

Reversal of Trade Creation and Trade Diversion Due to Preferential Rules of Origin

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Abstract

Restrictive preferential rules of origin (PROOs) moderate the “trade diversion and trade creation” effects associated with FTAs. Moderation of these effects occurs because restrictive PROOs reverse the course of trade creation and trade diversion brought about by FTAs. Such a reversal arises because restrictive PROOs induce compliance costs that lead to a lower utilization of tariff preferences by member-countries and a smaller increase in the relative price of imported goods from non-members. Restrictive PROOs cause less than full trade diversion from non-members to member countries, and less than complete trade creation to member countries. This paper infers this moderation effect of PROOs from the estimated parameters of the revenue function, since trade diversion refers to a decrease in the elasticity of substitution between import sources, and trade creation refers to a difference between the change in import price elasticity due to FTAs and the trade diversion effect. Empirical results support the conjectures that restrictive PROOs move in the opposite direction of FTAs partly undoing trade diversion and trade creation attributable to FTAs, that the moderation effect of restrictive PROOs does not fully offset the initial effect of FTAs on relative prices, and that the moderation effect of restrictive PROOs does not completely neutralize trade creation.

Key words: restrictive preferential rules of origin, revenue function, moderation of trade diversion/trade creation effects

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