Trade Creation and Trade Diversion

7.1 Definitions and Assumptions

Let it be supposed that country A is contemplating membership of a customs union with another group of countries represented, for the sake of simplicity, as Country B. The consequences of membership would be, first, that all tariffs will be removed on trade between A and B; secondly, A and B will adopt a common external tariff on imports from the rest of the world, the latter, again for the sake of simplicity, being denoted as Country C; finally, any revenues arising from the application of that tariff will become the common property of A and B together, the ultimate disposal of those revenues being a matter to be agreed between them. (It is assumed that membership will involve some change, somewhere, in the level and pattern of the previous internal or external tariff levels; if no such change occurs then there will be no effects on international trade.) The object of the analysis is to examine the implications of membership of such a customs union for the economic welfare of the members of the union – both individually and collectively – and for that of the rest of the world. For the time being it will be concerned only with static effects – that is, no changes are assumed in the underlying conditions of demand or supply.

In all economic analysis certain simplifying assumptions must be made at the outset; the world of reality is far too complex for any alternative procedure to be feasible. In the analysis which follows, for example, it is assumed that the costs of transporting goods and services between the countries concerned are small enough to be neglected; it is also assumed that the only impediment to international trade takes the form of import taxes, tariffs, of a fixed value per unit. Neither of these assumptions is particularly realistic but in fact their removal would add considerably to the complications of exposition without significantly affecting the major conclusions.
Two other assumptions underlying the traditional microeconomic analysis of customs unions are however of quite crucial importance. These are, first, that perfect competition prevails within the member countries and in international trade and, second, that the factors of production, labour and capital, are completely mobile within each member country but not between them.

These two assumptions are of far-reaching significance. The first implies that every price in every market, including that for labour, is precisely equal to the marginal cost of the last unit bought or sold. Hence the cost of production of any product is taken to be equal to its opportunity cost – that is, the value of output which could have been produced in some alternative activity had the resources in question not been absorbed in whatever is their current use. The second, that of complete mobility, implies a constant state of full employment of labour and capital. This follows necessarily from the assumption that the current price paid to factors of production – the wage in the case of labour – is equal to what that factor could be earning elsewhere. If it is released from the production of one commodity, therefore, each factor will immediately proceed to its alternative occupation and earn precisely as much as before. In this imaginary frictionless, timeless but completely rational world, no productive resources can be consigned to idleness because alternative, and equally rewarding, occupations always exist. That both assumptions are of questionable validity (except perhaps in the famous long run of orthodox theory) hardly requires stress.

One further assumption will be made about the proposed customs union for the time being. This is that the assumption of perfect competition – the world of a very large number of separate sellers and an equally large number of separate buyers – extends to its position in world international trade. That is to say, the customs union, regarded as a single buyer in world markets, is a sufficiently small element in those markets to prevent any changes in its demand for imports from affecting their world prices. In other words, the supply curve of imports from the rest of the world, C, can be treated as a horizontal line, the world price remaining unchanged whatever quantities are imported by A and B together. The consequences of removing this assumption will be explored at a later stage.

The core of Viner’s analysis involves the three concepts of trade creation, trade diversion and trade suppression, the word ‘trade’ in this context being a shorthand expression for international trade. By trade creation is meant a process through which the total volume of trade in a given product, or products in aggregate, is increased through the establishment of a customs union. Such a development could be the result of either of two separate causes or from both of them operating simultaneously. The first is known as the consumption effect – that is, an increase in the total consumption of a product as a result of a fall in its domestic market price; consumers are stimulated by the price reduction to substitute the product concerned for other products which have now become relatively expensive. The second is known as the production effect – the displacement of high-cost domestic production by cheaper imports from