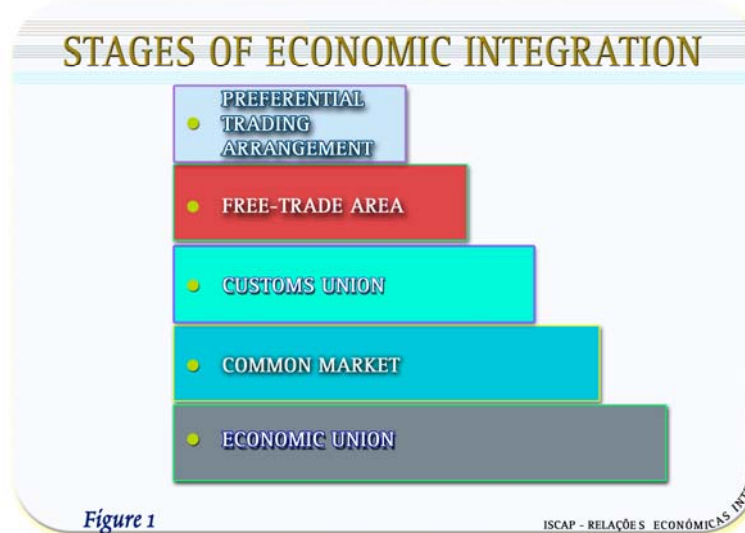




The lowest level of economic integration is the formation of a **preferential trading arrangement** (PTA), in which member countries agree to lower trade barriers within the group to levels below those erected against outside economies. A PTA does not imply complete elimination of trade barriers. An example of a preferential trade arrangement is where member countries agree to halve the tariffs on products traded between each other while maintaining existing tariffs on products from all other countries. The GATT/WTO specifically prohibits developed economies from forming a PTA, although it gives developing economies some leeway in forming regional groups that lower, but not completely eliminate, tariffs on each other.

Consider the text above and the figure 1 below, which displays the well-known five degrees of economic integration.



1. Which characteristics differentiate a free-trade area from a customs union and from a common market?
2. Nowadays, the European Union has “common economic policies” and a common currency. But, is the E.U. a true Common Market? Explain your answer.
3. True or False?

3.1. Trade creation – The increase in trade that results from a shift in trade policy and is, all other things equal, welfare enhancing.

3.2. Trade diversion – The redirection of a country’s foreign trade as a result of a discriminatory regional trade agreement, which, all other things equal, reduces the welfare gains from trade.

3.3. A free-trade area only diverts trade by inducing importers to buy goods in higher cost countries rather than from the world’s lowest-cost suppliers.

EFFICIENCY SMOTHERED BY A PREFERENTIAL PATCHWORK

Economists fear a US strategy of 'competitive liberalization' via bilateral agreements is doing more to tangle trade than to free it ...

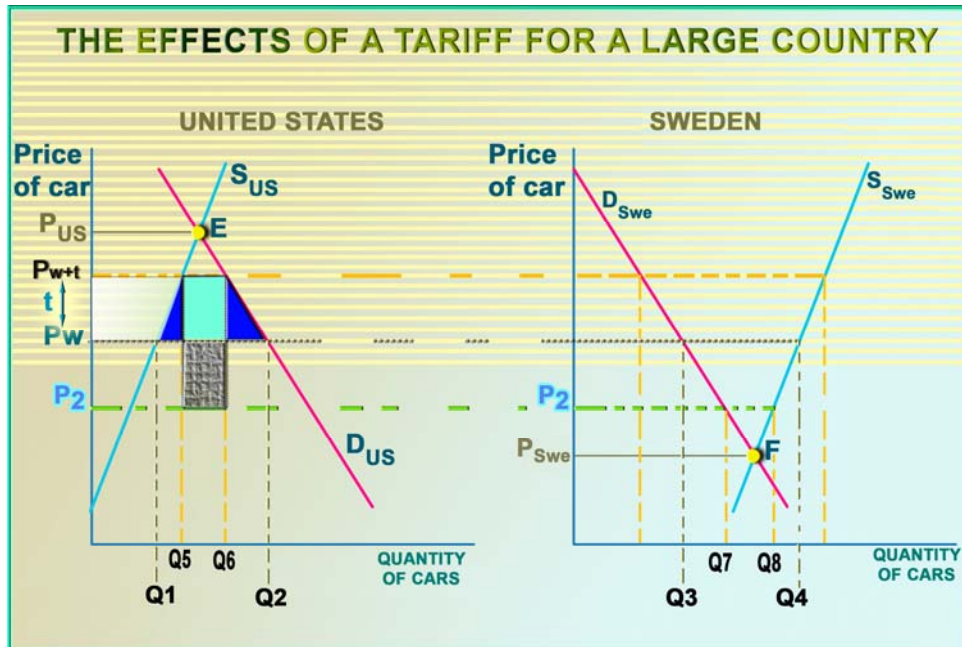
Pity computer manufacturers from Taiwan, beef farmers from Australia and carmakers from Japan. Thanks to the recent trade deal between Korea and the US, they may well become the latest victims of a phenomenon increasingly worrying businesses and trade ministers: "trade diversion". As bilateral trade deals proliferate across the world, export markets may increasingly reward not the more efficient producer but the more privileged one.

Financial Times, May 3 2007 – Analysis, p. 9

4. Make a comment on the above text.
5. Complete the following text – put a word or phrase in the white spaces.
«In the 19th century English political economist David Ricardo (1722-1823) further developed Smith's ideas. His work – in particular his concept of comparative advantage, which posited that states should produce and export only those goods that they can generate at than other nations and import those goods that other countries can produce – extolled benefits of free trade and was pivotal in undermining British mercantilism.»

Encyclopædia Britannica 2007 Ultimate Reference Suite

6. Suppose the world consists of two countries (the United States and Sweden). Before trade opens, equilibrium occurs at point E (in the United States) and point F (in Sweden). After a free international trade a world price, P_w , prevails. Then, the United States imposes a tariff, and ...



Using the above graphical illustration, describe the effect of a tariff for a large country and discuss the results.