4.1.5 Trading blocs and the World Trade Organisation (WTO)
Notes for Edexcel Economics A, unit 4.15 on trading blocs and the WTO
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Contents

What are the different types of trading blocs?

A trading bloc is when two or more economies agree to remove trade barriers.

There are different types of trading bloc:

- **Free trade agreement** = reduction or elimination of trade barriers
  - Trade barriers include tariffs (taxes on imports)
  - Trade barriers also include:
    - Paperwork for firms to fill in to transfer goods across borders.
    - Quotas to limit the quantity of imports.
    - Subsidies for domestic producers to make it harder for foreign producers to compete.
    - Free trade agreements may eliminate some or all of these trade barriers.
  - Example of a free trade agreement: Australia-UK Free Trade Agreement
  - Trade agreements can be bilateral (between two countries only) or regional (covering countries in a particular region).
- **Customs union** = no trade barriers + common external tariff.
  - A common external tariff is a tariff set at the same rate by all members of the bloc. It applies to all imports coming in from outside the bloc.
  - Example of a customs union: Mercosur, a trading bloc in South America.
- **Single market or common market** = no trade barriers + common external tariff + free movement of labour and capital.

    - Free movement of labour means workers can move to any country within the single market.
    - Free movement of (financial) capital, in the context of a single market, means unrestricted flows of money and financial assets across borders within the single market. This means a German company can invest in a French company in the EU for example.
    - Example of a single market: The European Union (EU).
- **Monetary union** = all member states have the same currency and the same single central bank in charge of monetary policy.
    - An example of this is the euro area (sometimes called the eurozone). All countries in the euro area have the euro as their currency.
    - The European Central Bank (ECB) is in charge of monetary policy for the entire euro area.
    - Note the EU and the euro area are different.
        - For instance, Poland and Denmark have their own currencies (and so are not in the euro area). However, Poland and Denmark are in the EU.

<u>What are the consequences of trading blocs?</u>

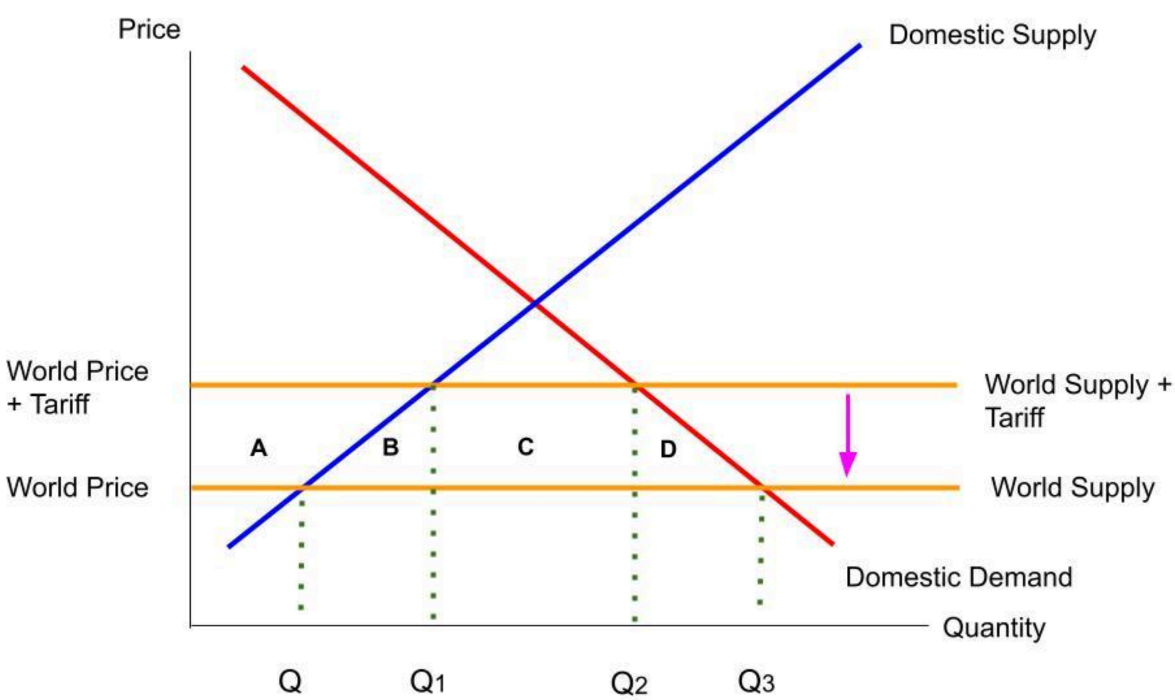
<u>1) Trade creation</u>

Trade creation is the increase in imports from another country within the trading bloc.

This occurs following the reduction in tariffs between countries within the trading bloc.

Reduced trade barriers lead to trade creation:

- Consider the market for clothing in the diagram below.
- Reduced tariffs within the bloc, for example, shift the world supply line down from (World Supply + Tariff) to (World Supply). This reduces the price down from (World Price + Tariff) to (World Price)
- This increases imports of clothes from (Q2-Q1) to (Q3-Q), creating trade with other countries in the bloc.
- This results in an **increase in consumer surplus** of area (A + B + C + D).
- Domestic producer surplus decreases by area A. This is because of increased international competition from imports within the bloc.
- Government revenue decreases by area C due to the loss of tariff revenue.
- Altogether, **social welfare increases by areas B + D** due to the extra trade created.



2) Trade diversion due to the common external tariff

Trade diversion means trade may be diverted from a more efficient producer to a less efficient producer.

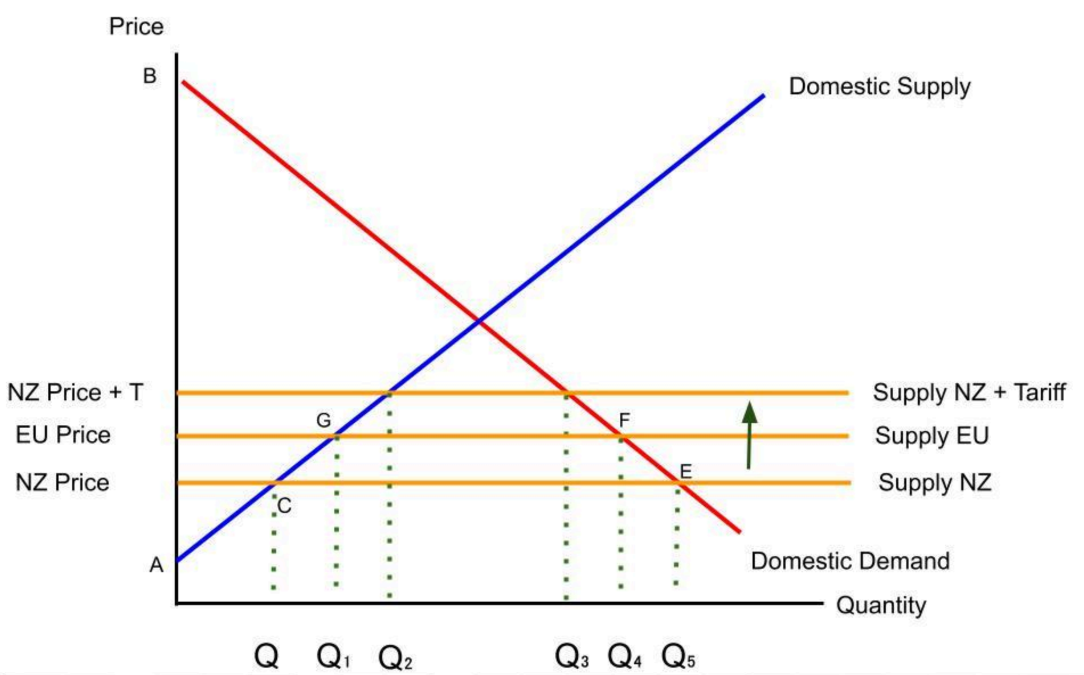
Consider when the UK joined the European Economic Community (EEC) in 1973, the predecessor to the EU. This diagram on the next page represents the UK market for fruit. The UK can choose to import fruit from NZ (New Zealand) or from the EU.

Outside the trading bloc, there are no tariffs on New Zealand imports.

- As a result, NZ prices are lower than EU prices without the tariff.
- So **without the tariff, the UK imports only from NZ.** The amount imported is (Q5-Q). There are no imports from the EU.

Now suppose, as the UK joins the EEC (or similarly the EU), the **UK must impose the common external tariff** on imports from New Zealand.

- This **shifts the NZ supply line upwards to NZ + tariff**, above the EU supply line.
- Hence after the tariff is imposed, it's cheaper for the UK to import fruits from the EU rather than NZ.
- So, **UK consumers buy from the EU rather than NZ**. Imports of fruit fall to (Q4-Q1).



- A tariff on NZ supply shifts NZ supply up from (Supply NZ) to (Supply NZ + Tariff)
- The domestic country previously consumed at the NZ price. After the tariff is imposed, they consume at the EU price.

- This is despite NZ being able to produce it more cheaply when neither NZ nor EU face tariffs. This is trade diversion.

Overall welfare effects of trade diversion:

- Trade diversion as below leads to a **fall in consumer surplus** (by area EU Price-F-E-NZ Price) due to the price rise.
- There is also a **rise in UK producer surplus**, due to the reduction in competition from NZ. The increase in UK producer surplus is area (EUPrice-G-C-NZ Price).
- Note government revenue remains at zero as there are no imports from NZ after the tariff is put in place. So there is no tariff revenue to claim.
- Altogether there is a **welfare loss from trade diversion of area CGFE.**
- This looks similar to the welfare loss from a unilateral rise in tariffs, except there is no government revenue to claim back, making the welfare loss appear larger for a given price rise.

3) Other consequences of trading blocs:

- **More specialisation within the bloc due to removal of trade barriers.**
  - Removing trade barriers makes specialisation more beneficial. Countries can specialise in production of a particular good and then trade, without having to face tariffs.
  - For example, Italy could specialise in wine, while Germany could specialise in cars.
  - This leads to "gains from trade", according to the theory of comparative advantage. In other words, the productive potential of economies within the bloc could increase.
- **Firm growth enables firms to benefit from economies of scale.**
  - Reduced tariffs within the bloc could increase export demand. This could increase firm size.
  - If firms produce more, they may be able to lower their long-run average cost (LRAC). In other words, firms can achieve economies of scale.
  - This could include bulk buying of inputs or spreading the cost of new machinery over a larger amount of output.
  - This could bring down prices for consumers, provided firms pass on the lower LRAC to consumers.
- **However, if there is a common external tariff, there could be less specialisation** at the global level. Domestic firm growth could be slowed due to reduced access to overseas markets.

- **Freedom of movement of labour may reduce geographical immobility of labour**.
    - This could make it easier for firms to find workers and for workers to find jobs that suit their skills.
    - However, it could lead to “brain drain”, where talented workers from poorer countries in the bloc leave the poorer countries to increase their pay. The poorer country would lose out on talented workers.
- **Freedom of movement of (financial) capital:**
    - When joining a trading bloc, Governments may remove restrictions on sending money abroad, to achieve free movement of capital.
    - This makes it easier for firms in one country to attract investment from another country.
    - However it could also encourage domestic investors to invest abroad rather than domestically.
- **Possible AD-AS effects:**
    - There could be a rise in aggregate demand (AD) due to the rise in exports to countries within the bloc. However, there could also be a fall in AD due to the rise in imports.
    - There could be an increase in short-run aggregate supply (SRAS) if business costs fall due to reduced tariffs on imports. However, this could be reversed in the case of trade diversion.
    - There could also be LRAS effects, due to the increase in competition within the bloc for example.

What are the consequences of monetary union?

Some countries such as Poland and Denmark have not adopted the euro as their currency. What are the pros and cons of joining a monetary union?

Monetary union

Advantages	**Disadvantages**
Reduced costs from converting currencies	One-off costs from updating prices
Greater price transparency and competition	A country cannot devalue / depreciate its currency
Lower interest rates (lower risk premium)	No independent monetary policy
Fiscal policy discipline leads to lower inflation	Rules on fiscal policy reduce fiscal flexibility
The success of monetary union depends on	
How much firms trade within the monetary union	
Government budget position (budget deficit or budget surplus)	
Whether member states' economic cycles are aligned.	

The advantages of monetary union are:

- **Less currency conversion**
  - Adopting the euro would remove the need to convert currencies when trading within the euro area.
  - This would reduce currency uncertainty for businesses within the monetary union.
  - Firms no longer have to hold as much foreign currency or use forward contracts to guarantee a future exchange rate. This saves costs for the firm.
- **Prices are easier to compare**
  - With prices within the union now being in the same currency, it is easier for consumers to compare prices in different countries.
  - This increase in price transparency may lead to more competition on prices.
- **Lower interest rates**
  - There may also be lower interest rates when joining the euro area. The reductions in currency risk, adopting ECB monetary policy and fiscal discipline all lead to more confidence that euro area governments can repay their debt.

    - However, some have argued there could be a risk premium from joining the euro area. The lack of policy flexibility, as a result of being in the euro area, makes it harder for member states to mitigate shocks. If anything, this could increase the risk of prolonged downturns and fiscal deficits.
- **Fiscal policy discipline can reduce the inflation rate**
    - Monetary unions may have rules limiting budget deficits of member states.
    - Limits on the budget deficit prevent governments from pursuing inflationary policies, keeping AD low and **bringing inflation down**. This could be an advantage by helping to control inflation.

The disadvantages of monetary union are:

- **One-off costs from updating price information.**
    - There could be short-term disruption and costs from updating prices and menus to be expressed in the new currency.
    - This presents an extra one-off cost for businesses.
- **Joining the euro area means a country would have to comply with euro area rules. This includes keeping budget deficits low.**
    - The monetary union may have an upper limit (e.g. 3% of GDP) on the budget deficit.
    - This reduces the flexibility of governments to respond to country-specific shocks using fiscal policy.
    - For example, suppose Greece faces a downturn while Germany faces a boom.
    - Greece may want to engage in expansionary fiscal policy to escape the recession.
    - Yet the fiscal rules may prevent expansionary fiscal policy as it would increase the budget deficit beyond the limit.
    - [At least in theory. Special circumstances, including Covid, have led to much higher budget deficits among euro area economies].
- **There is only one central bank setting monetary policy for the monetary union.**
    - This means monetary policy cannot be adjusted to deal with country-specific shocks.
    - For example, suppose there is high inflation in Germany but low inflation elsewhere in the euro area. Then the European Central Bank may not increase interest rates to bring down inflation, keeping inflation high in Germany.
    - Being outside the euro, countries such as Poland have their own independent central bank. This enables Poland's central bank to respond to Poland's economic cycle using monetary policy.

- **Monetary union prevents currencies depreciating or devaluing against those of other member states.**
    - Poland, being outside the euro area, has more flexibility in its currency in case of economic shocks.
    - As a result, the Polish currency, the zloty, can adjust automatically to correct any current account imbalances in Poland.
    - For example following the 2008 financial crisis, the zloty depreciated, leading to higher net exports and reducing the current account deficit. This reduced the severity of the downturn in Poland compared to other countries.

<u>What are the conditions necessary for the success of a monetary union?</u>

The euro area has the "Maastricht convergence criteria". These are a set of criteria a country must meet, before it can join the euro area. These include:

- **Inflation rates should be close between member states.**
    - This ensures monetary policy can be appropriate for all countries.
    - This can avoid instances of high inflation in one country and deflation in another.
    - If there were differing inflation rates, this could leave the central bank for the monetary union powerless to bring inflation back to target in all countries at the same time.
- **Fiscal policy constraints: Low budget deficits and low government debt-to-GDP ratios.**
    - For example the euro area's 3% of GDP limit on budget deficits.
    - As member states lack their own monetary policy and their own currency, fiscal policy is the one of the few available policy tools to adjust to the business cycle.
    - Running a low budget deficit ensures member states have the fiscal headroom to use fiscal policy to respond to country-level shocks.
    - It also **prevents a rise in inflation** driven by rising government spending.
    - This also keeps yields on government bonds low. In other words, investors trust in governments' ability to repay debts. With this reduced risk, investors do not require as much interest when lending the government money (through buying government bonds).

There are other Maastricht criteria, including government bond yields being near the euro area average and exchange rate stability before joining the euro area.

Beyond the Maastricht criteria, there may also need to be a **system of fiscal transfers**

- This refers to ways for **governments of states within the bloc to send funds to one another.**
- This could help mitigate country-specific shocks, such as a downturn in Greece while there is a boom in Germany.
- This is because monetary union rules restrict the policy tools of specific countries. This includes rules on fiscal deficits and the centralisation of monetary policy.
- However, it may be controversial for one government to send large amounts of money to another. An example is the controversy in Germany over sending money to Greece in the euro area crisis from 2009 into the 2010s.

What is the role of the World Trade Organisation?

The World Trade Organisation is an international body aiming to promote free trade.

The WTO plays the following roles in trade liberalisation:

- **Operates a set of rules for global trade.**
  - An example is the "most favoured nation" rule. Countries cannot discriminate between trading partners.
  - Suppose the UK lowered its trading barriers with France (its most favoured nation).
  - Then the UK would also have to apply these rules to other countries, giving all countries the most favoured nation treatment.
  - There are limited exceptions to this rule, such as free trade agreements with some conditions.
- **Resolves trade disputes.**
  - The WTO can adjudicate on trade disputes between countries.
  - For example, on accusations of unfair trade practices or of unfair tariffs.
- **Supports developing countries in their "capacity to trade".**
  - This could include training to help officials from developing countries understand WTO rules.
  - The WTO advises developing countries on building ports, technology for customs and teaches entrepreneurs how to reach overseas markets while complying with trade rules.
  - Note the WTO does not act as a large aid donor. Instead, the WTO provides assistance and expertise, while funding for large scale infrastructure projects may

come from other donors such as the World Bank and International Monetary Fund.
- However, these roles could be undermined by large countries in the WTO not sticking to the rules. In such circumstances, the WTO could prove powerless to enforce trade rules.

There is a possible conflict between regional trading blocs and the WTO.

- **Trading blocs may increase tariff rates if they impose common external tariffs**.
    - This could conflict with the WTO's goal of trade liberalisation (removing tariffs).
    - In particular, under the most favoured nation principle, if tariffs are lowered for one country, they should be lowered for other countries.
    - [There are some limited exceptions to this rule, such as when there is an elimination, as opposed to a partial reduction, in tariffs when joining a bloc].
- **This also applies to non-tariff barriers imposed by trading blocs on countries outside the bloc.**
    - An example of this are the "rules of origin" declarations.
    - Sending goods from the UK into the EU after Brexit may involve declaring the origin of the good.
    - This is to avoid goods from other countries sneaking into the EU via the UK (which has a zero-tariff trade agreement with the EU) to avoid EU tariffs and other regulations.
    - However, the rules of origin are being used to "discriminate", in terms of the tariffs set, based on which country the goods come from. This could conflict with the WTO's most favoured nation principle.
- Trading blocs may have their **own mechanisms to resolve trade disputes**, which may be different from those at the WTO.
- To the extent that regional trading blocs reduce tariffs, the WTO and trading blocs should be aligned.
    - There is, however, a debate about whether regional trading blocs are a "stumbling block" or a "building block" to an end goal of global free trade.

Other evaluation points for trading blocs

The success of trading blocs depends on the following points:

For free trade agreements, customs unions and single markets:

- **Proportion of exports / imports to countries within the bloc versus outside the bloc**
    - Where a trade agreement forms between countries that trade very little with each other, the trade creation and trade diversion effects are likely to be smaller.
- **The type of trading arrangement.**
    - For example, with or without common external tariffs. If there are common external tariffs, then there can be welfare losses from trade diversion.
- **Whether non-tariff barriers remain, even if tariffs are eliminated.**
    - In practice, free trade agreements do not eliminate all barriers to trade. Typically, they have targeted tariff elimination on most or all goods, but other trade barriers may remain.
    - Even though there has been progress in eliminating tariffs globally through trade agreements, non-tariff barriers are more likely to remain, such as customs paperwork.
    - This could reduce the extent to which trade deals lead to trade creation.

For a monetary union:

- **Whether the economic cycles of member states are aligned.**
    - For example, if member states have aligned economic cycles, the central bank of the monetary union can set appropriate policy for all member states.
    - This could be achieved by ensuring countries meet convergence criteria before joining the monetary union, such as converging inflation rates.
- **Proportion of trade with member states versus other countries**, similarly to other trading blocs above.
    - This is also important in monetary unions.
    - If there is little trade between members of the monetary union, then the benefits from reduced currency conversion and price transparency are smaller.
- Whether there is a **system of fiscal transfers** to smooth over country-level shocks.
    - This refers to ways for **governments of states within the bloc to send funds to one another.** See the section on monetary union earlier for more on this.

Practice question on trading blocs

Here is a practice question on trading blocs, written in the style of Edexcel Economics A. It features a short extract, followed by a practice question,

Short extract:

Some French politicians have suggested a referendum on whether France should leave the European Union (EU). France is a net contributor to the EU's budget, contributing 9.3 billion euros more than it gets back from the EU in direct payments. This includes funds from the EU to support French farmers. However, the trade, security and mobility benefits of being in the EU are likely to be substantial. 63.6% of imports into France come from other EU member states. Similarly, 54% of France's exports go to other EU countries.

Practice question: Referring to the information provided, evaluate the macroeconomic effects for France of being a member of the European Union. (15 marks)

Related resources for Edexcel Economics A

Edexcel Economics A notes, model answers and practice questions:
https://tfurber.com/edexcel-economics

Edexcel Economics A Theme 4 notes, model answers and practice questions:
https://tfurber.com/theme-4-edexcel-economics/

All model answers written in Edexcel Economics A style:
https://tfurber.com/edexcel-economics-model-answers/

Further notes on:

- Comparative advantage and specialisation.
- Globalisation.
- Restrictions on free trade.