Edexcel (B) Economics A-level

Theme 3: The Global Economy

3.1 Globalisation

3.1.3 Trading blocs

Notes

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.

Expansion of trading blocs:

Free trade area

This is where countries agree to trade goods with other members without protectionist barriers. For example, the North American Free Trade Agreement (NAFTA) is a free trade area, as is the European Free Trade Association (EFTA).

They allow members to exploit their comparative advantages, which increases efficiency.

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. They also have free trade between members. The European Union is an example of a Customs Union.

Common market

This establishes free trade in goods and services, a common external tariff and allows 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.

Impact on firms of trading blocs

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.

Growing interdependence

Trading blocs create a high degree of dependency on the performance of member economies. This increasing interdependence between economies could result in recessions spreading globally. It increases the vulnerability of the economy to external shocks and it means an economic decision of one member state affects other members. This level of interdependence could be seen in 2008 and 2009, when the effects of the global credit crunch spread across the globe.