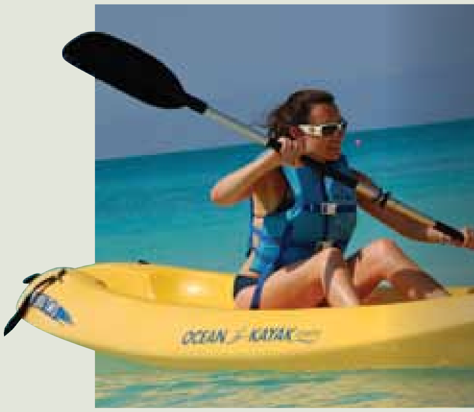


ASK AN ECONOMIST

Luciana Juvenal has been an economist in the Research division of the Federal Reserve Bank of St. Louis since 2008. Her research interests are international economics and finance. In her free time, she enjoys scuba diving, kayaking, dancing the tango and taking photographs.

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.

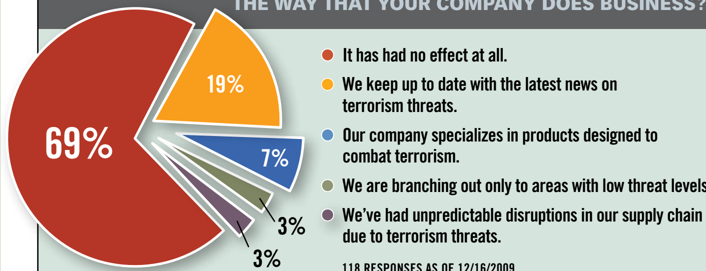
Finally, it is important to note that final goods go through a series of steps before they are available to the end consumer. These steps involve, for example, marketing and distribution, which add a nontradable component to the final goods' prices. This component certainly may differ across locations—distribution 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.

FED FLASH POLL RESULTS

When a new issue of *The Regional Economist* is published, a new poll is posted on our web site. The poll question is always pegged to an article in that quarter's issue. Here are the results of the poll that went with the October issue. The question stemmed from the article "Increasing Political Freedom May Be Key To Reducing Threats."

HOW HAS THE THREAT OF TERRORISM AFFECTED THE WAY THAT YOUR COMPANY DOES BUSINESS?



118 RESPONSES AS OF 12/16/2009

THIS ISSUE'S POLL QUESTION:

Which do you think is the top risk for reigniting inflation over the next several years?

1. There turns out to be less slack (smaller output gap) in the economy than many experts believe.
2. Commodity prices balloon again as investors tire of low-yielding Treasury securities and shift their money into higher-yielding commodity contracts and other assets.
3. The Fed waits too long to return the monetary supply to a pre-crisis level.
4. The federal budget deficit continues to mushroom.
5. There is no inflation risk—it's dead and buried.

After reading "Inflation May Be the Next Dragon To Slay," go to www.stlouisfed.org/publications/re to vote. Anyone can vote, but please do so only once. (This is not a scientific poll.)

A DAY DEVOTED TO STATE AND LOCAL GOVERNMENT FINANCE IN TOUGH TIMES

A daylong program about state and local government finance in these turbulent economic times will be held April 9 at Washington University in St. Louis. The program is being co-sponsored by that university's Weidenbaum Center on the Economy, Government and Public Policy and by the Federal Reserve Bank of St. Louis. The public is invited.

Professors from universities across the country will discuss such topics as the pros and cons of higher taxes, of borrowing and of cuts that local governments are making to cope with the recession; short-term viability versus long-run growth of various revenue sources; the role of state governments in the implementation of fiscal policy; and the increasing reliance on such nontraditional revenue sources as gambling and smoking.

Also on the agenda will be representatives of the Cato Institute, the National Council of State Legislatures, the Federal Trade Commission and the Center on Budget and Policy Priorities.

Details on the program are available at http://research.stlouisfed.org/conferences/turbulence.