

Optimal Trade Policies and Free Trade Agreements in a Vertically Related Industry

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Abstract

This paper examines effects of a formation of a free trade agreement between countries with vertical production and trade relationship under imperfect competition in a three-country model. When a country exporting an intermediate good signs a bilateral free trade agreement with a country that exports a final good using the imported intermediate good, the volume of trade between the non-member country also exporting the final good may or may not diminish, depending on the number of final-good firms in each country. Although welfare in the signatory country exporting the final good improves, other countries may or may not be better off. Nevertheless, in the presence of income redistribution between the signatory countries, the FTA formation may be strictly Pareto improving. We also discuss the possibility of multilateral trade liberalization followed by the two-country FTA, by comparing welfare levels under two-country FTA with those under three-country free trade.

Keywords: Free trade agreement; Vertically related industry; Welfare; Global free trade

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