

CRT Insights

There is trade 'diversion' or 'switch' in both Trade Creation and Trade Diversion

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There is a wide-spread myth that trade diversion is bad because trade is 'diverted' after FTA comes into being and trade creation is good because trade is 'created'. It must be however realized that in both trade creation and trade diversion there a 'switch' or 'diversion' of trade from one source to another source; the latter source being the FTA partner.

If the switch is from an inefficient source to an efficient source of supply in the FTA partner country it is considered as 'trade creation' and if the switch is from an efficient supplier to an inefficient source in the FTA partner it is considered as 'trade diversion'. The switch could be from a rest of the world supplier and/or domestic supplier to another source in the FTA partner country, depending from case to case.

In short, both the concepts of Trade Creation and Trade Diversion are efficiency-based concepts and both entail a 'switch' in the sources of supplies of goods in a post-FTA scenario, which is often confused with 'diversion' of trade - associated with a negative connotation.

It may be also reiterated, what has already been argued earlier, that trade diversion need not necessarily be bad and could be in fact 'trade-creating' and 'welfare-enhancing' in a dynamic setting.

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