

Voluntary Formation of Free Trade Area in a Three-Country Model

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Abstract

This paper investigates whether both an importing country and one of exporting countries form a free trade area (FTA) voluntarily in a “three-country” model where one importing country and two non-identical exporting countries exist. Two exporting countries are different with respect to the number of firms. An export subsidy (An import tariff) is available for each of exporting governments (an importing government). We construct a following three-stage game: In the first stage, each government of importing and exporting countries determines whether it forms an FTA independently. In the second stage, if the FTA is formed, then member countries set its subsidy and its tariff level to null for the “intra-member trade,” whereas the government intervention prevails for the trade between importing country and non-member one. Otherwise, then each of exporting governments (importing government) implements an export subsidy (an import tariff). In the third stage, given the level of trade policies, the firms in the exporting countries export a homogenous commodity and compete *à la* Cournot in the importing country. The main conclusions are as follows: [i] Suppose that an FTA is formed. The importing government reduces the external tariff irrespective of with which exporting country it forms the FTA. Non-member exporting country reduces the export subsidy (tax) if it has the lesser (larger) number of firms. [ii] The FTA can be formed between the importing country and the exporting country with the larger number of firms under some conditions, although the FTA between the importing country and the exporting country with the lesser number of firms cannot be formed. [iii] The FTA between the importing country and the exporting country with the larger number of firms benefits member countries as well as entire world, but hurts non-member country.

Keyword: Free Trade Area, Import Tariff, Export Subsidy, Number of Firms, Cournot Competition

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