OCR Economics A-level

Macroeconomics

Topic 4: The Global Context

4.4 Trade Policies and Negotiations

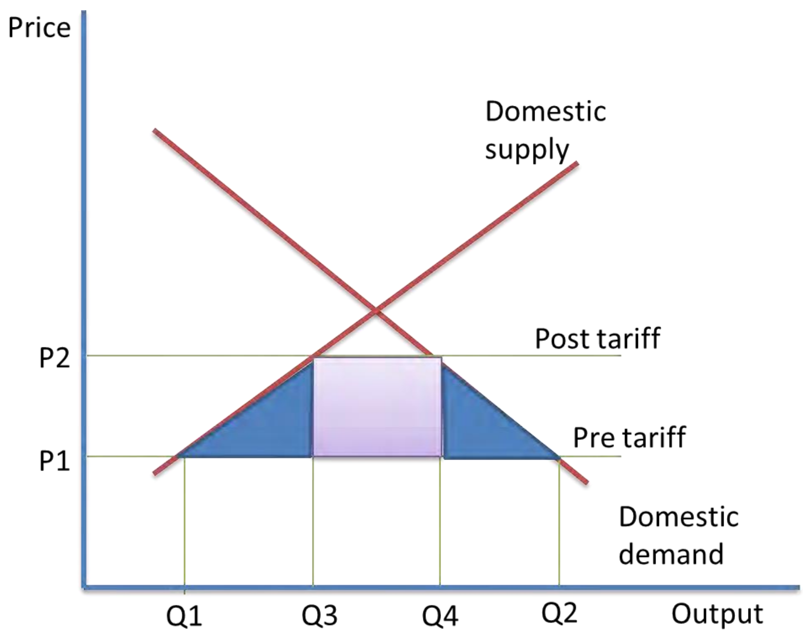
Notes

Different methods of protectionism

Protectionism is the act of guarding a country's industries from foreign competition. It can take the form of tariffs, quotas, regulation or embargoes.

- **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 stages of economic integration

- **Free trade areas**

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 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.

Monetary union

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.

- Economic union

This is made up of a common market with a customs union. The members have common freedom of movement of goods, services, capital and labour, as well as a common external trade policy. The EU is an economic union.

Economic unions with common currencies are called **economic and monetary unions.**

The internal and external consequences of economic integration

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-2044845

The costs and benefits of protectionism

Benefits of protectionism

- 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.

Costs of protectionism

- 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.

The case for and against 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 role of the WTO in promoting free trade

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.

The progress made and difficulties faced by the WTO, such as agricultural disputes and trade agreements

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.