CRT Insights

Trade Diversion is not necessarily bad!

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In the realm of trade in goods, mostly the debate on the net effects of Regional Trade Agreements (RTAs) has focused on whether a particular RTA is trade-creating or trade-diverting. Trade diversion is largely viewed with a negative connotation. It is another matter that numerous estimates from the gravity model generally support the contention that RTAs create trade.

The phenomenon of trade diversion occurs when it is assumed that the members of a regional grouping are not the lowest-cost producers. Due to preferential tariff concessions the members of a regional grouping acquire an advantage over the non-members and even the domestic producers in terms of lower product prices. A member country thus switches its imports from the more efficient rest of the world producers to the lesser efficient and higher cost partner member countries, taking advantage of the liberalized tariff treatment. This results in resource misallocation and amounts to trade diversion. In this sense, the grouping may be an efficiency-reducing arrangement. This has remained as one of the most cited arguments against regional groupings since the work of Jacob Viner and subsequently Meade and Lipsey.

There are various counter-arguments that need to be taken into account for any balanced understanding of the issue. Firstly, whether a particular regional grouping would be efficiency/welfare-reducing or not, is essentially an empirical question. Members of a regional grouping cannot be simply assumed away as inefficient producers vis-à-vis the rest of the world and/or domestic manufacturers. Second, a related issue is that it is the net effects of trade creation and trade diversion that need to be estimated for concluding whether the grouping would be welfare-enhancing or welfare-reducing.

Third, trade diversion need not necessarily be welfare-reducing in all circumstances, especially in a dynamic setting; hence there is nothing sacrosanct about its perceived negative impact. It is often missed out from the analytical debate on the subject that trade diversion in some products could itself lead to trade creation in other products over a period of time. Illustratively, if an intermediate product is cheaper in a member country as compared to the domestic price in the importing member country and it is imported by the latter on preferential terms from the former, it may become available as a further cheaper product in the importing country as compared to the landed price of the similar product when imported from efficient rest of the world but on MFN tariff. This makes the final product highly competitive in the importing country for the production of which the imported input is used. The possibilities of trade creation in the final product increase, via the forward linkage effect. Similarly, backward linkage effect in the country producing the intermediate product could also be present. Thus, through their backward and forward linkage effects, trade diversion could lead to trade creation in a dynamic setting under an RTA.

Finally, in certain cases, the phenomenon could be one of 'reverse trade diversion'. For instance, within the South Asian region there are several lower unit value export items already present and are not being imported by the South Asian countries from within the region. They are actually, being imported from outside the region, even when quality is not an issue. By not importing those by other South Asian countries results in welfare loss. Such costs of noncooperation have been estimated to be substantial for different South Asian countries. It may be said that the South Asian region has been thus characterized by some sort of 'reverse trade diversion'.

Overall, trade diversion may not be necessarily bad.