

broadly liberalizing as the regional agreement then there is no real harmful substitutive effect.<sup>11</sup>

- Trade Creation and Trade Diversion: A More Complicated Story With Global Firms and Economies of Scale<sup>12</sup>

Theoretically, the welfare effects of regional economic arrangements that could lead to the formation of trading blocs are negative if they are more trade diverting than trade creating. If the existence of these blocs hinders multilateral trade barrier reduction, the welfare effects would be different than if their effect were complementary or neutral. Historically, it was thought that, since free trade led to the most efficient utilization of resources and maximized world output and welfare, then any movement towards free trade must also increase welfare. Seminal work by Viner (1950) brought to light the possibility of negative welfare effects due to trade diversion of regional integration agreements (more specifically, customs unions).<sup>13</sup> Today, Viner's conclusions are considered logical but limited, and the trade diversion versus trade creation argument has been found to be too simplistic to reflect real world situations accurately. However, to explain the limitations of the theory and eventually the empirical evidence, one must first understand the basic ideas behind trade-creating and trade-diverting customs unions.

First, it is important to note that only *static, partial equilibrium* effects are measured by analyzing trade creation and trade diversion.<sup>14</sup> This is an important limitation. Trade creation occurs when a nation that is a member of a regional trade agreement (RTA) replaces some of its domestic production with *lower cost* imports from another member country. This occurs usually because the lower cost imports had been subject to a tariff or other trade barriers prior to the implementation of the RTA. Trade creation leads to a greater specialization based on comparative advantages, greater economic efficiency and welfare gains for member countries. This kind of trade-creation also benefits non-member countries since it increases the real income of the members which increases their demand for imports from the rest of the world.

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<sup>11</sup>Lloyd, *op. cit.*, p. 8.

<sup>12</sup>The following two sub-sections draw heavily on D. Salvatore, *International Economics*, 1983.

<sup>13</sup>J. Viner, *The Customs Union Issue*, 1950.

<sup>14</sup>Salvatore, *op. cit.*, p. 234.