Why do consumer prices differ among NAFTA members?

In perfectly integrated markets, prices of similar goods should be equalized once expressed in a common currency, according to theory. If the price in one location were higher than in another, people could make a riskless profit by shipping the goods from locations where the price is low to locations where the price is high. This would tend to move prices back to equality. In practice, prices of similar goods fail to equalize across countries. Why does this happen?

The idea of perfect market integration is more a benchmark used for economic analysis than something that we can see in practice. A market is said to be perfectly integrated if there are no barriers to trade flows. If barriers to trade are very high, we will observe that prices are essentially disconnected across countries. The failure of prices to equalize between countries is a sign that markets are not completely integrated.

Although North America Free Trade Agreement (NAFTA) members are highly integrated, they still face barriers. These frictions generate a departure from perfect market integration and, consequently, give rise to the possibility of price differences across countries.

Among the barriers is the cost of transporting goods from one location to another. Shipping goods from locations where the price is low to locations where the price is high generates profits only if the price difference is sufficient to compensate for the transport cost. If the price difference is small, arbitrage may not be profitable. The result is price differentials across locations.

Another barrier to trade is tariffs, which are likely to create a wedge between prices in two locations. Although NAFTA has certainly reduced impediments to trade and has dismantled tariffs for most goods, tariffs are still levied on some commodities.

Finally, it is important to note that final goods go through a series of steps before they are available to the end consumer. These steps involve, for example, marketing and distribution, which add a nontradable component to the final goods’ prices. This component certainly may differ across locations—distribution costs are not the same in Guanajuato, Mexico, as they are in Manhattan. This differential will be reflected in the final price of a good.

Submit your question in a letter to the editor. (See Page 2.) One question will be answered by the appropriate economist in each issue.