The Dangers of Sensitive Sectors in FTAs

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One More Mega-FTA

• TFTA: Tripartite Free Trade Area
  – 26 countries in Africa
    • EAC: East African Community
    • SADC: Southern African Development Community
    • COMESA: Common Market for Eastern and Southern Africa
Pros and Cons of all FTAs

• Preferential tariff cuts
  – Pro: trade creation
    • Similar to the classic “gains from trade”
  – Cons:
    • Trade diversion
    • Rules of origin (ROOs)
    • Exemption of sensitive sectors
      – Sensitive = Most likely to be trade-creating if included
Effects of FTAs

• Market-diagram Illustration
  – Suppose Country A can import a good from either Country B or Country C at prices
    \[ P_C < P_B \]
  – And Country A has a tariff greater than the price difference:
    \[ t > (P_B - P_C) \]
  – What happens when Country A forms a PTA with high-cost Country B, lowering its tariff to zero on imports from Country B?
Effects of FTAs

Before FTA
\[ P_C + t < P_B + t, \text{ so} \]
A imports from C

With FTA
\[ P_B < P_C + t, \text{ so} \]
A imports from B
Effects of FTAs

FTA of Country A and Country B:

Welfare effects
- Producers lose: $-a$
- Consumers gain: $+(a+b+c+d)$
- Gov’t loses: $-(c+e)$
- Net: $+(b+d)-e$

Market in Country A

Trade Creation

Trade Diversion
Effects of FTAs

FTA of Country A and Country B:

Implication:
Country A can lose from the FTA in this market, if $e > (b+d)$
(as it is in this picture)
Effects of FTAs

• Sensitive sectors
  – Area a is
    • The loss to producers
    • Part of the gain to consumers
    • The main reason why a sector would lobby to be named “sensitive” and excluded from the tariff cut on country B
  – See how it, and the gains and losses from PTA, varies with changing costs:
Higher price in outside country C (but still lower than price in partner, B: Increases Sensitivity, increases trade creation, reduces trade diversion.)
Lower price in inside country B (but still higher than price in outside, C: Increases Sensitivity, increases trade creation, reduces trade diversion.)
Effects of FTAs

• Sensitive sectors
  – Thus the sectors that are most likely to claim that they are “sensitive” due to large losses from the PTA are also the ones that would have
    • The greatest gain from trade creation
    • The smallest loss from trade diversion
  – My fear is that if proliferating FTAs allow too many sensitive sectors, the gains will be squeezed out leaving only the losses.
Pros and Cons of all FTAs

• Other aspects of actual FTAs
  
  – Pros:
    • Extension to trade in services
    • Harmonization of regulations
  
  – Cons (?):
    • Extension of IP protection
    • Trade enforcement of labor standards
    • Trade enforcement of environmental standards
    • Investor-State Dispute Settlement
Additional Pros and Cons of Mega-FTAs

• Preferential tariff cuts
  – Pros:
    • Larger potential for trade creation
    • If ROOs are cumulative, less distorting
    • Potential for adding members
    • Replace multiple rules with a single set
  – Cons:
    • Though there are fewer outsiders, each is harmed more by trade diversion
    • In fact (in TPP) there is more complexity
Additional Pros and Cons of Mega-FTAs

• Other aspects of actual Mega-FTAs
  – Pros:
    • May contribute to broader and more uniform standards
  – Cons:
    • Their use as weapons of geopolitics
Implications of Mega-FTAs for the WTO

• Might have created pressure to complete Doha Round.
  – Possible, just as NAFTA motivated Uruguay Round
  – Didn’t happen; Round is dead.
Implications of Mega-FTAs for the WTO

• By lowering trade barriers regionally, Mega-FTAs will
  – Hasten the decline of uncompetitive industries,
  – Thus gradually reduce political forces for protection
  – This may reduce the need to use WTO-sanctioned administrative protection (anti-dumping, etc.)
Implications of Mega-FTAs for the WTO

• Trade disputes will have alternative fora in which to be settled: Choice between WTO panels and FTA panels
  – This may lessen the role of the WTO Dispute Settlement Mechanism
  – But it will remain relevant
Implications of Mega-FTAs for the WTO

• WTO will continue to be important for plurilateral negotiations on issues that transcend the Mega-FTAs

• Some issues that lend themselves neither to plurilateral agreements nor to Mega-FTAs will remain unresolved
  – Most important: Subsidies
Implications of Mega-FTAs for China

• China must decide which Mega-FTAs
  – To join (TPP)
  – To create (RCEP)
  – To push for (FTAAP = Free Trade Area of Asia and the Pacific)

• Will China seek to use FTAs to
  – Wall itself off from other major countries?
  – Or join in economic integration with other major countries?
Figure 1: ASEAN, RCEP, and TPP member states
Figure 2.3: Membership of possible Asia-Pacific trade agreements

FTAAP-25 would include all economies shown.

FTAAP-21
- Papua New Guinea
- Hong Kong, China
- Russia
- Chinese Taipei

RCEP
- Cambodia
- India
- Laos
- Myanmar

FTAAP-17
- Australia
- Brunei
- Japan
- Malaysia
- New Zealand
- Singapore
- Vietnam

TPP
- Canada
- Chile
- Mexico
- Peru
- United States
Implications of Mega-FTAs for China: TPP

• If China does not join TPP
  – Will suffer from trade diversion in countries without China FTAs
    • US, Japan
    • Others
  – Will suffer from trade diversion due to ROOs even in countries with China FTAs
    • Chile, Peru, members of ASEAN
Implications of Mega-FTAs for China: TPP

• If China does not join TPP
  – Will not be subject to non-trade requirements of TPP
    • State owned enterprises
    • Labor Standards
    • Environment
  – May not need to open trade as much as TPP requires
Implications of Mega-FTAs for China: RCEP

• If RCEP, including China, succeeds
  – Minimal trade creation/diversion, since China already has FTAs with ASEAN and some other RCEP members
    • S Korea
    • New Zealand
  – Largest effect will be FTA with Japan
    • Some trade creation
    • Reversal of prior trade diversion from Japan’s other FTAs, including TPP.
Implications of Mega-FTAs for China: RCEP

• If RCEP, including China, succeeds
  – If it cumulates rules of origin, RCEP will reduce trade and investment diversion due to ROOs.

• Though initiated by ASEAN, RCEP will be viewed as a political triumph of China in building a China-centered economic bloc.