
Appendix A

Notes on Trade Creation, Diversion, and Economic Efficiency

The mere fact that an FTA between two countries would increase bilateral trade flows does not necessarily mean that it would yield an economic efficiency gain. The increase in bilateral trade is achieved at the expense of domestically produced goods, in a process known as “trade creation,” at the expense of imports from other countries outside the FTA bloc, known as “trade diversion,” or both. As Jacob Viner pointed out in his classic analysis (Viner 1950), trade creation improves economic efficiency because the FTA partner country turns out to be a lower-cost producer, compared with producers at home, of the product that is imported more as a result of an FTA. However, trade diversion might be detrimental not only to the welfare of the world as a whole but also to the importing country because the increased imports may not be the best choice due to the price discrimination against the third-country product. In other words, the increase in imports from the FTA partner country might not have occurred if there had been no price discrimination applied to the third party, which actually may have been a cheaper source of supply but was not able to compete with the FTA countries because of tariff discrimination.

In reality, an FTA is likely to have both trade creation and trade diversion effects. Thus the question of the economic efficiency impact of an FTA would depend on which effect dominates. In practice, however, it is extremely difficult to accurately measure the magnitude of trade-creating and trade-diverting effects. Nevertheless, economic theory tells us that there are several indicators of whether an FTA is likely to yield more trade creation or trade diversion. For example, it is generally believed

that trade creation is more likely to dominate if FTA members' tariffs are high before an FTA is formed. The prospect for this case not only has declined for any country over the years due to global efforts to reduce tariffs in the GATT system but also is slim in the case of a Korea-US FTA since both countries have relatively low tariff except in a few sectors.

More important and difficult to evaluate, however, is the sectoral pattern of trade between the prospective members of an FTA. The question is whether the FTA partners are competitive or complementary. The sources of export growth in bilateral trade resulting from an FTA would vary by sector, depending on the comparative advantage of each country. In those sectors where the two countries are complementary, Viner argues that the export expansion would mainly come from the replacement of imports from third countries, known as trade diversion. This is why Viner argues that the desirability of an FTA decreases as the degree of complementarity increases. This argument is controversial because even if an FTA produces predominantly trade-diverting effects, there are still some cases where an FTA may be desirable—namely, where trade diversion does not result in a loss in economic efficiency.

For example, Wonnacott and Lutz (1989) argue that if both countries are producing their products at the lowest possible cost or at least below the world cost levels, then the gains per unit of trade creation will be large and the costs per unit of trade diversion small. In this case, therefore, trade diversion is less likely to create any loss of efficiency in both the FTA countries and the world. Another example lies in the case of sectors in which existing trade barriers before an FTA are mainly nontariff barriers such as quotas and other quantitative restrictions. In such sectors, the FTA partner's products that are more often imported as a result of trade diversion may in fact be a lower-cost source than those diverted from nonmember countries. This is particularly likely to be true if it was quantitative restrictions that prevented the imports before the FTA was in place. In this case, trade diversion may in fact improve economic efficiency.

In the case of both Korea and the United States, there are sectors still protected by quantity restrictions. The United States still maintains import quantity restrictions on machine tools and apparel and textiles, although this restriction, set out in the Multi-Fiber Agreement (MFA), is supposed to be lifted by the end of 2004, in accord with the WTO agreement. The United States also protects some agricultural products by import quotas, such as dairy products, peanuts, and sugar. In Korea, there are many agricultural products that are still protected by quantity restrictions. Another example is the case of intermediate goods. When the intermediate goods are imported at a cheaper price as a result of trade diversion, the efficiency gain in production may compensate for the efficiency loss resulting from importing from a higher-cost source. This may have a significant impact in the case of Korea since the share

of food and consumer goods in total imports to Korea is only about 10 percent.

In sum, existing economic theories and studies do not provide a clear-cut answer to the question of the impact of trade creation and diversion on economic efficiency.