Will the Real “Natural Trading Partner” Please Stand Up?

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Abstract

Adherents to the “natural trading partner” hypothesis argue that forming a PTA is more likely to raise welfare if member countries already trade disproportionately with each other. Opponents of the hypothesis claim that the opposite is true: welfare is likely to be higher if member countries trade less with each other. This paper shows that neither analysis is correct and that the “natural trading partner” hypothesis can be rescued if it is redefined in terms of complementarity or substitutability rather than in terms of volume of trade.

• JEL Classifications: F02, F13, F15

• Key Words: Regional Integration, Partner Relations with the Rest of the World, Choice of Partner

I. Introduction

The “natural trading partner” hypothesis has recently become popular in the regional integration literature. Two versions of the hypothesis exist, referring either to the volume of trade between potential partners of a preferential trading arrangement (PTA) or to the distance and transport costs between them. Authors who adhere to the hypothesis argue that integration with “natural trading partners” is likely to raise welfare because the likelihood and extent of trade diversion is minimized when the volume of trade between prospective partners is large. Others

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argue the opposite. And though it is true that the “natural trading partner” hypothesis does not hold in general, the studies aiming to refute it have some analytical problems of their own which have so far been ignored in the literature.

This paper shows that the analysis requires a more careful examination of the link between the partner country and the rest of the world, and that such an examination leads to different results.¹ It is shown that commercial opportunities exist whose exploitation has not been fully examined in the traditional analysis of the “natural trading partner” hypothesis. One of the implications of the analysis presented here is that an alternative definition of “natural trading partner” exists under which the hypothesis is likely to hold.

The paper is organized as follows. Section 2 presents the “natural trading partner” hypothesis as found in the literature and Section 3 shows the analysis aimed at refuting it. Section 4 lists the main implications of that analysis. Section 5 points out its limitations and presents a new analysis. Section 6 concludes and provides new policy recommendations. The “natural trading partner” hypothesis is rescued once appropriate changes in the definition are made.²

II. The “Natural Trading Partner” Hypothesis

A number of studies claim that if two countries or regions are “natural trading partners”, they are more likely to gain from a preferential trade agreement (PTA) between them. The claim based on the version of the hypothesis referring to the volume of trade apparently originates with Lipsey (1960). He argues in his famous survey that “… a customs union is more likely to raise welfare the higher is the proportion of trade with the country’s union partner and the lower the proportion with the outside world.” In a similar vein, Summers (1991) states: “Are trading blocs likely to divert large amounts of trade? In answering this question, the issue of natural trading blocs is crucial because to the extent that blocs are created between countries that already trade disproportionately, the risk of large amounts of trade diversion is reduced”. Also, Wonnacott and Lutz (1989) state that if the prospective members are already major trading partners, integration “…will be

¹The link between partner country and rest of the world has been examined in 3x3 models, including Riezman (1979) and Lloyd (1982). Bagwell and Staiger (1993a, b) and Bond and Syropoulos (1996) endogenize trade agreements and show that maintaining free trade is harder in a bloc-ridden world. None of these papers examines the “natural trading partner” hypothesis.

²The term “traditional” for this type of analysis is also found in the title of Panagariya (1999).