

Edexcel Economics A-level  
**Unit 4: The Global Economy**

Topic 2: Trade and the World  
Economy

**2.4 Trade liberalisation**

Notes



## **Types of trading blocs (regional trade agreements and bilateral trade agreements):**

### **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.

### **Monetary unions, including conditions necessary for their success:**

This is sometimes called a currency union. Members of a monetary union share the same currency. This is more economically integrated than a customs union and free trade area. The Eurozone is an example of this.

A common central monetary policy is established when a monetary union is formed. The single European currency, the Euro, was implemented in 1999 to form the Eurozone.



Monetary unions use the same interest rate. The Euro, for example, floats against the US Dollar and the Pound Sterling. Member nations are required to control their government finances, so budget deficits cannot exceed 3% of GDP. This is one of the four convergence criteria countries have to meet in order to join the Euro. The other three are:

- Gross National Debt has to be below 6% of GDP
- Inflation has to be below 1.5% of the three lowest inflation countries
- The average government bond yield has to be below 2% of the yield of the countries with the lowest interest rates. This ensures there can be exchange rate stability.

The optimal currency zone is created when countries achieve real convergence. Member countries have to respond similarly to external shocks or policy changes. There has to be flexibility in product markets and labour markets to deal with shocks. This could be through the geographical and occupational mobility of labour, and wage and price flexibility in labour markets. Fiscal transfers could be used to even out some regional economic imbalances.

## **Costs and benefits of regional trade agreements:**

### **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.

#### **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.

