AQA Economics A-level

Macroeconomics

Topic 6: The International Economy

6.2 Trade

Notes

The distinction between absolute and comparative advantage

A country has **absolute advantage** in the production of a good or service if it can produce it using fewer resources and at a lower cost than another country.

Comparative advantage occurs when a country can produce a good or service at a lower opportunity cost than another country. This means they have to give up producing less of another good than another country, using the same resources.

Countries can specialise where they have comparative advantage. This increases economic welfare.

The benefits of free trade

Free trade is the act of trading between nations without protectionist barriers, such as tariffs, quotas or regulations.

Free trade provides the following benefits:

- Countries can exploit their comparative advantage, which leads to a higher output using fewer resources and increases world GDP. This improves living standards.
- Free trade increases economic efficiency by establishing a competitive market. This lowers the cost of production and increases output.
- By freely trading goods, there is trade creation because there are fewer barriers. This means there is more consumption and large increases in economic welfare.
- More exports could lead to higher rates of economic growth.
- Specialising means countries can exploit economies of scale, which will lower their average costs.

The following costs could be considered:

- Free trade has resulted in some job losses, since countries with lower labour costs have entered the market.
- Free trade might have contributed to some environmental damage. This is especially from the increase in manufacturing.

The reasons for changes in the pattern of trade between the UK and the rest of the world

Comparative advantage

There has been a recent growth in the exports of manufactured goods from developing countries to developed countries. This is because developing countries have gained an advantage in the production of manufactured goods, due to their lower labour costs, so production shifted abroad.

The deindustrialisation of countries such as the UK has meant the manufacturing sector has declined. This means that production of manufactured goods has shifted to other countries, such as China, whilst the UK now focuses more on services, such as finance.

This has led to the industrialisation of China and India. Their share of world trade has and the volume of manufactured goods that they export has increased.

However, since China's population is now ageing, their wage competitiveness has fallen. This is also due to the rise of the middle class in China, who demand higher wages and consume more.

Impact of emerging economies

The collapse of communism has meant that more countries, especially developing countries, are participating in world trade.

International trade is arguably more important for developing countries than developed countries. It contributes towards 20% of LDC economies compared to 8% of the US economy.

Between 1995 and 2005, India's share of textiles and clothing fell from 35% in 1995 to 16% in 2005. Instead, India's manufacturing sector seems to produce more engineered goods than clothing and textiles. This has resulted in UK manufacturers selling fewer manufactured goods abroad.

China and India are important for African infrastructure. They have invested in their infrastructure in exchange for natural resources.

Both China's and India's share in agriculture, mining and fuel has declined. Both countries are important in the Euro area, with trade and financial relations. China is a main import source, whilst both are important for capital.

Growth of trading blocs and bilateral trading agreements

With more trading blocs, trade has been created between members, but diverted from elsewhere. Trade creation occurs when a country consumes more imports from a low cost producer, and fewer from a high cost producer. Trade diversion occurs when trade shifts to a less efficient producer. Usually, a country might stop importing from a cheaper producer outside a trading bloc to a more expensive one inside the trading bloc. Moreover, protectionist barriers are often imposed on countries who are not members, so trade is diverted from producers outside the bloc to producers within the trading bloc.

The policies of developed countries have limited the ability of developing countries to export primary commodities. For example, the EU Common Agricultural Policy (CAP) means domestic farmers receive subsidies to encourage production and lower costs. This increases the incomes of domestic farmers and protects the industry, but farmers in other countries find it hard to compete with them. Therefore, they are not able to access the market in developed countries, which limits their participation in trade.

Changes in relative exchange rates

For a long time, China has been running a trade surplus with the US. Since 2006, the US trade deficit has narrowed with China, and China has reduced their trade surplus, too. China has planned this change from export-led growth to growth fuelled by domestic consumption. When running the trade surplus, China had kept their currency's value, the Renminbi, low, in order to make their exports relatively cheap.

It could be argued that one of the reasons for the UK's current account deficit is the strength of the pound compared to the Euro. In 2015, it reached a seven year high against the Euro (more information: http://www.bbc.co.uk/news/business-31811791).

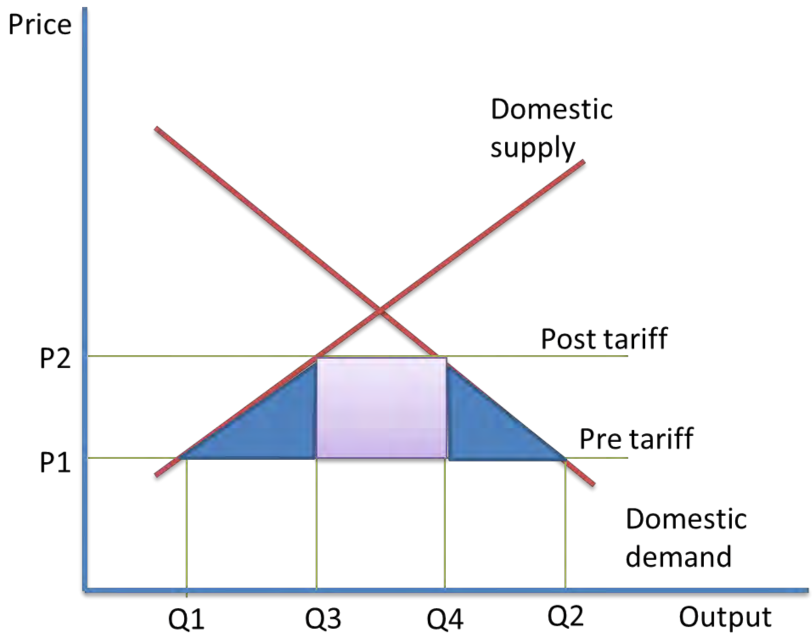
Protectionism

Protectionism is the act of guarding a country's industries from foreign competition.

Methods of protectionism and their impact

Tariffs

Tariffs are taxes on imports to a country. It could lead to retaliation, so exports might decrease. The impact of tariffs is that the quantity demanded of domestic goods increases, whilst the quantity demanded of imports decreases.



The tariff diagram illustrates the effects of imposing a tariff. The original quantity of imports is Q2 – Q1, and the new quantity of imports is Q4 – Q3.

The purple shaded rectangle shows the revenue the government gains from imposing the tariff. This could help finance government expenditure.

The two blue triangles show the area of deadweight loss of welfare, as a result of the tariff.

- **Quotas**

A quota limits the quantity of a foreign produced good that is sold on the domestic market. It sets a physical limit on a specific good imported in a set amount of time. It leads to a rise in the price of the good for domestic consumers, so they become worse off.

- **Export subsidies**

This is a form of government intervention to encourage goods to be exported rather than sold on the domestic market. The government might use direct payments, tax relief, or provide cheap access to credit.

- **Embargoes**

This is the complete ban on trade with a particular country. It is usually politically motivated.

- **Excessive administrative burdens ('red tape')**

Excessive administration increases the cost of trading, and hence discourages imports. It makes it difficult to trade with countries imposing red tape, and is particularly harmful for developing countries which are unable to access these markets.

It is harder to notice this type of protectionism, which is why it is favoured among some countries.

The causes and consequences of countries adopting protectionist policies

- If a country employed several protectionist measures, then a trade deficit would reduce. This is because they will be importing less due to tariffs and quotas on imports.

- Infant industries might need protecting. These are industries which are relatively new and receive support. Protectionism is usually short term until the industry develops, at which point the industry can trade freely.

- Protectionism could be used to correct market failure. It can deal with demerit goods and protect society from them.

- Governments might employ protectionist measures to improve the current account deficit.

- Governments might want to protect domestic jobs.

- Protectionism could distort the market and lead to a loss of allocative efficiency. It prevents industries from competing in a competitive market and there is a loss of consumer welfare. Consumers face higher prices and less variety. By not competing in a competitive market, firms have little or no incentive to lower their costs of production.

- It imposes an extra cost on exporters, which could lower output and damage the economy.

- Tariffs are regressive and are most damaging to those on low and fixed incomes.

- There is a risk of retaliation from other countries, so countries might become hostile.

- Protectionism could lead to government failure.

Customs union

Countries in a customs union have established a common trade policy with the rest of the world. For example, they might use a common external tariff.

It also has free trade between members. The European Union is an example of a Customs Union.

Common markets establish free trade in goods and services, a common external tariff and allow free movement of capital and labour across borders. When the EU was established, it was a Common Market. EU citizens can work in any country in the EU.

Other features of a customs union include:

- Safety measures for imported goods, such as for food, are common across all members.
- There are common customs rules and procedures.
- There is a structure for the combined administration of the nations within the Customs Union.
- There is a common trade policy. This helps to create and guide trading relationships with countries and blocs outside the Customs Union.

The main characteristics of the Single European Market (SEM)

- Free movement of goods, services, capital and labour between nations.
- Administrative provisions, laws and regulators are approximated between member nations. This could mean some laws are better suited to some countries, and not so much for others.
- Competition policy is common across the whole of the EU.
- There are common external tariffs.

The consequences for the UK of its membership of the European Union (EU)

Trade creation and trade diversion

With more trading blocs, trade has been created between members, but diverted from elsewhere. Trade creation occurs when a country consumes more imports from a low cost producer, and fewer from a high cost producer. Trade diversion occurs when trade shifts to a less efficient producer. Usually, a country might stop importing from a cheaper producer outside a trading bloc to a more expensive one inside the trading bloc. Moreover, protectionist barriers are often imposed on countries who are not members, so trade is diverted from producers outside the bloc to producers within the trading bloc. The UK trades mainly with the EU, at the expense of former trade links in the Commonwealth.

- **Reduced transaction costs**

Since there are no barriers to trade or no border controls, it is cheaper and simpler to trade.

- **Economies of scale**

Firms can take advantage of a larger potential market in which to trade. For example, the EU has 500 million people to sell to. By specialising, firms and countries can exploit their comparative advantages, and the gains of efficiency and advanced technology can be reaped.

- **Enhanced competition**

Since firms operate in a more competitive market, they become more efficient and there is a better allocation of resources. There could be the long run benefits of dynamic efficiency too, although these benefits are not always spread evenly across each member.

- **Migration**

By being a member of a Customs Union, the supply of labour is increased, which could help fill labour shortages. However, this might mean some countries lose their best workers.

This summary by the BBC summarises the main costs and benefits of EU membership for the UK:

http://www.bbc.co.uk/news/uk-politics-20448450

- ## Role of the WTO in trade liberalisation:

The WTO promotes world trade through reducing trade barriers and policing existing agreements. It also settles trade disputes, by acting as the judge, and organises trade negotiations.

Every member of the WTO must follow the rules. Those who break the rules face trade sanctions. In addition to trade in goods, the WTO covers the trade in services and intellectual property rights.

As of 2015, there are 161 member states in the WTO.

Possible conflicts between regional trade agreements and the WTO:

Trading blocs might distort world trade or adversely affect those who do not belong to them. There could be an inefficient allocation of resources as a result of policies such as the EU CAP.

Conflicts between blocs could lead to a rise in protectionism. A common external tariff contradicts the WTO's principles, since although there is free trade between members, protectionist barriers are imposed on those who are not members.

Some countries might argue that the WTO is too powerful, or that it ignores the problems of developing countries. This could be since developed countries do not trade completely freely with developing countries, which limits their ability to grow.

Setting up a customs union or a free trade area could be seen to violate the WTO's principle of having all trading partners treated equally. This is especially if a common external tariff is applied. However, they can complement the trading system and the WTO strives to ensure that non-members can trade freely and easily with the members of a trade bloc.