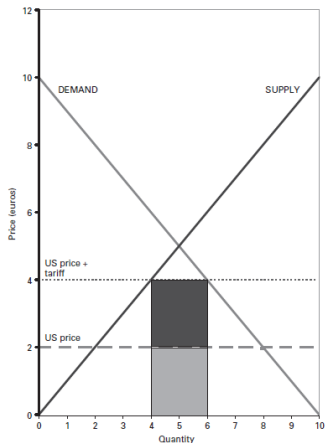
- 1 A custom union can improve consumer welfare through **trade creation**, as goods become more affordable compared to the tariff-adjusted price.
- 2 However, it may also reduce overall economic efficiency due to **trade diversion**, where goods are sourced from less efficient producers.
- 3 The net impact of the customs union on welfare depends on the balance between trade creation and trade diversion.
- 4 If trade creation dominates, the customs union is likely to be beneficial overall.
- 5 If trade diversion is more significant, the union may lead to a welfare loss compared to a free trade scenario without tariffs.

Custom Union Static Impact: Consumer Gains



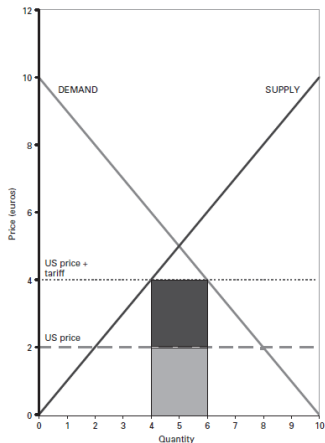
- French consumers benefit from the custom union as they can now import goods at the lower "German price" instead of the higher "US price + tariff."
- This price reduction increases consumer surplus, as represented by the area between the demand curve and the new, lower price.

Custom Union Static Impact: on French Government and Producers



- The custom union reduces tariff revenue for the French government, as some of the tariff revenue previously collected on US imports is now lost.
- French producers lose market share and producer surplus due to the lower German price, as German imports displace some of the French producers' output.

Custom Union Static Impact: on US and German Exporters



- US exporters are the biggest losers, as they lose access to the French market entirely. Their previous export revenue from sales to France disappears.
- German exporters benefit significantly, capturing the French market share lost by US exporters and increasing their export earnings.

Political Motivation Behind the Customs Union

- The custom union had a strong political motivation, aiming to reduce France's reliance on US imports and ease pressure on France's limited US dollar reserves post-World War II.
- It also aimed to integrate Germany more closely into Western Europe, promoting economic and political stability.
- Economic efficiency gains were uncertain and likely modest, with the primary effect being a reallocation of benefits within Europe, favoring consumers and German exporters at the expense of French producers and US exporters.

The US Perspective on the Custom Union

- Although the US preferred multilateral trade liberalization under the General Agreement on Tariffs and Trade (GATT), it accepted the European Economic Community (EEC)'s customs union.
- The EEC promised that the average common external tariff would be lower than the average of each country's individual tariffs prior to the union.
- This compromise was seen as progress toward liberalizing trade, albeit not fully aligned with the US's multilateral trade goals.

Custom Union Dynamic Impact: Assumptions and Technological Progress

- Traditional analyses assume static, one-time effects and small economies.
- Technological progress drives European growth, creating new goods, lowering production and transaction costs.
- Static analysis shows this as outward shifts in demand and supply, especially supply.
- With balanced technological progress, trade expands faster than production, benefiting consumers, exporters, and government revenue.

Dynamic Effects of a Custom Union

- 1 Custom union reduces trade barriers, increasing competition and reducing transaction costs.
- 2 Sectors with high fixed costs benefit from economies of scale, enhancing efficiency.
- 3 Increased competition reduces market power, lowering deadweight loss and improving welfare.
- 4 Technological advances may accelerate, reducing trade diversion and increasing trade creation.

Dynamic Effects of a Custom Union: Economies of Scale and Strategic Advantage

- With economies of scale, winners gain more, while losers face larger losses.
- German producers gain a cost advantage over both French and US producers.
- This locks trade patterns, with French imports relying on Germany instead of the US.
- Custom union shifts trade to intra-union partners, increasing intra-union trade more than total production.

Dynamic Effects of a Custom Union: European Economic Community

- The formation of the EEC shifted trade from non-union partners to intra-union partners.
- Intra-union trade expanded more rapidly than overall production.
- Dynamic effects supported strategic trade and technological advantage within the union.
- Theories of trade creation and diversion align with observed results in the EEC.

Dynamic Effects of a Custom Union: Technological Effects

- Dynamic effects of custom unions suggest that benefits may go beyond static analysis.
- Technological progress, competition, and economies of scale can amplify trade creation and reduce trade diversion.
- The EEC experience highlights how customs unions can drive economic integration and strengthen intra-union trade.