# Trade Creation and Trade Diversion in the European Union: An Alternative Approach

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**Abstract.** This paper analyzes empirically the existing trade relationships between the trading partners which include Greece, the other European Union Countries (EU), the rest of the world countries (ROW), and Turkey. It also investigates whether Greece's accession to the EU caused a structural break in the allocation of total supplies of agricultural and manufactured products over domestic and foreign supplies. Finally, it predicts the possible trade effects of the accession of Turkey to the European Union. We estimate an expenditure or complete-import model via the Almost Ideal Demand System. The model includes home-produced commodities and imports from three trading regions: EU, ROW and Turkey, and specify the relationships between the shares in total supplies and total real demand and relative prices.

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## 1. Introduction

Recent enlargement of the European Union by ten new countries may generate imbalances in trade relationships among its current members. In addition, the accession of Turkey into the European Union is expected to change the terms of trade between the trading partners, both within the European Union and in countries elsewhere. Economists and policy makers have spent a considerable amount of time analyzing these issues, from both theoretical and empirical viewpoints. [1]

From a theoretical viewpoint, models have proliferated. Under a free-trade agreement, a country's trade creation occurs when low-price imports from its trading partner displace domestic production. A country's trade diversion occurs when imports from its trading partner replace imports from third-party countries which still face high tariffs barriers. Viner's (1950) original distinction between trade creation, under which countries lowering their tariffs shifted away from reliance on high-cost domestic industry to imports from the lower-cost partner countries, and trade diversion (where low-cost production in the rest of the world is displaced by higher-cost production in the partner country), has been modified and amended in a number of ways.

This is particularly true in recent years, where free-trade areas and custom unions have seen mushrooming multilateral trade liberalization in order to improve the terms of trade through optimal tariffs and non-tariffs barriers on imports. In this respect, a number of key questions require convincing answers. Does the establishment of free-trade areas lead to trade creation or trade diversion? Does the formation of free-trade areas improve the competitiveness of the trading partners and to what extent? In what way will the expected arrival of Turkey in the European Union alter the existing structure of trade both within the European Union and the world over? A reasonable answer to these questions requires an evaluation of the existing trade relationships and the anticipated changes, which, by nature, is quite difficult to do accurately.

From the theoretical point of view, a country's trade relationships are based on the comparative advantage in the production of goods, which is attributed both to internal and external factors. The traditional approach used to explain the comparative advantage position of a country includes: first, the Ricardian approach, according to which the comparative advantage is attributed to the international differences in the productivity of labor; and, second, the Hecksher-Ohlin (H-O) or factor-proportions theory according to which: (1) the comparative advantage is due to the availability of all productive factors; and (2) the countries tend to export the commodities whose production is based on plentiful factors of production.[2]

In order to accept or reject the possibility of making accurate predictions for international trade flows, the Ricardian and H-O theories, have been subjected to empirical verification. The empirical studies have produced mixed results. While the Ricardian approach predicts accurately that countries export those commodities in which the productivity of labor is relatively high, it makes a number of misleading predictions in the sense that it: (1) predicts an extreme degree of specialization not observable in the real world; (2) ignores the income distribution within the trading patterns; (3) allows no role for the differences in resources among the trading countries as a cause of trade; and (4) neglects the role of scale economies in the creation (diversion) of trade. On the other hand, the empirical findings of the factor-proportions theory are not entirely convincing either. Many investigators in the field support the argument that the existing differences in the means of production among the trading patterns alone cannot explain the development of international trade or the level of prices at the international level, without taking in account the international differences in technology. In addition, it is argued that the comparative advantage of a country does not constitute the only factor which explains the structure of the international trade, and factors such as transportation cost, international economic and political developments, scale economies and the like, will divert the structure of international trade from that predicted by the H-O theory.

Over the last twenty years many empirical studies, following different approaches from those in the traditional trade models, have attempted to isolate the effects that the observed globalization trend could have on the structure of international trade[3]. This issue has intensified with the establishment of large unions