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Market presence, contestability, and the terms-of-trade effects of regional integration

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Abstract

This paper examines the impact of market presence and contestability on the price behavior of US exporters in Brazil's market when MERCOSUR and MFN trade liberalization take place. Using detailed panel data on trade and tariff rates, we find that *both* the preferred supplier's market presence and threat of entry *lower* (*raise*) the US price reaction to MFN (preferential) trade liberalization, with similar *quantitative* effects. Thus, presence in, or threat of entry into, partners' markets implies lower optimal MFN tariffs, and regional agreements can have pro-competitive effects in contestable markets. We also examine the 'symmetry' hypothesis between the effect of tariffs and exchange rates.
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1. Introduction

The number of regional integration agreements (RIAs) has increased dramatically in the last decade. In fact, nearly all members of the WTO belong now to one or

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more RIAs. The recent proliferation of RIAs has created renewed interest in their impact on both member and non-member countries. One of the major concerns is the effect on the terms of trade faced by non-member countries. As discussed in Winters (1997), this effect should be a major focus when assessing the effect on non-member countries' welfare.

Terms-of-trade effects associated with Spain's accession to the EEC have been estimated by Winters and Chang (2000). And in their forthcoming paper, Chang and Winters (henceforth CW) show in the case of MERCOSUR that non-member countries suffer a decline in their terms of trade and that this decline is due to their reaction to the improved market access by preferred rival competitors within the integrating market. CW have also shown that Brazil's MFN trade liberalization results in a terms-of-trade loss for Brazil and a gain for exporters to Brazil.[1]

This paper extends CW's work in several ways. First, CW only include the Argentine product categories that are present in Brazil's market, and these merely cover 38% of all Argentine product categories in 1991 and 55% in 1995. We extend the empirical analysis by examining how the price response of non-member countries is affected by the presence or absence of Argentine product categories in Brazil's market. Second, the mere *threat* of entry by preferred suppliers may be sufficient to discipline non-member incumbents within a 'contestable' market. It may be reasonable to expect that when conditions facing potential Argentine entrants into Brazil's market improve, i.e. when Brazil's market becomes more contestable for Argentine suppliers (as with RIA formation), incumbents will attempt to deter entry by reducing prices. Third, in a paper on the 'pass-through' to domestic prices of changes in tariffs and exchange rates, Feenstra (1989) has shown that the two effects should be equal. We provide an empirical test of this 'symmetry' hypothesis as a check on the model.

Though contestability and issues concerning 'limit pricing' have been examined as far back as Bain (1949, 1954) and Hines (1957), they have not been studied empirically in an international setting, and certainly not in the context of regional integration.[2] This paper shows that trade policy changes affect incumbent suppliers, and that this effect depends on market presence and contestability.

As mentioned above, the extent to which a change in tariff or exchange rate is reflected in a change in domestic prices has been examined in Feenstra (1989).[3] He

[1]Ashenfelter et al. (1998) employ a similar pricing methodology in a domestic context for two firms as marginal costs change in a single firm and for the industry. In particular, they regress the price one firm, Staples, charges for a product on the marginal cost of that product as well as on the cost of Office Depot, another rival firm in the industry.

[2]Baumol et al. (1988) offer a general exposition on the market behavior of incumbent firms and the threat of entry. They argue that markets may in fact be 'perfectly contestable', in which case price cannot be above average cost.

[3]For an extensive survey of the literature on exchange rate 'pass-through', see Goldberg and Knetter (1997). They state that a 50% exchange rate 'pass-through' is about average for the estimated responses for shipments to the US. They also examine the 'symmetry' hypothesis.

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