WJEC (Eduqas) Economics

AS-level

Macroeconomics

Topic 4: International Trade

4.1 Free trade and protectionism

Notes

The benefits and costs 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.

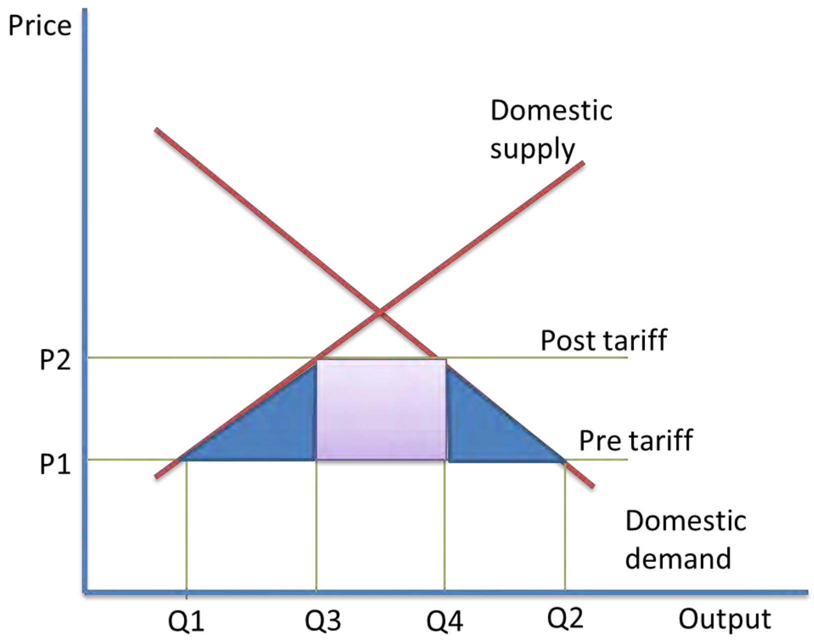
Protectionism

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.

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.