AS – ECONOMICS (9708)

MACRO

CHAPTER 5
International Trade

Topics
1. Terms of Trade
2. Principles of Absolute Advantage
3. Principles of Comparative Advantage
4. Free Trade
5. Protectionism
6. Trade Blocs
7. Trade Creation and Trade Diversion

TOPIC 1: TERMS OF TRADE

1. TERMS OF TRADE

Definition: It is the ration of export prices to import prices. It can be calculated with the following formulae:

$$\text{Terms of Trade (TOT)} = \frac{\text{Price index of exports}}{\text{Price index of imports}} \times 100$$

THREE types of TOT

Favorable	Unfavorable	Balanced
Export Prices > Import Prices $\frac{110}{105} \times 100 = 104$	Export Prices < Import Prices $\frac{105}{110} \times 100 = 95$	Export Prices = Import Prices $\frac{110}{110} \times 100 = 100$

Note: A TOT of greater than 100 is always favorable and TOT below 100 is unfavorable. However if the value of TOT falls e.g. from 120 to 118, this shows that TOT has become less favorable. One thing to note is that on its own TOT has no value and it must be compared with other years or a base year will give valuable results.

Movements in TOT

Favorable/Improvement in TOT	Unfavorable/Deterioration in TOT
1. Price of Exports increases and price of Imports stay the same	1. Price of Exports decreases and price of Imports stay the same
2. Price of Imports decreases Price of exports stay the same	2. Price of Imports increases and prices of exports stay the same
3. Price of Exports rise more faster than the rise in price of imports	3. Price of Imports rise more faster than the rise in price of exports.
4. Price of Exports fall slowly as compared to fall in prices of imports.	4. Price of Imports fall slowly as compared to fall in prices of exports.

2. CAUSES OF CHANGES IN TOT

There are TWO causes of changes in TOT:

1. Changes in the demand of exports and imports
2. Changes in the supply of exports and imports

1. Changes in the demand of exports and imports

Other factors remaining constant if the demand for exports increases it will increase the price for exports hence improvement in TOT. On the other hand if the demand for exports decreases it will reduce the price of exports and deteriorating the TOT.

Quantity Demanded Exports ↑ Price of Exports ↑ → TOT Improves
Quantity Demanded Exports ↓ Price of Exports ↓ → TOT Deteriorates

Other factors remaining constant if the demand for imports increases it will increase the price of imports hence deterioration in TOT. On the other hand if the demand for imports decreases it will reduce the price of imports, hence improving the TOT.

Quantity Demanded Imports ↑ Price of Imports ↑ → TOT Deteriorates
Quantity Demanded Imports ↓ Price of Imports ↓ → TOT Improves

2. Changes in the supply of exports and imports

Other factors remain constant if the supply of exports fall it will increase the prices of exports and improve TOT. On the other hand if the supply of exports increase it will reduce the price of exports and deteriorate the TOT.

Quantity Supplied Exports ↓ Price of Exports ↑ → TOT Improves
Quantity Supplied Exports ↑ Price of Exports ↓ → TOT Deteriorates

Other factors remain constant if the supply of imports increase it will reduce the price of imports and improve TOT. On the other hand if the supply of imports decrease it will increase the price of imports and deteriorate the TOT.

Quantity Supplied Imports ↑ Price of Imports ↓ → TOT Deteriorates
Quantity Supplied Imports ↓ Price of Exports ↑ → TOT Improves

Determinants of Demand and Supply for Exports and Imports and their Prices

Factors	Description
1. Changes in the factors of production	If the resources in the country are more dedicate to export industries rather than import competitive industries it will ruin the TOT, because an increase supply of exports will reduce the export prices. But if the resources are more deployed to the import competing industries then TOT will improve because demand for imports will fall leading to a fall in import price.
2. Changes in Technology	Technology increased for more exports, TOT will deteriorate because of a high supply for exports will reduce the price for exports. But if technology is more fore import competing goods TOT will improve.
3. Change in Tastes	If demand for imported goods increase TOT declines and vice versa.
4. Economic Growth	If the demand in the country for imported goods increase more than the supply for import competing goods TOT will be unfavorable and vice versa.
5. Tariff (Tax on imports)	Increase in tariff will increase the import price and TOT will be worsened and vice versa.
6. Quotas (Quantity limits on Imports)	Increase in quotas will increase the import price, due to less supply which will result in TOT will be worsened and vice versa.
7. Changes in Exchange rates (Devaluation and Revaluation)	Devaluation leads to expensive imports and cheaper exports leading to unfavorable TOT. Whereas revaluation leads to cheaper imports and expensive exports leading to a favorable TOT.
8. Market Conditions	If a country has a monopoly in a particular export, it can increase the export prices, leading to a favorable TOT.
9. Import Substitutes	If a country produces import substitute the demand for its imports would be low hence a favorable TOT.
10. Inflation and Deflation	If domestic inflation rate is higher than the international the exports would be more expensive, improving the TOT and vice versa.

TOPIC 2: PRINCIPLES OF ABSOLUTE ADVANTAGE

Definition | Absolute Advantage: In the context of international trade absolute advantage is a situation where from a given set of resources, one country can produce more of a particular produce than another country. We will take an example into consideration to understand the concept.

(1) Coffee		(2) Robots	(3) Coffee	(4) Robots	(5) Coffee	(6) Robots	(7) Coffee	(8) Robots
8	or	4	4	2	8	0	5	3
3	or	6	1.5	3	0	6	3	3
			5.5	5	8	6	8	6

Consider a simple world economy of two countries, Coffenia and Robotia, that produce coffee and robots. In the table above, columns 1 and 2 show the quantities of coffee and robots that one worker in one day can produce in Coffenia and in Robotia, if they produce only coffee or only robots.

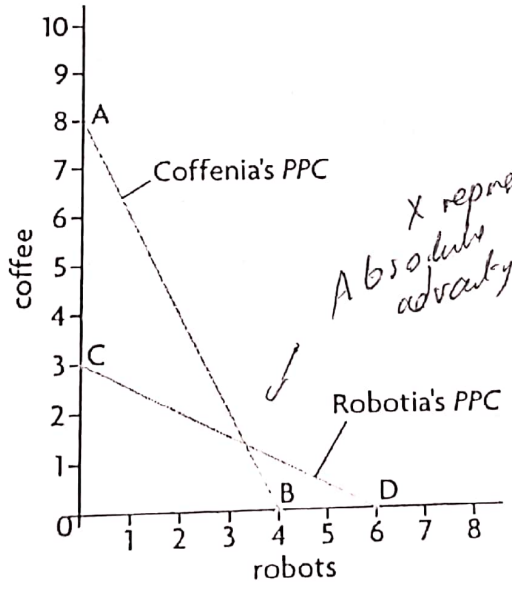
Using this information in the table, we can construct production possibilities curves (PPCs) for Coffenia and Robotia, shown in Figure (a).

— Coffenia produces 8 units of coffee and 0 Robots, it is at point A
— Coffenia produces 0 units of coffee and 4 Robots, it is at point B

— Robotia produces 3 units of coffee and 0 Robots, it is at point C
— Robotia produces 0 units of coffee and 6 Robots, it is at point D

Robotia's absolute advantage in robots, because its PPC extends further on the robot axis
Coffenia's absolute advantage in coffee, since its PPC extends further on the coffee axis.

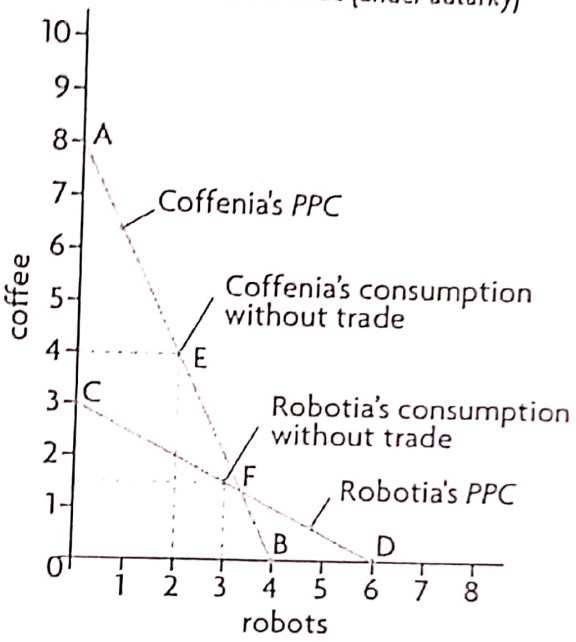
(a) Coffenia: absolute advantage in coffee;
Robotia: absolute advantage in robots



Production and consumption with no trade

Coffenia and Robotia can produce anywhere along their PPC, depending on how they allocate their resources between production of coffee and robots. If they do not trade with each other, each one produces both robots and coffee, as this is the only way they can consume both. Under no trade, suppose that each worker in Coffenia and Robotia spends half her/his time producing robots and half producing coffee. The results are shown in columns 3 and 4 in the Table, and they are plotted on Figure (b) to point E on Coffenia's PPC (4 units of coffee and 2 robots) and point F on Robotia's PPC (1.5 units of coffee and 3 robots). Total production in both countries is therefore 5.5 units of coffee and 5 robots, appearing at the bottom of columns 3 and 4.

(b) Production and consumption in Coffenia and Robotia without trade (under autarky)

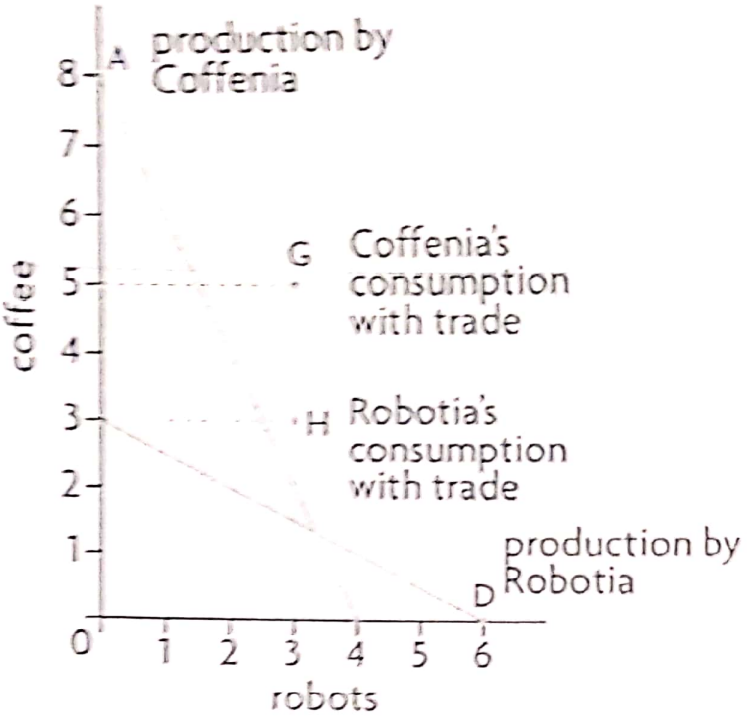


Production and consumption with trade

Suppose that both countries agree to specialize in and export the good in which they have absolute advantage. Coffenia therefore specializes entirely in production of coffee, moving to point A on its PPC, and Robotia specializes entirely in production of robots, moving to point D on its PPC. This is shown in columns 5 and 6, where Coffenia produces 8 units of coffee (and 0 robots) while Robotia produces 6 robots (and 0 units of coffee). Adding up total production in both countries, we see that compared to no trade, production has increased by 2.5 units of coffee and 1 robot!

Now suppose that Coffenia and Robotia agree to trade with each other at the 'price' ratio of 1:1; in other words, 1 unit of coffee trades for 1 robot. Figure (c) shows that as a result of trade, Coffenia consumes at point G and Robotia at point H. **Whereas both countries are producing on their PPC, due to trade they can consume at a point outside their PPC!** Hence both countries become better off because specialization according to absolute advantage leads to a 'global' reallocation of resources where production takes place by the most efficient (low- cost) producers.

Production and consumption in Coffenia and Robotia with trade based on absolute advantage



TOPIC 3: PRINCIPLES OF COMPARATIVE ADVANTAGE

Definition | Comparative Advantage: In the context of international trade, a situation where a country can produce a product at a lower opportunity cost than another country. David Ricardo, in his famous theory of comparative advantage was able to show that countries can gain from specialization and trade even if one country has the absolute advantage in both goods. Example: If country A can produce both machines and agriculture better than country B, however the country B has a lower opportunity cost than country A in production of agriculture, then according to comparative advantage country A should specialize in machines whereas country B should specialize in agriculture.

Law of comparative advantage

A country has a comparative advantage in the production of a good when this can be produced at a lower opportunity cost than its trading partner. According to the theory (or law) of comparative advantage, as long as opportunity costs in two (or more) countries differ, it is possible for all countries to gain from specialization and trade according to their comparative advantage. The global allocation of resources improves, resulting in greater global output and greater global consumption, allowing countries to consume outside their PPC.

(1) Cotton		(2) Microchips	(3)	(4)
20	or	10	$\frac{10 \text{ units of microchips}}{20 \text{ units of cotton}} = \frac{1}{2}$	$\frac{20 \text{ units of cotton}}{10 \text{ units of microchips}} = 2$
25	or	50	$\frac{50 \text{ units of microchips}}{25 \text{ units of cotton}} = 2$	$\frac{25 \text{ units of cotton}}{50 \text{ units of microchips}} = \frac{1}{2}$

Consider a simple world economy of two countries, Cottonia and Microchippia, producing cotton and microchips. The table shows the quantities of each good that one worker can produce in one day if only one or the other good is produced.

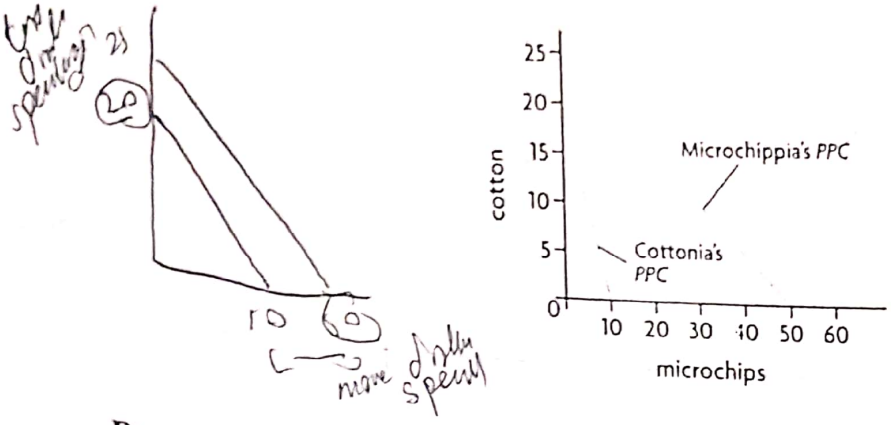
Using this information in the table, we can construct production possibilities curves (PPCs) for Cottonia and Microchippia, shown in Figure (b).

— Cottonia produces 20 units of cotton and 0 Microchips
— Cottonia produces 0 units of cotton and 10 Microchips

— Microchippia produces 25 units of cotton and 0 Microchips
— Microchippia produces 0 units of cotton and 50 Microchips

We can see that Microchippia has an absolute advantage in the production of both cotton and microchips, because with the same resources (one worker in one day) it can produce more of both goods than Cottonia.

Figure (a) plots the PPCs of each of the two countries based on the data of the Table (assuming straight-line PPCs). Microchippia's absolute advantage in the production of both goods is apparent from the fact that its PPC lies entirely above the PPC of Cottonia.



Determination of comparative and absolute advantage from the graph

When comparing the PPCs of two countries, we can see immediately whether one country has the absolute advantage in one or both of the goods.

— If the **PPCs intersect**, this means that each country has an absolute advantage in one of the two goods (for example, Coffenia in coffee and Robotia in robots).

— If the **PPCs do not intersect**, as in the Figure above, this means that the country with the PPC lying fully above the second PPC has an absolute advantage in the production of both goods (in our example this is Microchippia).

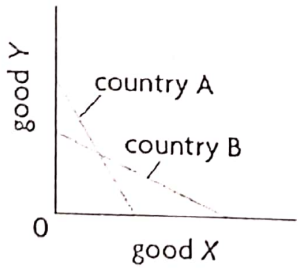
If two PPCs do not intersect, as in the figure above, how can we determine comparative advantages?

→The flatter PPC has a comparative advantage in the good measured on the horizontal axis.

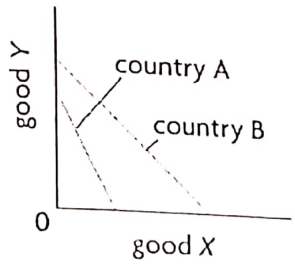
→The steeper PPC has a comparative advantage in the good measured along the vertical axis.

In the figure below, Microchippia's PPC is flatter than Cottonia's PPC; therefore, Microchippia has a comparative advantage in microchips, which are measured along the horizontal axis. Cottonia, with the steeper PPC, has the comparative advantage in cotton.

(a) Country A: absolute advantage in good Y; Country B: absolute advantage in good X



(b) Country A: comparative advantage in good Y; Country B: comparative advantage in good X



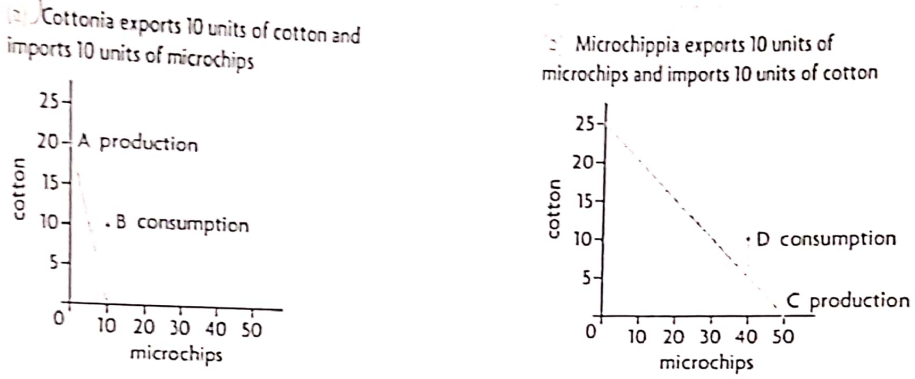
Production and consumption with trade

In fact, it can be shown that with trade, both countries will consume at a point outside their PPCs.

— In Figure (a), Cottonia produces at point A of its PPC where it specializes entirely in cotton; in

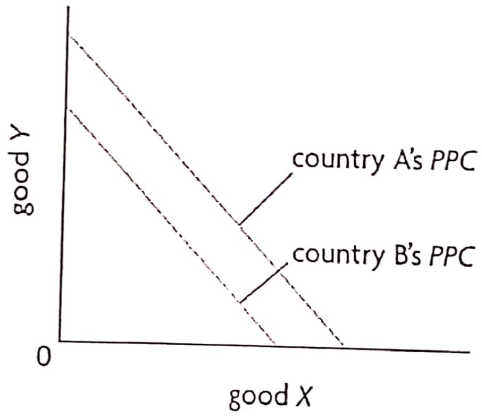
— Figure (b), Microchippia produces at point C where it specializes entirely in microchips.

Therefore, whereas under no trade they would be producing and consuming on their PPC, as a result of specialization and trade both countries succeed in increasing their consumption to a greater level than what is possible under no trade.



PPC and No Trade

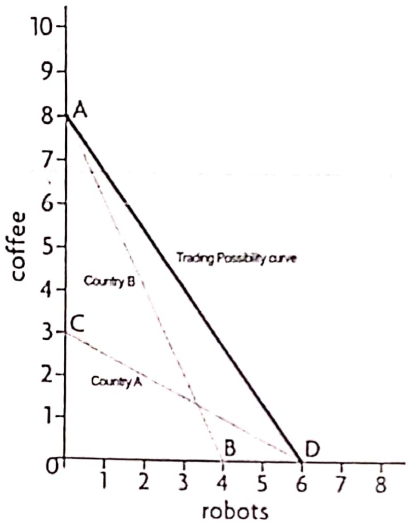
If two PPCs are parallel means that the two countries face identical opportunity costs for the two goods. If opportunity costs are identical, there is no country in which one good is relatively cheaper; therefore, there is no country that has a comparative advantage in the production of one or the other good. Under these circumstances there are no possibilities for countries to gain from specialization and trade, and there is therefore no point in these countries specializing and trading with each other.



Note: Parallel PPC leads to no trade.

Trading possibility curve

Definition: A diagram showing the effects of a country specializing and trading. This highlights that countries can consume on a point outside their PPC if they take part in international trade.



From the above diagram we can see that if Country A still wishes to consume 2 units of coffee, it could now produce 6 units of robots and exchange 2 units of robots for 2 units of coffee. It would then have its 2 units of coffee but will have 4 extra units of robots (previously which were 2 without trade).

In any question of this chapter
-> refer to absolute and comparitive advantage

TOPIC 4: FREE TRADE

Definition | Free Trade: Free international trade is the exchange of goods and services across national borders without any government restrictions. When free trade exists, firms are free to export and import what they want in the quantities they want. There are several advantages and disadvantages of free trade.

Refer to absolute -> and comparitive advantage

Advantages and Disadvantages of Free Trade

Advantages	Disadvantages
1. Economy in the Use of Productive Resources: Each country tries to produce those goods in which it is best suited. As the resources of each country are fully exploited, there is thus a great economy in the use of productive resources. This also leads to economies of scale for the country.	1. Exhaustion of Resources: In order to earn present export advantages a country may exploit her limited natural resources beyond proper limits. This may lead to exhaustion of essential material resources like iron, coal, oil, etc. The future generation thus stands at a disadvantage.
2. Wider Range of Commodities: International trade makes it possible for each country to enjoy wider range of commodities than what is otherwise open to it. The commodities which can be produced at home at relatively higher cost can be brought from the cheaper market from abroad and the resources of the country thus saved can be better employed for the production of other commodities in which it is comparatively better fitted.	2. Effect on Domestic Industries: If no restrictions are placed on the foreign trade, it may ruin the domestic industries and cause widespread distress among the people. This will due to unemployment created since it will lead to jobs losses.
3. Scarcity of Commodities: If at any time there is shortage of food or scarcity of other essential commodities in the country, they can be easily imported from other countries and thus the country can be saved from shortage of commodities and low standard of living.	3. Effect on Consumption Habits: Sometimes it so happens that the traders in order to make profits import commodities which are very harmful and injurious to the people for instance, if opium, wine, etc., are imported, it will adversely affect the health and morale of the people.
4. Promotes Competition: International trade promotes competition among different countries. The producers in home country, being afraid of the foreign competition, keep the prices of their products at reasonable level.	4. It can lead to activities like dumping. This is when foreign firms sell their products in large quantities at below than the cost price deliberately to destroy the local industry.
5. Speedy Industrialization: International trade enables a backward country to acquire skill, machinery; and other capital equipment from industrially advanced countries for speeding up industrialization.	5. It might lead to BOP deficit. This is when a country is importing more than its exporting. This can exhaust the counties financial resources.
	6. It might make a country dependent on another country. This might be potentially disastrous in times of war. e.g. relying for oil

Unevenly distributed

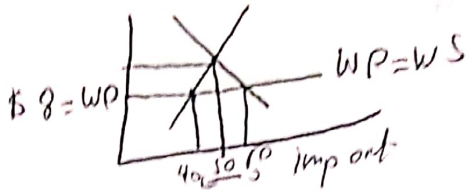
This is done by importing good quality raw material from abroad

data response question

an economy start selling product at very low prices, destroying the local economy. e.g. China

Evaluations

1) Only beneficial if it was done on theories of absolute and comparitive advantage
2) International trade is only beneficial if both countries are on the same stage of economic development
3) Benefit of the economy depending on the level of trading bloc they have developed -> benefit is lowest in free trade areas and highest in economic union. (Topic 6)



TOPIC 5: PROTECTIONISM

Definition | Free trade: Free trade refers to the absence of government intervention of any kind in international trade, so that trade takes place without any restrictions (barriers) between individuals or firms in different countries.

Diagrams in International Trade

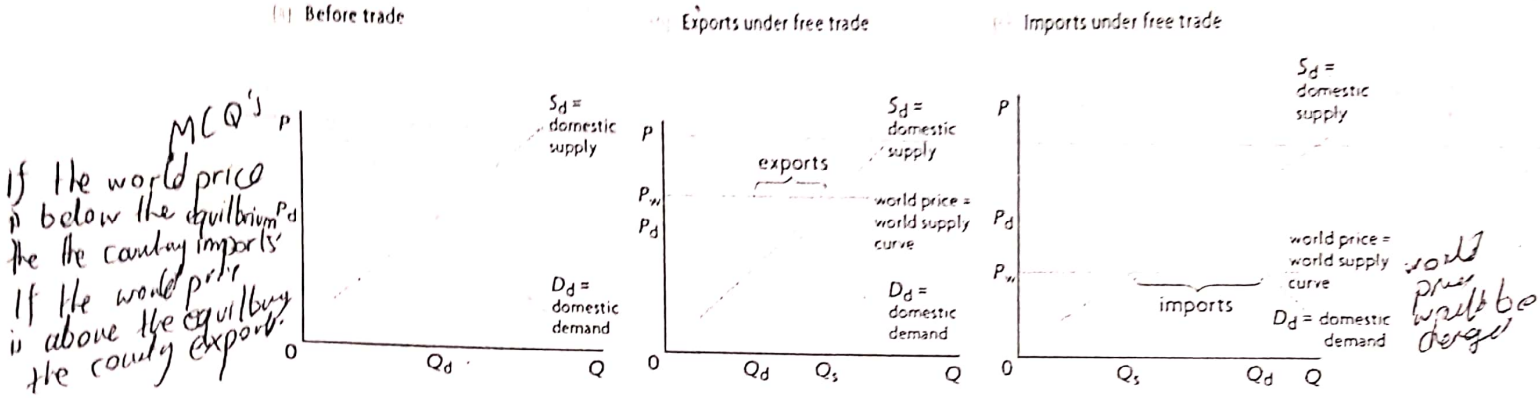


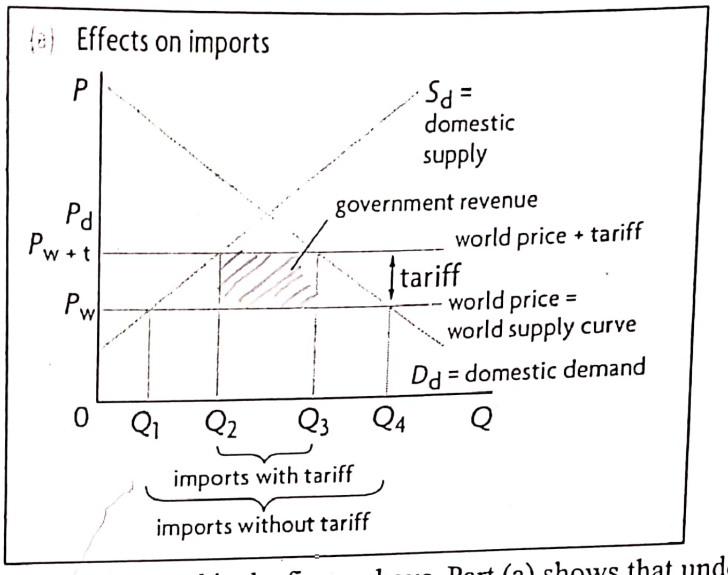
Diagram (a) [No-Trade]	Diagram (b) [Export]	Diagram (c) [Import]
Figure (a) shows the familiar equilibrium price and quantity of goods determined in a domestic market under no international trade. When the country decides to open its economy to international trade, the question arises, should goods be imported or exported?	When the world price, Pw, to be higher than the domestic price, Pd. Once the country opens its economy to international trade, it accepts the world price Pw, and the domestic price, Pd will no longer be relevant. At the higher price Pw, the quantity of goods supplied, Qs, is larger than the quantity of goods demanded, Qd. This excess quantity supplied, which is Qs − Qd, is available to be sold to buyers abroad, or exported.	When the world the world price of goods, Pw, is lower than the domestic price, Pd. Accepting the world price Pw, where the quantity of goods demanded, Qd, is larger than quantity of goods supplied, Qs, the country now has an excess quantity demanded, Qd − Qs, which is the quantity of bindles to be purchased from abroad, or imported.

Definition | Protectionism: This refers to the protection of domestic industries from foreign competition by means of tariffs and non-tariff barriers. This is also called protectionism. The main aim of the government is to give a competitive advantage to domestic industry. There are several methods that a government can use for trade protectionism:

1. Tariffs
2. Quotas
3. Exchange Controls
4. Export Subsidies
5. Embargos
6. Voluntary Export Restraints (VER)
7. Excessive Administrative Burdens (Red Tape)
8. Exchange Rate Manipulation

1. Tariffs

Definition: Also known as custom duties and they act as a tax by artificially raising the price of foreign products. These tariffs might be ad valorem or specific. Tariffs may serve two purposes. One is to protect a domestic industry from foreign competition (a protective tariff), and the other is to raise revenue for the government (a revenue tariff).



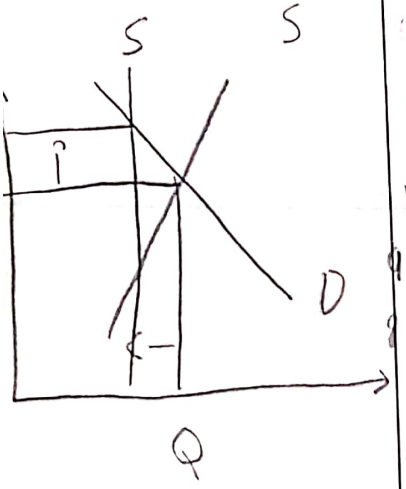
The effects of a tariff are illustrated in the figure above. Part (a) shows that under free trade, the country accepts the world price Pw, at which it produces quantity Q1 (given the intersection of Sd with the world supply curve), demands quantity Q4 (given by the intersection of
Dd, with the world supply curve), and imports Q4–Q1. Suppose a tariff is imposed on the imported good. As a result, the price of the imported good rises, to Pw + t, causing the domestic price of the good to rise above the world price by the amount of the tariff, to Pw + t.

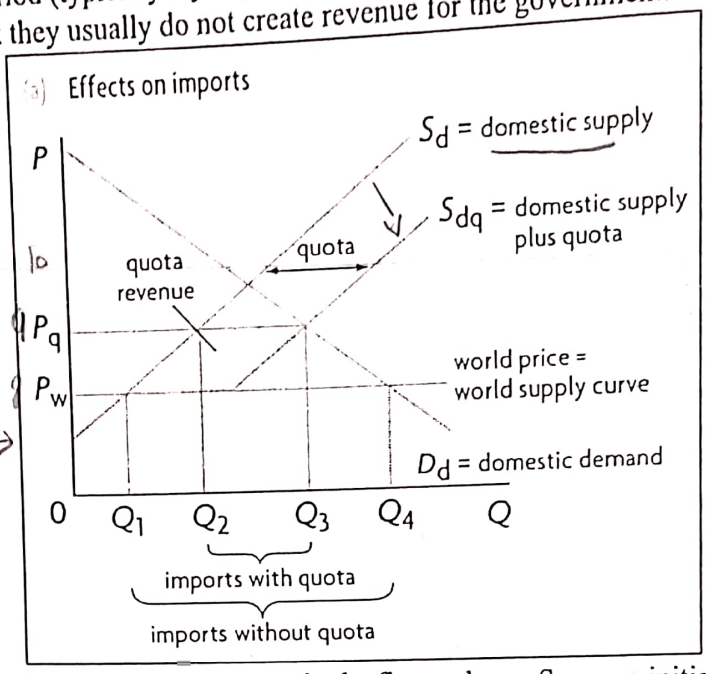
Advantages	Disadvantages
1. The domestic production increases from Q1 to Q2 this will also lead to increase in employment locally. 2. The government earns tax revenue. This can be used for other developmental projects. 3. Imports fall from (Q1-Q4) to (Q2-Q3) this helps the government achieve its objective.	1. Consumers lose from the tariff, because they must pay a higher price, Pw + t; and they can only buy a smaller quantity, Q3 (rather than Q4) 2. There is a negative impact on income distribution, because the tariff is a type of regressive tax 3. Foreign countries might lose their exports

Physical quantity restriction

2. Quotas

Definition: This is a legal limit to the quantity of a good that can be imported over a particular time period (typically a year). The effects of quotas are similar to the effects of tariffs, except that they usually do not create revenue for the government.





We can see the effects of an import quota in the figure above. Suppose initially the economy is importing under free trade; quantity Q1 is supplied by domestic producers, quantity Q4 is demanded, and the excess of quantity demanded over quantity supplied, Q4 − Q1, represents imports. The government then decides to impose a quota on imports, limiting the quantity that can be legally imported to Q3 − Q2. This restriction in effect shifts the supply curve to the right by the amount of the quota. In the figure the new, after-quota supply curve is shown by Sdq and represents domestic supply plus the quantity specified by the quota. The new equilibrium domestic price is determined by the intersection of the domestic demand curve with Sdq, and is Pq.

Note: The advantages and disadvantages are the same as Tariffs.

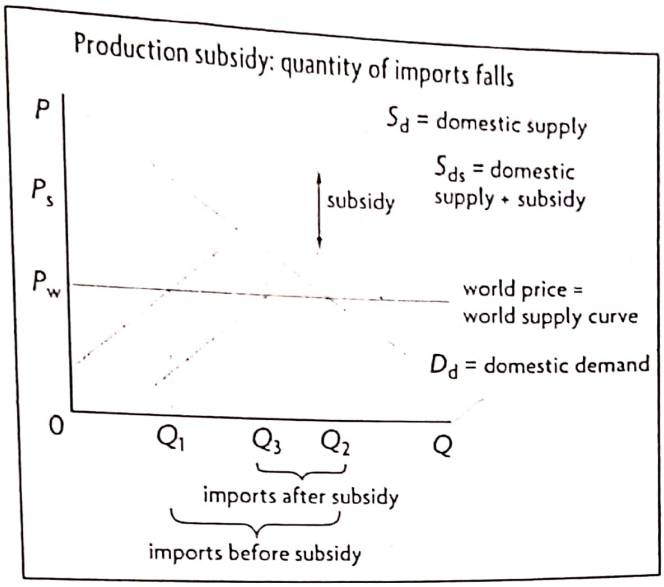
3. Exchange Controls

Definition: This requires foreign currency owned by exporters to be surrendered to the central bank which will pay for them in the home currency. Importers who want foreign currency must apply to the central bank which can thus control the variety and volume of imports by controlling the issue of foreign currency.

4. Export Subsidies

Definition: Some governments give subsidies to certain domestic industries so to protect them from foreign low-price goods. The subsidy reduces the domestic product and hence make it more difficult for the foreign producer to sell a similar product in the home market. Thee losers will be the foreign firms and domestic taxpayers. Domestic producers will gain. Consumers will also benefit in the short run. In the long run, however, they may lose if the more efficient foreign firms are driven out of business and the subsidized domestic firms raise their prices.

AATIK TASNEEM | AS-LEVEL: ECONOMICS (9708) | 03041122845



Under free trade, the country would produce quantity Q1 of the good, quantity demanded would be Q2, and excess demand of Q2 – Q1 would be satisfied by imports. Now suppose the government grants a subsidy to domestic firms producing the good per unit of output produced. The subsidy causes the domestic supply curve to shift rightwards by the amount of the per unit subsidy, to S_{ds}. The good continues to sell at the world price, P_w. This increases the local quantity supplied from Q1 to Q3 and reduces imports from (Q1-Q2) to (Q3-Q2)

5. Embargos

Definition: An embargo is a complete ban either on the imports of a particular product or on trade with a particular country. A government may want to ban the import of a product that it regards as harmful, e.g., non-prescription drugs or weapons. A ban on trade with a particular country may arise from political disputes.

6. Voluntary Export Restraints (VER)

Definition: It is an agreement between two countries where the government of the exporting country agrees to restrict the volume of its exports of a good or services. Example: Japan has several VERs with EU and the USA in the exports of its cars.

7. Excessive Administrative Burdens (Red Tape)

Definition: A government may seek to discourage imports by requiring importers to fill out time consuming forms. It may also set artificially high product standards to restrict foreign competition. Such measures restrict consumer choice.

8. Exchange Rate Manipulation

Definition: A government may manipulate the country's exchange rate in order to give its producers a competitive advantage. This can be done by keeping the exchange rate below its market value to encourage exports and reduce imports. This may lead to other governments lowering their exchange rates in response though.

Usually done in fixed and managed floating exchange rate.

Arguments FOR trade protection

There are several arguments that can be made in the favor in trade protectionism

1. Protect infant industries
2. Protect declining industries
3. Protect strategic industries
4. Prevent dumping
5. Improve the terms of trade
6. Improve the balance of payments
7. Earn tax revenue
8. Retaliation

1. Protect infant industries

Infant industries are small firms who do not have a comparative advantage against the already established firms, since the existing firms are already technically and financially superior which allows them economics of scale. Hence protection allows these small firms to gain economies of scale and become competitive however there is also the risk that an infant industry may become dependent on protection. Knowing that rival foreign products are being made artificially expensive, it may not feel any pressure to lower its costs.

2. Protect declining industries

If a local industry declines it might cause sudden unemployment. In this situation temporary protection may allow the company to run and prevent structural unemployment however this will come at the cost of the consumers who will be denied cheaper imported goods.

3. Protect strategic industries

Some governments seek to protect industries that produce products they regard as strategic, such as weapons, fuel and food. They may not want to be dependent on foreign supplies of these products. For example, a government may be worried that firms and households in its country would be seriously disadvantaged if fuel was cut of due to a trade dispute or a military conflict. As a result it may protect some home industries even if they are relatively inefficient

4. Prevent dumping

Dumping refers to the practice of selling a good in international markets at a price that is below the cost of producing it. Dumping is considered to be an unfair trade practice, and is illegal according to international agreements. Through protection the country can impose tariffs or quotas in order to limit imports of the subsidized, or dumped good. However the main problem with this argument is that because of difficulties involved in proving that dumping is being practiced, many governments often use it as an excuse to offer protection to their domestic producers when this protection is not necessary or justifiable.

5. Improve the terms of trade

By imposing trade restrictions the demand for imports can be lowered hence reducing their prices which will improve the terms of trade. However this will only work if the demand for imports is elastic. If the demand is inelastic and tariffs are imposed they will in return increase prices of imports and worsen the TOT. Furthermore such actions can also distort trade and is likely to reduce global output. It may also provoke retaliation.

6. Improve the balance of payments

A balance of payments deficit occurs when the outflow of money from a country is greater than the inflow, and usually happens when there is an excess of imports over exports. If imports are greater than exports, it would seem that a way to correct the problem would be to impose barriers to the entry of imports into the country, limiting imports and therefore the need to make payments abroad. However, decreased imports would come at the expense of falling exports in exporting countries, and there is a risk of retaliation Trade protection could be used as a short-term emergency measure if there is a serious balance of payments deficit. Over the longer term there are other, more effective ways to deal with this problem.

7. Earn tax revenue

Government also impose restrictions like taxes to earn tax revenue which can be used to provide merit goods to the masses and the government can use the money for development. However, tariffs have certain disadvantages, as they are a regressive type of tax, and so have negative impacts on income distribution. The convenience of relying on tariff revenues may also work as an excuse for governments to delay tax system reform. Therefore, reliance on tariffs as a source of government revenues should be a temporary measure to be gradually phased out as countries grow and develop.

8. Retaliation

Some government also use restrictions as a source of relation. This way a government tries to persuade another government to reduce its trade protection. Furthermore this is also used this might also be the case in case of a political dispute where county's impose embargos. However it should be noted that there is, a risk that a trade war will develop.

Arguments AGAINST trade protection

1. Increased Prices
2. Retaliation
3. Firms might become inefficient
4. Bureaucratic inefficiency

1. Increased Prices

Methods like tariffs and red tape might push up prices and restrict the choice of consumers. This is due to higher prices of protected goods and lower quantities of goods available in the market (the only exception is subsidies, where the quantity consumed and price paid by consumers remain unaffected). The losses experienced by consumers as a rule are greater than the benefits to producers, confirmed by many studies that measure the effects of trade restrictions.

2. Retaliation

If one country imposes restriction the other country might retaliate and this could lead to the loss of comparative and absolute advantage. This might also lead to a trade war which will lead to everyone losing the game at the end of the day.

3. Firms might become inefficient

Local firms might start taking protectionism for granted and stop focusing on cost cutting and being efficient. Hence protection should not prevent growth and should only be used for a short period of time and removed as soon as possible.

4. Bureaucratic inefficiency

Sometimes imposing restrictions might lead to large administrative costs like collecting tariffs, ensuring quotas and preventing black markets. Furthermore government officials might start accepting bribes from importers to give them favorable treatment which might lead to corruption.

TOPIC 6: TRADE BLOCS

Definition | Trade Blocs: This is a regional group of countries that have entered into a trade agreement. The purpose is to reduce international trade barriers and encourage international trade. There are several examples of these trade agreements, e.g. NAFTA, ASEAN, European Union (EU). The process of regional integration entails FOUR successive stages, under which countries link their economies more closely:

1. Free Trade Area
2. Customs Union
3. Common Market
4. Economic and Monetary Union

1. Free Trade Area

Definition: In this type of trade bloc, the governments of the member countries agree to remove trade restrictions between each other. The members are allowed to determine their own external trade policies towards non-members. An example of a free trade area is the North American Free Trade Agreement (NAFTA). This consists of the USA, Canada and Mexico.

2. Customs Union

Definition: Customs unions go a stage further in terms of economic integration than free trade unions. As well as removing trade restrictions between members, members of a customs union agree to impose a common external tariff on trade with non-members. The world's oldest customs union is the Southern Africa Customs Union (SACU). Its members include Botswana, Lesotho, Namibia, South Africa and Swaziland. These countries impose the same tariff on goods being imported from outside the trading bloc. The countries share tariff revenues and coordinate some trading policies.

3. Economic and Monetary Union

Definition: An economic union includes even more economic integration. In this case, restrictions are removed on the movement not only of goods and services, but also capital and labor. The European Union (EU) is an example. It operates a single market and its members have adopted the same policies on a number of labor market and social issues. Most of the___ members have adopted the same currency, the euro, and the European Central Bank operates___ a single interest rate.

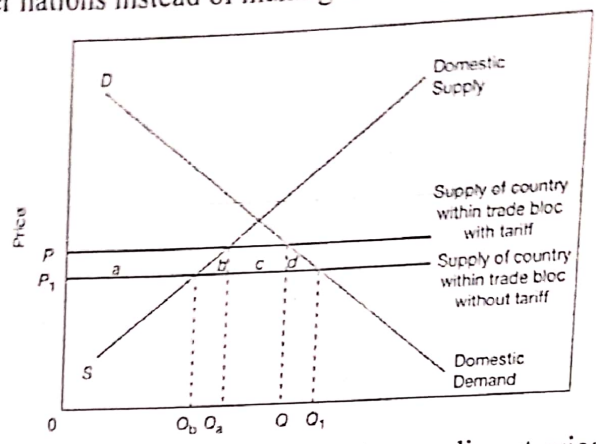
– Monetary union involves economies operating the same currency, as the members of the euro area do.

– Full economic union is the final stage of integration. This involves the members having the same currency and following all the same economic policies. In effect, the different economies become one economy. This occurred when the 13 original states formed the United States of America.

TOPIC 7: TRADE CREATION AND TRADE DIVERSION

1. Trade Creation

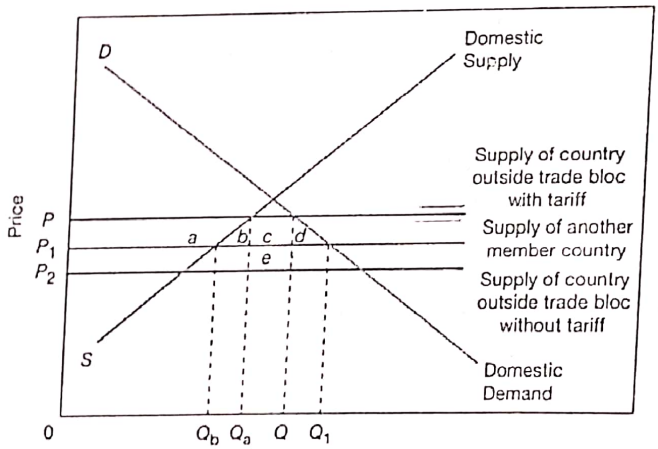
Definition: This is a situation when the removal of tariffs allows members to specialize in those products in which they have a comparative advantage. A country imports cheaper products from member nations instead of making more expensive products domestically.



As we see from the diagram above the economy was first trading at price P with quantity Q. When the county starts to purchase from member countries with lower prices, the quantity consumed increased to Q1. However domestic production fell from Qa to Qb.

2. Trade Diversion

Definition: Trade diversion occurs when membership of a trade bloc results in a country buying imports from a less efficient country within the trade bloc rather than from a more efficient country outside the trading bloc. This results in a less efficient allocation of resources.



As we see from the diagram above that it is clearly cheaper to buy from a country without a tariff at price P2 however the country is buying at P1 because it is much expensive to buy at price P. Hence though a foreign country is more efficient in production however due to a common tariff we won't buy from it.