157. Preferential trade agreements

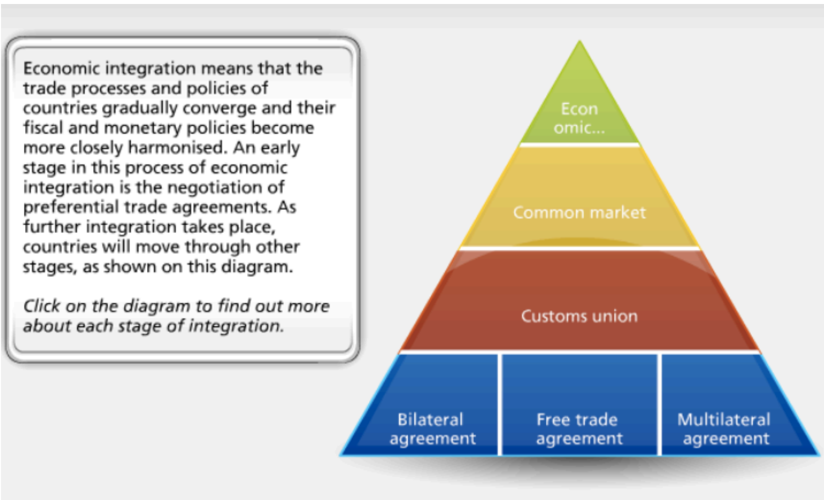
Item 157 – Grade 3

Ib question

• Distinguish between bilateral and multilateral (WTO) trade agreements.

- Economic integration

  → It means that the trade processes and policies of countries gradually converge and their fiscal and monetary policies become more closely harmonized



- Bilateral trade agreements

  → An agreement relating to trade between two countries. The aim is usually to reduce or remove tariffs and/or quotas that have been placed on items traded between the two countries.

- Multilateral trade agreements

  An agreement relating to trade between multiple countries. The aim is usually to reduce or remove tariffs and/or quotas that have been placed on items, but the agreement in this case applies to all of the multiple countries involved.

158. Trading blocs

Item 158 – Grade 3

Ib question

• Explain that preferential trade agreements give preferential access to certain products from certain countries by reducing or eliminating tariffs, or by other agreements relating to trade.

• Distinguish between a free trade area, a customs union and a common market.

• Explain that economic integration will increase competition among producers within the trading bloc.

• Compare and contrast the different types of trading blocs.

A trading bloc

→A group of countries that join together in some form of agreement in order to increase trade between themselves and/or to gain economic benefits from cooperation on some level (This coming together is economic integration)

1. Preferential trading areas (PTA)

   → A trading bloc that gives preferential access to certain products from certain countries. This is usually carried about by reducing, but not eliminating, tariffs.

   → Ex) There is one between the EU and the African, Carribbean and Pacific Group of States (ACP). This is an agreement between the EU and 78 counties in the ACP.

2. Free trade areas

→ An agreement made between countries, where the countries agree to trade freely among themselves, but are able to trade with countries outside of the free trade areas in whatever way they wish.

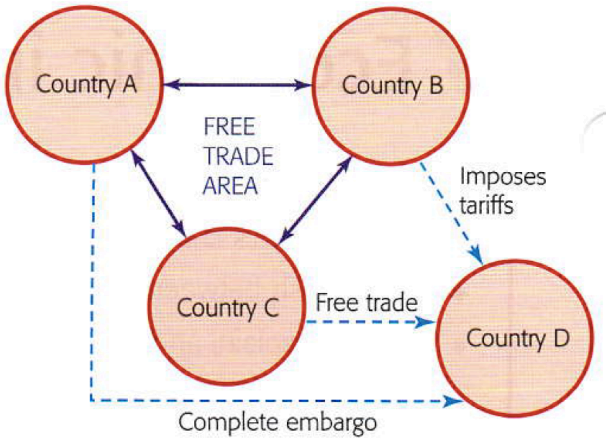


Figure 25.1 A free trade area

Explanation for this diagram

- In this hypothetical case, countries A, B, and C have signed a free trade agreement and are now trading freely among themselves.
- HOWEVER, under the agreement, each country may trade with any other country in any way sees fit
- Country A has political grievances with country D and so has placed a complete embargo on foreign trade
- Country B protects its economy from country D by placing tariffs on a number of its imports
- Country C has a good relationship with country D and trades freely with it
- Examples of free trade area:

  → North American Free Trade Area (NAFTA), which consists of USA, Canada, and Mexico

  → European Free Trade Association

  → South Asia Free Trade Agreement

3. Customs unions

→ It is an agreement made between countries, where the countries agree to trade freely among themselves, and they also agree to adopt common external barriers against any country attempting to import into the customs union

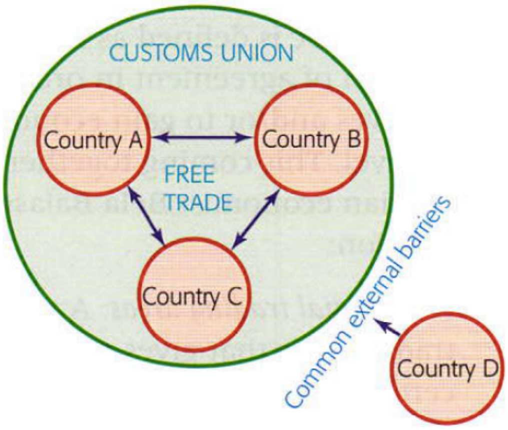


Figure 25.2 A customs union

Explanation for the diagram

- Countries A, B, and C have joined in a custom union and are trading freely with each other
- If country D wishes to export goods to the customs unions, the goods will be treated in the same way, no matter which country the goods enter
- If the customs union has agreed to place tariffs on the products of country D, then those tariffs will be imposed, no matter what the point of entry to the customs union
- Examples of custom unions:

  → The EU has one

  → Switzerland-Liechtenstein customs union

  → The East African Community (Kenya, Uganda, and Tanzania)

  → Mercosur (Brazil, Argentina, Uruguay, Paraguay, and Venezuela)

4. Common markets

→ A customs union with common policies on product regulation , and free movement of goods, services, capital, and labour

- Examples: The EU, The CARICOM Single Market and Economy (CSME)

5. Economic and monetary union

   → It is a common market with a common currency and a common central bank

   → Example: The Eurozone, which includes the member countries of the EU that have adopted the euro as their currency and have the European Central Bank as their central bank

6. Complete economic integration

   → It is the final stage of economic integration, at which point the individual countries involved would have no control of economic policy, full monetary union, and complete harmonization of fiscal policy

   → This is what the Eurozone is moving towards

Evaluation of trading blocs

The benefits of being a member of a trading bloc

(Which are similar to those of free trade)

→ A greater size of market with the potential for larger export markets, increased competition leading to greater efficiency, more choice, and lower prices for consumers.

→ The consequences may not be even, as some domestic producers a re likely to gain from the larger market while others may find themselves unable to compete,

→ There may be further stimulus for investment due to the larger market size, and foreign investment might be attracted from outside the bloc as a way of getting a foot in the door of the larger market

→ There is also an argument that, along with the economic gains, a trading bloc will foster greater political stability and cooperation.

→ It is also possible that trade negotiations may be easier in a world made up of a number of large trading blocs, rather than among 149 sovereign states

The disadvantages of being a member of a trading bloc

→ Since trading blocs favour increased trade among members, but enact discriminatory policies against non-members, this can be damaging to the achievements of the multilateral trading negotiations f the WTO. There is concern that the breakdown in WTO talks in Geneva in July 2006 will lead to an increase in the number of individual trade negotiations. These may undermine the international trade rules and limit the potential gains to trade achievable with more liberalized world trade. This may not be as much of a problem for large economies as it might be for small or poor economies that have little bargaining power.

159. Trading blocs (HL)

Item 159 – Grade 3

Ib question

• Explain the concepts of trade creation and trade diversion in a customs union.

• Explain that different forms of economic integration allow member countries to gain from economies of scale.

- Trade creation and trade divisions

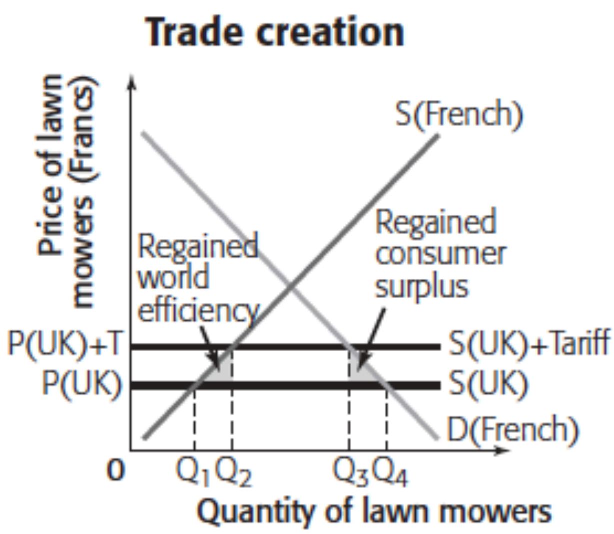
→ Relates to the concept of custom unions

Trade creation

- It occurs when the entry of a country into a customs union leads to the production of a good or service transferring from a high-cost producer to a low-cost producer

→ This is an advantage of greater economic integration

Example

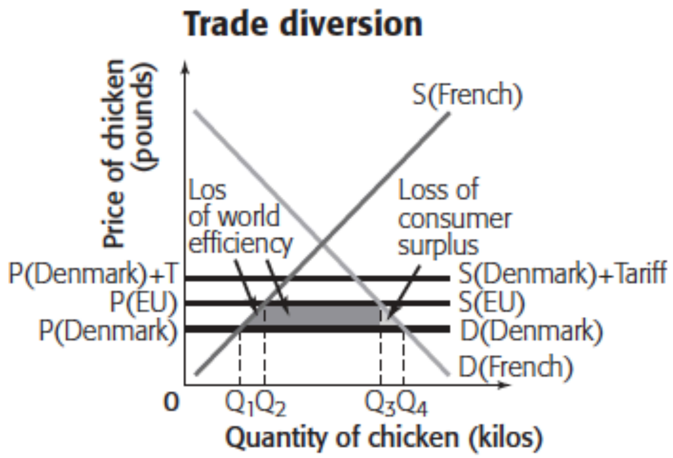


- Trade diversion

- It occurs when the entry of a country into a customs union leads to the production of a good or service transferring from a low-cost producer to a high-cost producer

  → This is a disadvantage of greater economic integration

Example



160. Monetary union

Item 160 – Grade 4

Ib question

• Explain that a monetary union is a common market with a common currency and a common central bank.

• Discuss the possible advantages and disadvantages of a monetary union for its members.

Economic and monetary union

→ It is a common market with a common currency and a common central bank

→ Example: The Eurozone, which includes the member countries of the EU that have adopted the euro as their currency and have the European Central Bank as their central bank

Advantages

- Exchange rate fluctuations that used to exist between countries will disappear with a common currency → this should eliminate exchange rate uncertainty between the countries involved, which should increase cross-border investment and trade
- A currency which has the enhanced credibility of being used in a large currency zone should be more stable against speculation than the individual currencies were.
- Business confidence in the member countries tends to improves as there is less of a perceived risk involved in trading among the countries. This in turn should lead to both internal growth and trade growth.
- Transaction costs are eliminated within the monetary union. When countries have different currencies there is a charge when currencies are exchanged, but this will not happen with the existence of a single currency.
- A common currency makes price differences more obvious between countries and should, over time, lead to prices equalizing across borders.

Disadvantages

- When countries enter a monetary union, interest rates are decided by the central bank, meaning that individual countries are no longer free to set their own interest rates and so the tool of monetary policy is no longer an option to influence the inflation rate, the unemployment rate, and the rate of economic growth.
  → This is especially damaging if one country in the union is experiencing an economic situation that is not being experienced by the others
  → Ex) If one country is experiencing high inflation due to strong consumer demand, they would want to increase interest rates to reduce the demand but this would not happen since other countries are not experiencing inflation
- A monetary union will be weak and vulnerable without fiscal integration, in the form of common treasury, harmonized tax rates, and a common budget, while a common central bank is seen as essential in monetary union
  → This is because some countries will be more fiscally irresponsible than others and this may threaten the stability of the union
- Individual countries are not able to alter their own exchange rates in order to affect the international competitiveness of their exports or the costs of their imports
- The initial costs of converting the individual currencies into one currency are very large. The costs include: Taking the old currencies off the market, printing and distributing the new currency, converting databases and software, rewriting all price lists and invoice systems, re pricing all goods and services in the economy, and recalibrating all machinery that takes coins and notes etc.

When would the membership be most beneficial and when would it make a difference?

- If countries are in a situation where there were large fluctuations between the exchange rates of the countries involved, where the union is going to create a single currency with a significant proportion of the world's foreign currency market and where business confidence will be strongly boosted between member countries

→ It is likely to be BENEFICIAL

- If countries are in a situation where fluctuations in exchange rates are miniamal, where the common currency would not be siginigicant on he world market, so would stull be susceptible to speculation, and where business confidence is already high

→ It is likely to be DISADVANTAGEOUS