

CHAPTER 6

THE NEGATIVE EFFECTS OF THE FREE TRADE AGREEMENT

6.1 Introduction

Free trade is now one of the favorite phrases used by political leaders and in the media around the world. It is usually accompanied by terms such as “globalization” and “liberalization”. In fact, free trade is being promoted with such vigor that many people almost automatically think that it is a good thing for all nations to practice free trade.

However, consider the case of poor countries all over the world. Even if they enjoy preferential access under certain agreements, such as the Lomé agreement, they may earn little simply because the prices of their products are kept artificially low by the buyers (Khor, 1998). Indeed, this is the sad experience of developing countries in world trade for at the past century and more. The colonial division of labor by which the master countries produced industrial products at high prices and the colonies exported raw materials at low prices continues today. Between 1980 and 1992 the terms of trade for commodities vis-à-vis manufactured goods fell by 52 per cent. In other words, an average unit of commodities exported by the South in 1992 only bought half of what bought in terms of imported goods about a decade earlier.

This has led to astonishing losses for the South. Take the case of sub-Saharan Africa, the world’s poorest region. A United Nations study (1995) has shown that between 1980 and 1989 the region’s terms of trade fell by 28 per cent. This led to a loss of income of US \$16 billion in 1989 alone, which is equivalent to 9.1 per cent of sub-Saharan Africa’s combined gross domestic product (GDP). In the four years from 1986 to 1989 sub-Saharan Africa suffered a total \$55.9 billion of income losses due to the decline, equivalent to 15 per cent of GDP. It would be hard indeed to tell Africans that free trade has benefited them greatly.

Against this background, it seems logical that most of the trade liberalization efforts within the region have been focusing on the region itself. With the acceptance of the new democratic South Africa, there has been a renewed effort for greater regional cooperation, as was indicated in earlier Chapters. However the Free Trade Agreement between South Africa and the EU does not seem to fit into this series of developments; nor does it seem to be beneficial to the region in terms of trade creation and welfare, as was indicated by Chapter 6. This Chapter will therefore launch a thorough investigation into the question of whether the concerns expressed by South Africa's neighbors can be substantiated.

Section 6.1 will be dedicated to the possible impact of a regional FTA and will analyze the findings of an existing study on closer regional cooperation. The results of this study for a regional FTA will be shown. The focus then shifts to the main issue of this Chapter, namely trade diversion. After a brief look at the theory behind trade diversion, the effects of the deal, which has been concluded, will be analyzed. The Chapter finishes with some general remarks on further regional cooperation and ideas for the improvement of this study.

6.2 The Effects of Regional Cooperation

6.2.1 Possible Implications of Freer Trade in the Region: A South African Perspective

After months of exhaustive negotiations, three important South African trade agreements were concluded in the first half of 1997. Although separate, the three were closely linked and would affect each other in vital ways, which would hopefully benefit not only South Africa, but the region as a whole. The SADC free trade agreement protocol was the first regional agreement since the Uruguay Round. It was also the first substantial agreement between developing countries and less developed countries, and this made it an unusual agreement (SADC, 1997). It was, however, closely linked to the EU negotiations. From a South African perspective it made no sense whatsoever to improve EU access to South African markets at a rate more rapid than the improved SADC access. This would be detrimental to regional development.

A problem however loomed for Botswana, Lesotho, Namibia and Swaziland because a free trade agreement in SADC and a probable reduction in tariffs for the EU would affect their revenue base. These issues would also have to be taken into consideration during talks with the EU. It is self-evident that the improvement of South Africa's trade and investment links with its neighbors is vital to future regional stability.

Whilst South Africa's trade with its Southern African neighbors constitutes a relatively small percentage of its total trade, regional trade has been growing rapidly over the past few years. Southern African countries, such as Zimbabwe, Zambia, Malawi and Mozambique accounted for 64 per cent of South Africa's African export market (excluding Botswana, Lesotho, Namibia and Swaziland) in 1994 (Customs and Excise, 1997). In addition, a significant percentage of South Africa's exports to these countries outside the Southern African Customs Union (SACU) consists of manufactured goods.

It has been widely accepted that the countries of the Southern African region can achieve their full potential only through close cooperation in the exploitation of natural resources in a coordinated fashion, the pooling of technical expertise, the harmonization of trade practices and the promotion of economies of scale. The aim of the SADC is to create a community providing for regional peace and security, sector cooperation and an integrated regional economy. As a regional institution it has laid the basis on which regional planning and development in Southern Africa can be pursued. It also provides the desired instrument by means of which member countries could move along the path towards eventual economic integration. With particular benefit to South Africa, SADC provides the framework for translating the imperatives of GEAR (growth, equity and redistribution) onto a regional plane. In doing so it enhances the degree to which, individually, and collectively, the countries of the region offer a climate for sustained growth and development.

It is therefore essential that the South African government should adopt a clear policy on regional planning and development in Southern Africa. Such a policy should however be the culmination of both interaction and consultation between all national and provincial line-function departments and discussions with the other countries in Southern Africa (SADC, 1997). South Africa

should encourage a step-by-step approach to development, taking into account the availability of resources and labor. Furthermore, the existing disparate levels of economic performance in the region will naturally dictate economic development approaches and priorities. One of the issues which will need to be looked at urgently is the question and problem of urbanization, or in a broader sense regionalization, meaning the tendency of people to move towards centers of high economic activity in search of better living conditions.

The SADC was given the task of gradually establishing a common market, and is therefore responsible for progressively eliminating barriers to the free movement of capital, labor, goods and services. It is also concerned with issues of good governance, human rights and democratic practice. There are basically two models for regionalism — sectoral cooperation and trade integration (OECD, 1995). Regional cooperation entails cooperation in specific economic sectors such as transport, energy and mining. In contrast, trade integration involves a gradual movement towards integration in trade, investment, the movement of capital and human resources across the region and the harmonization of national economic policies across the region. Regional integration, on the other hand, involves the gradual process of moving from a preferential trade area towards the establishment of an economic union in which, in addition to a common market, member countries harmonize fiscal and monetary policy. The SADC is currently implementing, through its trade protocol, a preferential (free) trade area, as a first step to the long-term objective of establishing a common market in the region, as specified in its treaty.

South Africa considers it in its long-term interest to propose an asymmetrical preferential access arrangement, favoring other SADC member states, rather than an immediate free trade regime,. This should avoid contributing to the de-industrialization of these countries (Imani Development (International) Ltd, 1997a). The SADC is thus in the process of implementing both integration and cooperation simultaneously. Although the two are distinct modes of regional integration, success in one area tends to reinforce success in the other. Cooperation in areas such as the development of transport and communications infrastructure in the region, for example, enhances member countries' ability to trade with each other. Trade integration and sectoral cooperation could contribute both directly and indirectly to sustainable economic growth and development in all member countries of the region. The ultimate goal of the SADC would be to form an

economic union, which would constitute a common market and allow free movement of labor and capital.

It has often been argued that opening up the South African market to agricultural imports from SADC countries may threaten South African maize, wheat, tobacco, beef and sugar producers, as some SADC countries have a comparative advantage in the production of these commodities. On the other hand, it may release land currently used for the production of these crops for the production of crops in which South Africa itself has a comparative advantage. The next section is therefore devoted to a study of possible sensible agricultural products within a SADC free trade area.

6.2.2 The Imani Study of Sensitive Agricultural Products within a SADC Free Trade Area

The Imani study, conducted in 1997, was contracted by the SADC Secretariat to provide insight into possible effects on agricultural production of a revised tariff structure for the region. The study did not cover the entire agricultural sector. Only the major commodities traded were considered. These are:

- meat and live animals;
- grain products —wheat, maize, edible flour and meal;
- sugar — cane, raw or refined;
- tea;
- tobacco;
- cotton and cotton seeds;
- rice;
- fruit – citrus, apples.

When a free trade area is established, the member countries have to agree on a schedule for reducing tariffs to zero levels. In terms of the GATT as well as the Marrakech Agreement, free trade means “substantially all trade”. This is not clearly defined and there is some dispute as to what it entails, but it has been taken as meaning approximately 90 per cent of trade by value in all sectors (SADC, 1997). In any free trade agreement however, there are always exclusions as

member countries seek to protect sensitive sectors. It has been the common experience of regional integration arrangements worldwide that the agricultural sector gives rise to major negotiating difficulties in the path of free trade (Maasdorp, 1998).

According to the WTO, a product could be regarded as sensitive on one or more of the following grounds:

- It might yield a substantial part of the government's revenue from customs or excise duties.
- It might be important for reasons of national security.
- It might be of great political and social importance if it is labor intensive. The down-scaling or closure of the industry concerned would then lead to a significant increase in unemployment and to social hardship. However, employment is not regarded by the WTO as a good yardstick for exclusion since, under a free trade area, some new companies will open and some existing ones will close. What is lost on the swings might be gained on the roundabouts.
- It might be critical in the country's balance of trade. This happens only in small economies (such as island economies in the Caribbean) where a single industry might account for a large proportion of total export revenue, and its failure would then have important balance-of-payments repercussions.
- It might be in a sub-sector which is inefficient and which depends on tariffs for its survival.

Before analyzing the results of the Imani study, let us take a look at other recent studies of sensitive agricultural products in the region and the methodology used. The IDC (1998), for example, identified sensitive products on the basis of high import tariffs. On this basis the only agricultural product, which showed up was tobacco (for Zimbabwe, Zambia, Tanzania, Mozambique and Malawi). Holden (1996) on the other hand used an economic policy model to estimate the effects of SADC free trade on output, trade, employment and customs revenue for 27 traded goods for the member countries in 1993. He pointed to the data difficulties and warned that the results should be treated with caution. The agricultural sector was not disaggregated by tariff line so that no sensitive products were identified. For the agricultural sector as a whole, however, there was some modest creation and expansion of production.

A study of the establishment of a common external tariff (CET) for Common Market of Eastern and Southern Africa (COMESA) (Imani Development (International) Ltd, 1995) covered all the SADC countries except Botswana and South Africa (which are not members of COMESA). The methodology was based on two related concepts: the effective rate of protection (ERP) and the domestic resource cost (DRC). The COMESA CET study depended on a questionnaire survey, with a widely varying response rate because of the data requirements, and consequently it did not cover all subsectors. Thus, it provided little comparability. DRCs were also used in studies of the effects of trade liberalization in the maize and beef sectors in South Africa and Zimbabwe (Masters, 1995)

The Imani study also calculated ERPs for the SADC countries. The analysis showed that the most sensitive agricultural commodity was sugar, while dairy, cereals and milling, meat and tobacco were also sensitive. The list of potentially sensitive agricultural products is contained in Table 6.1, followed by a brief discussion of the implications of these sensitivities for some selected commodities in the Southern African region.

Table 6.1. Potentially Sensitive Agricultural Products

Product	Country
Grain milling products	Malawi, Namibia
Tobacco	Malawi, Mauritius, South Africa
Edible fruits and nuts	Mauritius
Coffee, tea and spices	Malawi, Mauritius
Meat	Namibia
Dairy produce	South Africa, Zambia, Zimbabwe
Sugar	Malawi, South Africa, Swaziland, Tanzania
Cereals	Malawi, Zambia, Zimbabwe

Source: Imani Development (International) Ltd, 1997

The sensitivity of sugar production is not based so much on protection *per se* as on the distorted nature of the regional sugar trade, particularly the differential access enjoyed by the various producing countries to preferential regional and world markets, under the Lomé and SACU

agreements. The argument, which was presented to the SADC by SASA (South African Sugar Association) is that the growth of the industry would be better achieved if producing countries were to cooperate in world marketing negotiations, anti-dumping procedures, research and technology rather than by disrupting local markets. It now appears likely that the SASAs proposals, supported by the South African Department of Trade and Industry, for a SADC Sugar Protocol will be adopted.

Grain millers in the smaller economies such as Malawi face two major problems: they do not enjoy economies of scale, and there are no effective anti-dumping measures. Thus, they would be unlikely to be able to withstand competition from larger mills in South Africa and Zimbabwe (Maasdorp, 1998). Also vulnerable are the small-scale peasant maize growers who lack the marketing and management skills to compete with commercial producers in South Africa and Zimbabwe. The severity of the threat to these growers could be determined with accuracy only if there were a comparative price study in the SADC region.

In other studies of this sector in the SADC region, Takavarasha et al. (1996) found that maize production in Zimbabwe was efficient for domestic but not for export markets (except perhaps for immediate regional markets) because of the high transport costs associated with such a bulky commodity. Of the producing regions in South African itself, Jooste et al. (1996) found that only the Highveld under irrigation had a comparative advantage. Masters (1996) quote World Bank calculations of DRCs for Zambian maize production, all well below unity (indicating a comparative advantage). Despite this finding, the Bank's policy recommendation was that Zambia should not concentrate on exports since other agricultural activities could make better use of domestic resources.

Acting on the recommendations of the Imani study, SADC ministers decided to draw up three lists with commodities for immediate liberalization, temporary exclusion and gradual liberalization, according to the perceived sensitivity of the products. For the last two lists, tariffs will be reduced on a linear basis to zero at the end of eight years after the Protocol takes effect. However, some highly sensitive products may require a longer period. Reductions for sensitive products will start at a later stage than those for products on the gradual liberalization list

(Maasdorp, 1998). The reductions will also be asymmetric due to South Africa's trade dominance. Thus, SACU tariffs will be reduced more rapidly than those of the non-SACU countries. To offset this, the non-SACU countries will liberalize their tariffs towards the BLNS countries more rapidly than towards South Africa.

Although the precise details have still to be agreed upon, the process could be fairly smooth. A high proportion of intra-SADC trade is already duty free, largely through SACU but also through bilateral free trade or zero-rated raw material imports. For the non-SACU countries a significant proportion of trade is about to become duty free under the CBI and COMESA, and presumably such trade will fast-track the SADC tariff reduction schedule. Most of the tariffs, which will need to be reduced relate to non-SACU countries' imports from South Africa, with a smaller volume of trade comprising SACU (especially South African) imports from the non-SACU countries (Imani Development (International) Ltd, 1997a).

Although the Imani study is useful in pointing out sensitive products under a free trade agreement, it does not point to losers and gainers in terms of welfare and trade flows. The GTAP analysis conducted in this regard is similar. Unfortunately it is also unable to analyze the effects on individual countries, but groups all the SADC countries together under the rest of Southern Africa classification. South Africa on the other hand is broken out. This restriction arises mainly due to data constraints. Efforts are however under way to extend the current GTAP database. The next section will give an indication of the effects of a FTA in the Southern African region.

6.2.3 A GTAP Analysis of the Southern African FTA (SAF-RSA Scenario)

It should be remembered that the SAF-RSA scenario depicted the situation were all tariffs were eliminated or set to a target rate of zero. The scenario therefore symbolizes a complete FTA between South Africa (SAF) and the rest of Southern Africa (RSA). Because of data constraints it was impossible to break the analyses up for each country within the RSA. Remember also that there are slight differences between the SADC and the countries included in the RSA. However for the purposes of this study we will have to accept these shortcomings in the absence of a more detailed alternative.

The analysis of the imaginary FTA between South Africa and the rest of Southern Africa begins by looking at the changes in output. Figure 6.1 indicates that the output changes are rather small for all sectors, with the decline on the grain and oilseeds sector being the largest for South Africa. The biggest increase for that country is in the dairy sector. For the rest of Southern Africa the biggest increase in output is in the livestock and meat sector, while other agricultural products and the dairy sectors show the largest declines.

Figure 6.1. Percentage Changes in Output under the SAF–RSA Scenario

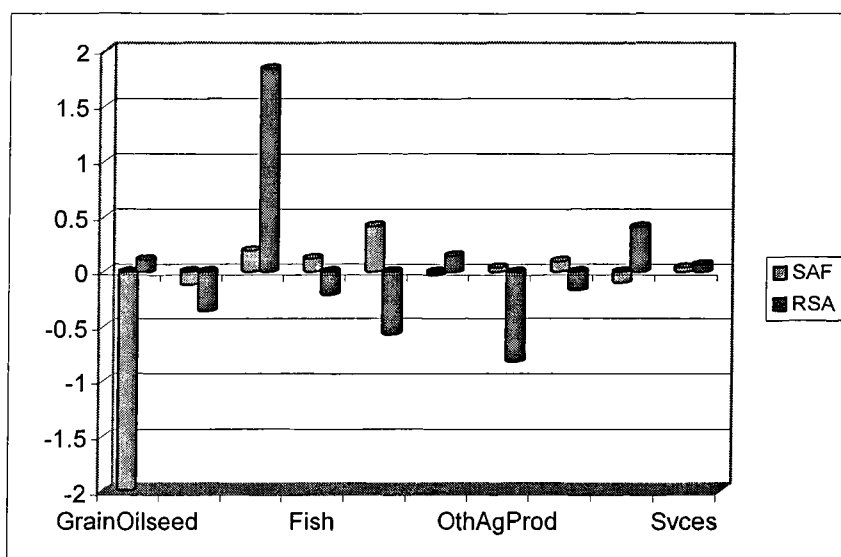


Figure 6.2 shows the increase in trade flows between South Africa and the rest of Southern Africa under this scenario. Only the grain sector shows a decline. This is the result of initial subsidies on grains within the rest of Southern Africa. The FTA forces the elimination of all tariffs, and hence the decline in trade flows.

Figure 6.3 depicts the changes in prices for both imports and exports between the rest of Southern Africa and South Africa. Note that all the changes are favorable for the rest of Southern Africa:

Figure 6.2. Percentage Changes in Trade Flows of the Rest of Southern Africa with South Africa

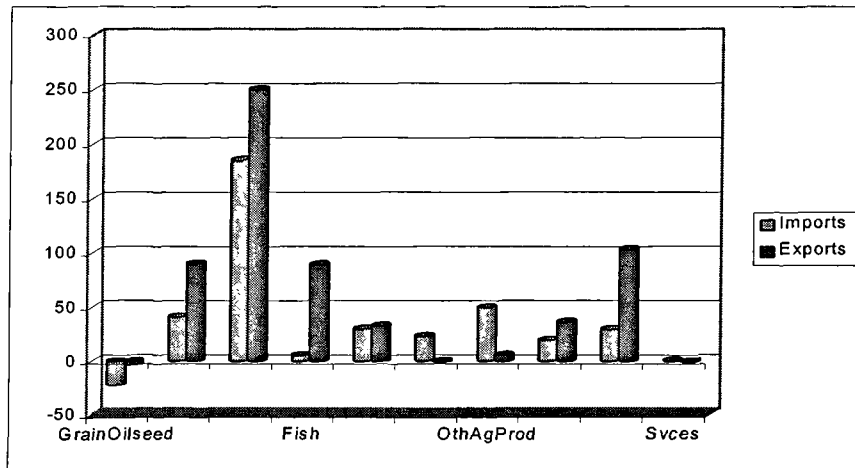
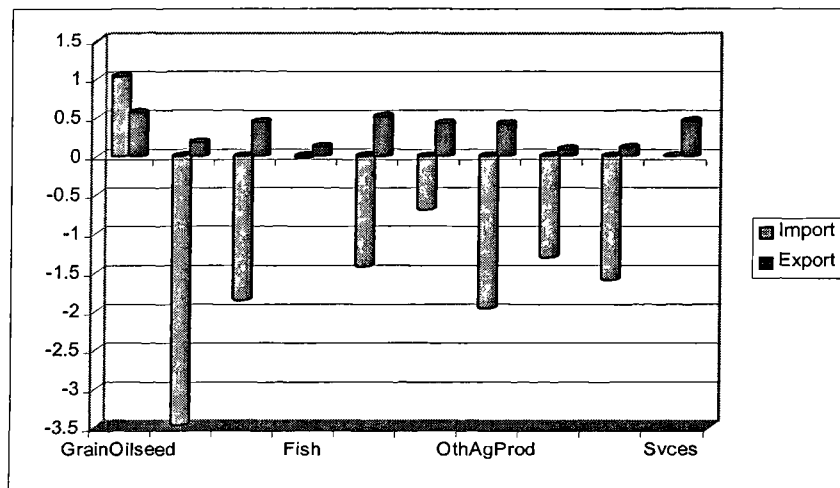
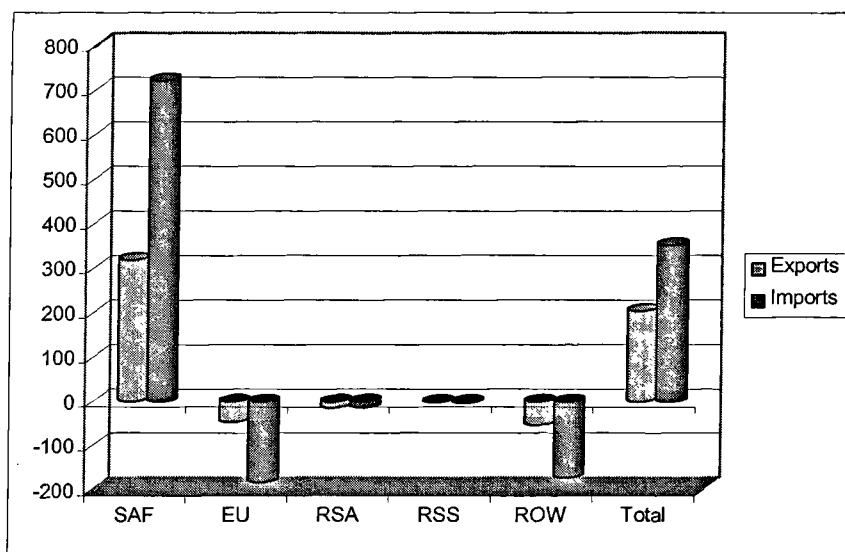


Figure 6.3. Percentage Changes in the Prices of Trade Flows of the Rest of Southern Africa with South Africa



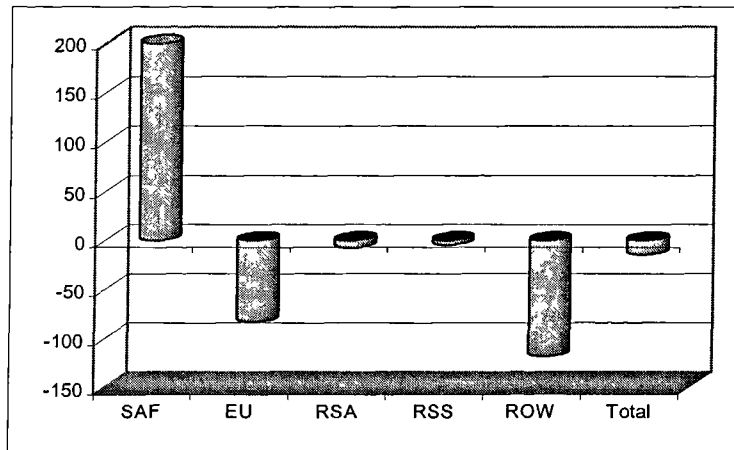
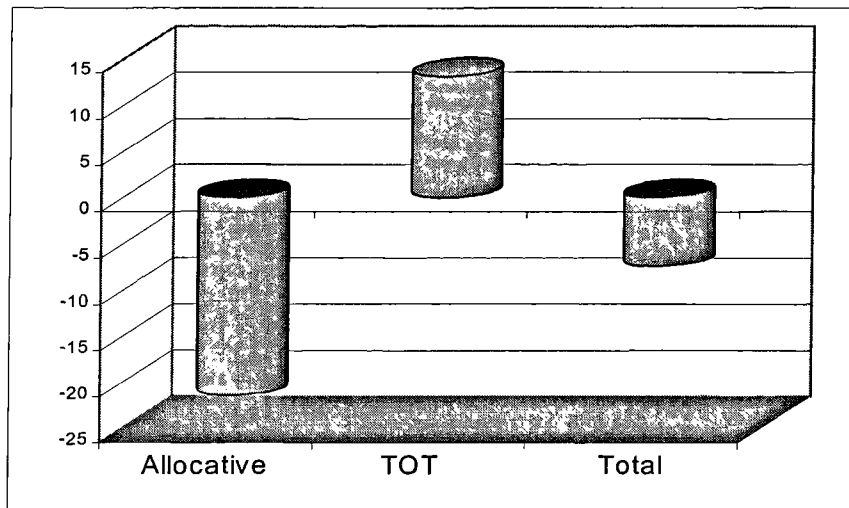
cheaper imports and higher export prices (except for grain imports, the reason for which was given earlier). Figure 6.4 then gives the change in total value of the trade flows. There are increases, as was expected, for both imports and exports for South Africa, but surprisingly, the changes of the values of the trade flows for the RSA are negative. All the other regions also have negative changes, although the overall effect is positive.

Figure 6.4. Changes in Total Value of Trade Flows (\$ million)

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A similarly disturbing result is indicated by Figure 6.5. The total welfare effect for the rest of Southern Africa is negative, and only South Africa gains. The overall effect this time is negative. Does this mean that the rest of Southern Africa actually loses under the FTA with South Africa? Does this result indicate that the theory of free trade should be rejected? Surely the explanation given in the previous Chapter, that this result maybe due to bad data, is not satisfactory. The answer lies in trade diversion effects. Figure 6.6 provides a partial explanation of the problem.

Figure 6.6 depicts the decomposition of the welfare effects for the rest of Southern Africa under the SAF–RSA scenario. Although the terms of trade (TOT) effect is positive, as was indicated earlier by the change in prices, the biggest effect is due to allocative efficiency, which is negative in this instance. This is a clear example of trade diversion, where increased trade and tariff reduction does not lead to welfare gains. This phenomenon can be easily explained by trade

Figure 6.5. Total Welfare Effect of the SAF-RSA Scenario**Figure 6.6. Decomposition of Welfare Effects for the Rest of Southern Africa**

theory, and is thus not contradictory in any sense. It is however highly unfortunate from the perspective of the rest of Southern Africa in the context of regional liberalization efforts. South Africa would gain from such an agreement, while the overall result for the rest of Southern Africa is negative. Individual countries within SADC could however experience welfare gains. Negotiations towards a regional free trade agreement are bound to become a discussion over sensitive products, and therefore it will be highly unlikely that total elimination of tariffs will

occur within the near future. The Imani study on sensitive products is therefore clearly relevant in this context.

To clear up any uncertainties still existing around trade diversion effects, the next section will present a very basic illustration of the issue.

6.3 Trade Diversion

6.3.1 Theoretical Background

In this section an analysis of trade diversion is presented. The analysis uses a partial equilibrium framework, which means that the effects of the preferential trade liberalization with respect to a representative industry are considered.

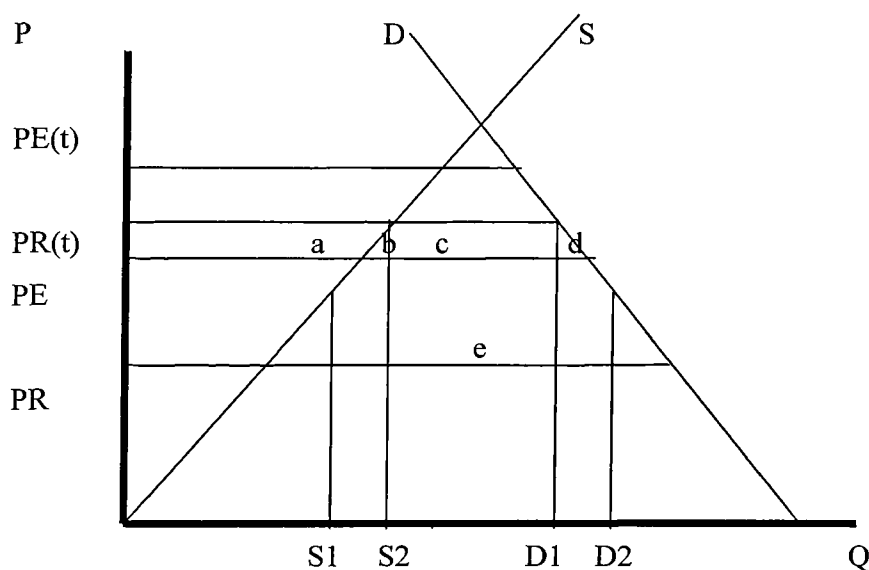
For illustration purposes, assume that South Africa (SAF) and the EU are forming an FTA, excluding the rest of Southern Africa (RSA). Each region has supply and demand for a homogeneous good in the representative industry. Furthermore assume that South Africa is initially not trading freely. Instead it has a most favored nation (MFN) specific tariff applied on imports from countries of both the EU and the rest of Southern Africa (i.e. the same tariff against both sets of countries). First, we will describe an initial tariff-ridden equilibrium. Then, we will calculate the price and welfare effects that would occur in this market if South Africa and the EU formed a free trade area. After the FTA is formed, South Africa maintains the same tariff against the rest of Southern Africa (i.e. the non-FTA region).

In general, trade diversion means that a free trade area diverts trade, away from a more efficient supplier outside the FTA, towards a less efficient supplier within the FTA. In some cases, trade diversion will reduce a country's national welfare but in other cases national welfare could improve despite the trade diversion. These cases are represented in Figures 6.7 and 6.8 below.

Figure 6.7 depicts the case in which trade diversion is harmful to a country that joins an FTA. The figure shows the supply and demand curves for SAF. PE and PR represent the free trade supply

prices of the good from the EU and the RSA, respectively. Note that the RSA is assumed capable of supplying the product at a lower price than the EU. We assume that South Africa has a specific tariff $t_E = t_R = t^*$ set on imports from both the EU and the RSA. The tariff raises the domestic supply prices to $PE(t)$ and $PB(t)$, respectively. On the figure $t^* = PE(t) - PE = PR(t) - PR$.

Figure 6.7. Welfare Analysis of SAF under Welfare-Reducing Conditions



Since, with the tariff, the product is cheaper from the RSA, South Africa will import the product from the RSA and will not trade initially with the EU. Imports are given by the distance $D1 - S1$. Initial tariff revenue is given by area $(c + e)$, the tariff rate times the quantity imported. Next, assume South Africa and the EU form an FTA and South Africa eliminates the tariff on imports from the EU. Now $t_E = 0$ but t_R remains at t^* . The domestic prices on goods from the EU and the RSA are now PE and $PR(t)$, respectively. Since $PE < PR(t)$, South Africa should import all of the product from the EU after the FTA and nothing from the RSA. This would thus create a loss of export revenue for the RSA. At the lower domestic price, PE , imports would rise to $D2 - S2$. Also since the non-distorted (i.e. free trade) price in the RSA is less than the price in the EU, trade is said to be diverted from a more efficient supplier to a less efficient supplier. The welfare effects are summarized in Table 6.2.

Table 6.2. Welfare Effects of Free Trade Area for South Africa

Consumer surplus	$+(a + b + c + d)$
Producer surplus	$-a$
Government surplus	$-(c + e)$
National welfare	$(b + d) - e$

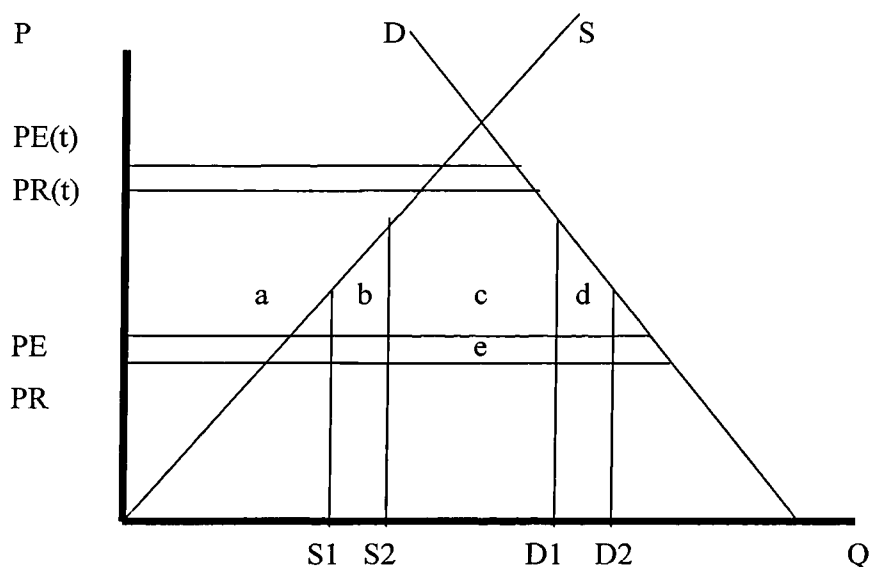
Consumers of the product in South Africa benefit from the free trade area. The reduction in the domestic price of both imported goods and the domestic substitutes raises consumer surplus in the market. The magnitude of the change in consumer surplus is presented in Table 6.2 and Figure 6.7. Producers in South Africa suffer losses as a result of the free trade area. The decrease in the price of their product on the domestic market reduces producer surplus in the industry. The price decrease also induces a decrease in the output of existing firms, a decrease in employment, and a decrease in profit and/or payments to fixed costs. The government loses all the tariff revenue that had been collected on imports of the product. This reduces government revenue, which may in turn reduce government spending or transfers, or raise government debt.

The aggregate welfare effect for South Africa is found by summing the gains and losses to consumers, producers and the government. The net effect consists of three components: a positive production efficiency gain (b), a positive consumption efficiency gain (d) and a negative tariff revenue loss (e). Notice that not all of the tariff revenue loss (c + e) is represented in the loss to the nation. That is because some of the total losses (area c) are, in effect, transferred to consumers. Because there are both positive and negative elements, the net national welfare effect can be either positive or negative. Figure 6.7 depicts the case in which the FTA causes a reduction in national welfare. Visually, it seems obvious that area e is larger than the sum of a and b. Thus, under these conditions, the FTA with trade diversion would cause national welfare to fall.

If conditions were different, however, the national welfare change could be positive. Consider Figure 6.8, which differs from Figure 6.7 only in that the free trade supply price PE offered by the EU is lower and closer to the RSA's free trade supply price PR. The description above

concerning the pre- and post-FTA equilibria remains the same and trade diversion still occurs. The welfare effects remain the same in direction, but differs in magnitude. The consumer surplus gain is now larger because the drop in the domestic price is larger. Also the net national welfare effect, $(b + d - e)$ appears, visually, positive. This shows that in some cases, formation of an FTA that causes trade diversion may have a positive net national welfare effect. Thus, trade diversion may be, but is not necessarily, welfare-reducing.

Figure 6.8. Welfare Analysis of SAF under Welfare-Enhancing Conditions



Generally speaking, the larger the difference between the non-distorted prices in the FTA partner country and in the rest of the world, the more likely that trade diversion will reduce national welfare. Trade creation, on the other hand, means that a free trade area creates trade that would not have existed otherwise. As a result, supply occurs from a more efficient producer of the product. In all cases trade creation will raise a country's national welfare. The same analysis can be used to show this result.

The analysis above considers the welfare effects for participants in one particular market in one country that is entering into a free trade area. However, when a free trade area is formed, presumably many markets and multiple countries are affected, not just one. Thus to analyze the

aggregate effects of an FTA, one would need to sum up the effects across markets and across countries. The simple way to do this is to imagine that a country entering an FTA may have some import markets in which trade creation would occur and other markets in which trade diversion would occur. The markets with trade creation would definitely generate national welfare gains while the markets with trade diversion may generate national welfare losses. It is common for economists to state that, “if the positive effects from trade creation are larger than the negative effects from trade diversion, then the FTA will improve national welfare.” A more succinct statement, though also somewhat less accurate, is that “if an FTA causes more trade creation than trade diversion, then the FTA is welfare improving.”

However, the converse statement is also possible, i.e. “if an FTA causes more trade diversion than trade creation then the FTA may be welfare reducing for a country.” This case is actually quite interesting since it suggests that a movement to free trade by a group of countries may actually reduce the national welfare of the countries involved. This means that a movement in the direction of a more efficient free trade policy may not raise economic efficiency. Although this result may seem counter-intuitive, it can easily be reconciled in terms of the theory of the second-best.

Recall that the second-best theory suggested that, when there are distortions or imperfections in a market, the addition of another distortion could actually raise welfare or economic efficiency. In the case of an FTA, the policy change is the removal of trade barriers rather than the addition of a new trade policy. However, the second-best theory works much the same in reverse. Before a country enters an FTA it has policy-imposed distortions already in place in the form of tariff barriers applied on imports of goods. This means that the initial equilibrium can be characterized as a second-best equilibrium. When the FTA is formed some of these distortions (i.e. the tariffs applied to the FTA partners) are removed. However, other distortions remain (i.e. the tariffs applied against the non-member countries). If the partial tariff removal substantially raises the negative effects caused by the remaining tariff barriers with the non-FTA countries, then the efficiency improvements, caused by free trade within the FTA, could be outweighed by the negative welfare effects caused by the remaining barriers outside the FTA, and national welfare could fall.

This is in essence what happens in the case of trade diversion. Trade diversion occurs when an FTA shifts imports from a more efficient supplier to a less efficient supplier, which by itself causes a reduction in national welfare. Although the economy also benefits through the elimination of the domestic distortions, if these benefits are smaller than the supplier efficiency loss, then national welfare falls. In general, the only way to assure that trade liberalization will lead to efficiency improvements is for a country to remove its trade barriers against all other countries.

6.3.2 Trade Diversion under the Existing South African–EU FTA and the SAF-RSA Scenario

The creation of Free Trade Agreements always creates the danger of negative trade-diverting effects, which can swamp out any positive trade-creating effects resulting from reduced tariffs, as indicated above. For example, under the FTA scenario, South Africa lowers its tariffs towards imports from Europe, making them cheaper than imports from other sources. However because of unchanged tariffs towards imports from other countries which might be more efficient producers, commodities are preferentially imported from Europe, which might not be the most cost-effective producer. This creates welfare losses in both the trading partner countries, as well as in the efficient-producer country, which loses its export revenues.

The analysis identifies some examples of trade diversion. These can be found in allocating efficiency losses, as indicated in Figures 5.35 and Figure 5.36. Unchanged tariff structures towards third parties, such as the rest of South Africa, result in the import of commodities from countries which are not the lowest cost producers — for example, the import of livestock and meat from the EU. Figure 5.29 also indicates trade diversion effects. Both the EU and South Africa replace previous low-cost suppliers with imports from the partner country, due to preferential access, which creates losses in the Southern African region and therest of the world. Only in the case of the FTA scenario are the trade-creating effects larger than the diversion effects, resulting in an overall gain.

Now let us consider again the case of the welfare losses for the rest of Southern Africa in a liberalization agreement with SAF (SAF-RSA Scenario). There should theoretically be much scope for trade creation within the region, as current tariff barriers are high. However it might be the case that, because of existing high tariffs towards third parties outside the agreement, the trade diverting effects will crowd out beneficial trade creation effects. South African and RSA imports might not be produced at the most efficient rates, thereby generating welfare losses within the respective countries, in this case the RSA.