

4.1.5 Trading Blocs and the World Trade Organisation

Trading Blocs

A trading bloc is a group of two or more countries that agree to reduce or remove barriers to trade between themselves.

For example the EU Customs Union .

Free Trade Agreement

A free trade agreement (FTA) involves countries reducing or eliminating trade barriers between themselves while retaining their own trade policies towards non-members.

For example, the Australia UK Free Trade Agreement removes tariffs on **99%+** of UK goods, saving UK exporters an estimated **£200 million** per year in duty costs.

Customs Union

A customs union involves free trade between members alongside a common external tariff on non-members.

Free trade between members + common external tariff on non-members

A common external tariff means all members impose the same tariff on imports entering from countries outside the bloc.

For example, the EU Customs Union applies a Common External Tariff, an American car imported into Germany faces the exact same 10% duty as one imported into France or Spain.

The key difference from a free trade agreement is that members of a customs union cannot independently set their external tariffs.

Single Market / Common Market

A single market involves free trade, a common external tariff and the free movement of labour and capital.

Free trade + common external tariff + free movement of labour and capital

Workers can move between member countries to find employment, while financial capital can move freely between countries.

For example, despite Turkey being part of the EU customs union their exclusion from the EU single market means they do not experience several potential benefits .

Monetary Union

A monetary union involves a single market alongside a common currency, common central bank and common monetary policy.

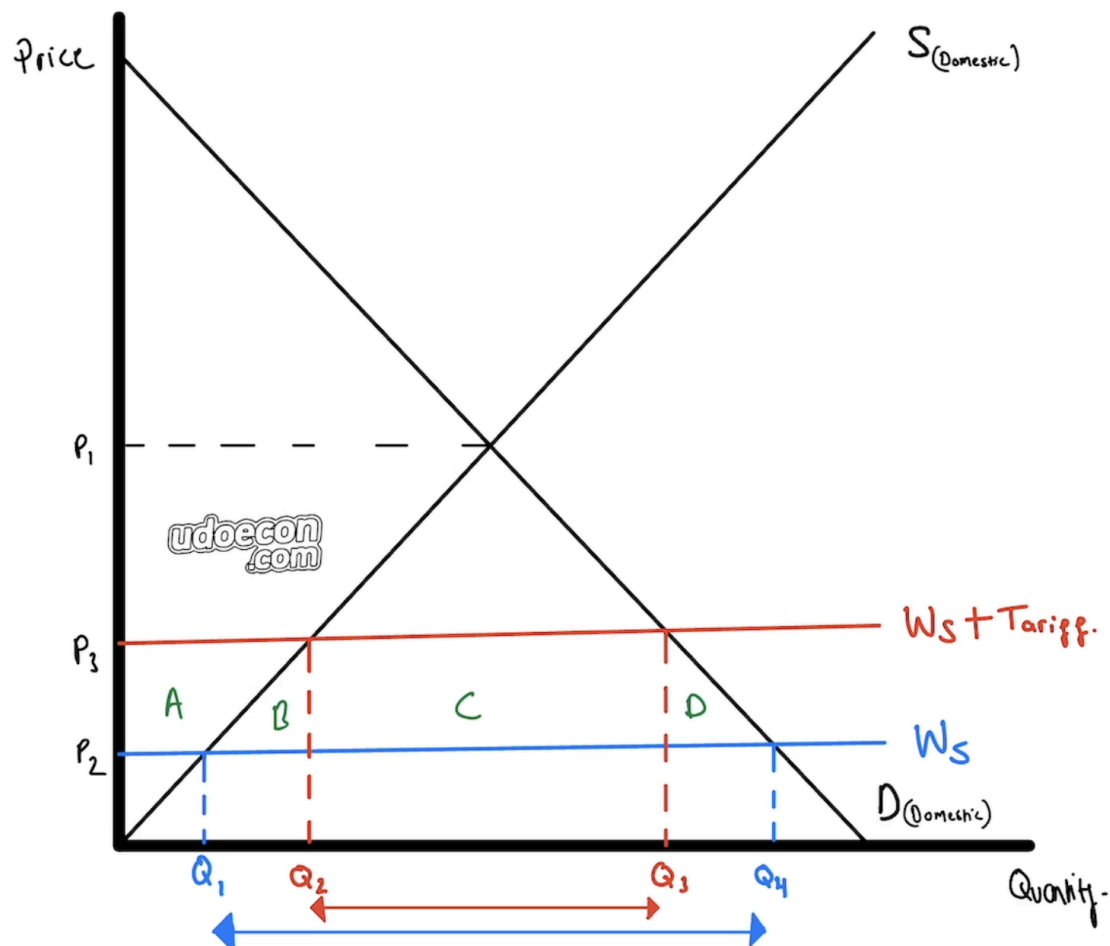
Single market + common currency + common central bank + common monetary policy

For example, countries in the Eurozone use the euro, with the European Central Bank (ECB) responsible for monetary policy.

The EU and Eurozone are not the same. For example, only 21 out of the 27 EU nations belong to the Eurozone monetary union e.g Poland is not part of Eurozone despite being an EU country .

Benefits of Trading Blocs

Trade Creation



Trade creation occurs when removing trade barriers causes consumers to switch from relatively expensive domestic production towards cheaper imports from another member of the trading bloc.

Tariffs between members ↓ → import prices ↓ → imports from members ↑ → resources allocated towards more efficient producers → economic welfare ↑

We can show trade creation on a tariff diagram, removing the tariff causes the domestic price to fall from P3 to P2 and imports increase from Q2 – Q3 to Q1– Q4.

This causes:

- Domestic producer surplus ↓ by A (Due to more international competition from other imports inside the bloc)
- Government tariff revenue ↓ by C
- Net welfare ↑ by B + D

Greater Specialisation

Removing trade barriers encourages countries to specialise according to their comparative advantage. Countries no longer need to dedicate as many factors of production to goods they have a higher opportunity cost of producing. Instead, they can allocate more resources towards goods they have a lower opportunity cost of producing and trade with other countries for the remaining goods.

For example, Saudi Arabia dedicates a majority of its factors of production towards the oil industry which allows them to exploit their comparative advantage thus exploit economies of scale, lowering average costs. As more resources are concentrated in oil rather than domestic agriculture, Saudi Arabia trades its oil exports for other goods, importing over 80% of its food requirements.

Economies of Scale

Access to a larger market can allow firms to expand production.

Trade barriers ↓ → export demand ↑ → firm output ↑ → economies of scale ↑ → LRAC ↓ → international competitiveness ↑

Increased Competition

Removing trade barriers exposes domestic firms to greater competition from firms elsewhere in the bloc.

Competition ↑ → pressure to reduce costs + innovate ↑ → prices ↓ + quality ↑

Greater Labour Mobility

Single markets allow workers to move more freely between member countries.

Free movement of labour ↑ → geographical labour mobility ↑ → firms find workers with required skills more easily → labour shortages ↓ → productive potential ↑

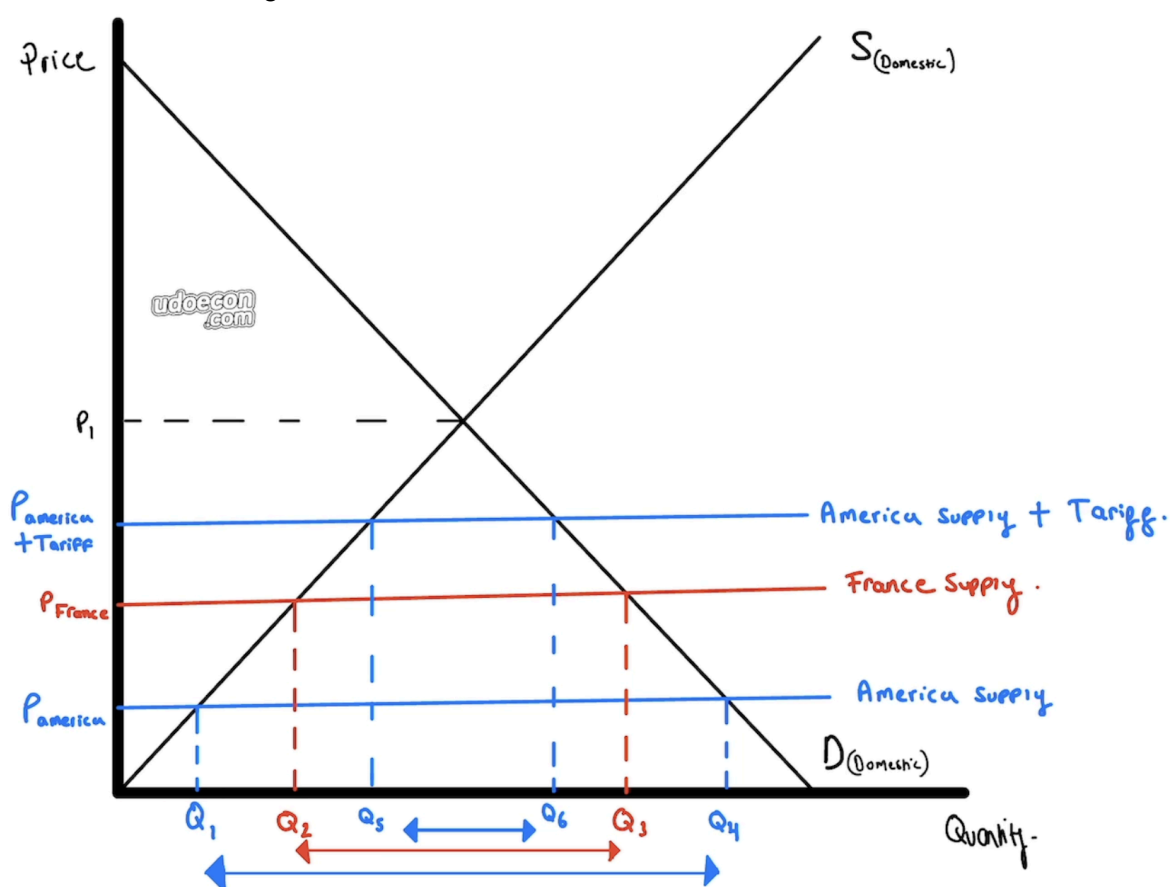
Costs of Trading Blocs

Trade Diversion

Trade diversion occurs when membership of a trading bloc causes imports to switch from a more efficient non-member producer towards a less efficient member producer.

This can occur because a common external tariff makes imports from non members artificially more expensive.

For example, When Spain joined the EU Customs Union, the EU's 20% Common External Tariff forced Spain to stop buying cheaper American wheat and switch to tariff free expensive French wheat, creating clear trade diversion.



We can see this on the trade diversion diagram .

As before joining the trading bloc, **America is the lowest cost producer**, so the UK imports from America at **P America**. Domestic supply is **Q1**, domestic demand is **Q4**, so imports are **Q4 - Q1**.

After joining the EU Customs union, the UK imposes a **tariff on American imports**, raising their price to **P America + tariff**. French imports face no tariff, so **P France is now cheaper**.

Therefore, the UK switches its imports **from America to France**, with imports now **Q2 - Q3**.

This is **trade diversion** because trade has shifted from a **more efficient, lower cost non member (America)** to a **less efficient, higher cost member (France)** due to the tariff.

Therefore, although a trading bloc may increase trade between its members, it does not necessarily improve global efficiency.

Structural Unemployment

Greater competition may cause less competitive domestic industries to decline.

Trade barriers ↓ → foreign competition ↑ → demand for inefficient domestic firms ↓ → output ↓ → workers made redundant → structural unemployment ↑

Monetary Union

A monetary union involves member countries sharing a common currency and a common central bank responsible for monetary policy.

Membership can reduce trading costs and exchange rate uncertainty, but countries also give up important parts of their economic policy independence.

Lower Transaction Costs

Using the same currency removes the need to constantly exchange currencies when trading.

Currency conversion ↓ → transaction costs ↓ → costs of international trade ↓ → trade potentially ↑

Firms also face less exchange rate uncertainty and have less need to hedge against currency movements.

Loss of Independent Monetary Policy

Members cannot independently set their own interest rates because one central bank must choose monetary policy for the entire union.

This becomes problematic when member countries experience different economic conditions.

For example:

Post pandemic inflation spiked to **22.5% in Estonia** while remaining at **6.9% in France**, the ECB's uniform -0.5% interest rate was dangerously low for Estonia's massive price overheating.

Loss of Exchange Rate Flexibility

Members cannot depreciate their currency against other members.

Normally:

Recession → currency depreciation → exports cheaper + imports dearer → net exports ↑ → AD ↑ → recovery

Countries in a monetary union lose this adjustment mechanism.

For example, Poland remained outside the euro after the 2008 financial crisis. The zloty depreciated, supporting net exports and helping reduce the severity of the downturn.

Conditions for a Successful Monetary Union

A monetary union is more likely to succeed when:

- Member countries have similar economic cycles and inflation rates
- Labour can move freely between countries
- Financial capital is mobile
- Governments have sustainable fiscal positions
- There is a system of fiscal transfers between stronger and weaker economies

Fiscal transfers are particularly important because countries have surrendered independent monetary policy. A struggling member can receive resources from stronger members to help respond to an asymmetric shock.

World Trade Organisation (WTO)

The World Trade Organisation (WTO) is an international organisation that aims to promote free trade and trade liberalisation.

Trade liberalisation means reducing or removing barriers to international trade, such as tariffs.

Promoting Trade Liberalisation

The WTO encourages countries to negotiate reductions in protectionist trade barriers.

Trade barriers ↓ → international trade ↑ → specialisation according to comparative advantage ↑ → gains from trade ↑

Resolving Trade Disputes

Countries can bring disputes to the WTO when they believe another member has violated trade rules.

The WTO can adjudicate disputes involving issues such as unfair tariffs or other unfair trade practices.

Supporting Developing Countries

Written by [udoecon.com](https://www.udoecon.com)

The WTO can help developing economies increase their capacity to participate in international trade.

Limitations of the WTO

The effectiveness of the WTO depends on countries being willing to follow its rules.

Large economies may have greater bargaining power and may be better able to resist WTO decisions, reducing the WTO's ability to enforce global trade rules. Smaller developing economies may have less ability to do this.

Conflict Between Trading Blocs and the WTO

Trading blocs can both support and conflict with the WTO's aim of global free trade.

Trade barriers between members ↓ → regional trade ↑ → trade creation ↑ → movement towards freer trade

However:

Common external tariffs ↑ → barriers against non-members ↑ → trade diversion ↑ → global efficiency potentially ↓

For example, a trading bloc may divert trade away from a non-member with a comparative advantage towards a less efficient member country.