Economics in the real world

Student resources

A-level

Adam Smith Institute

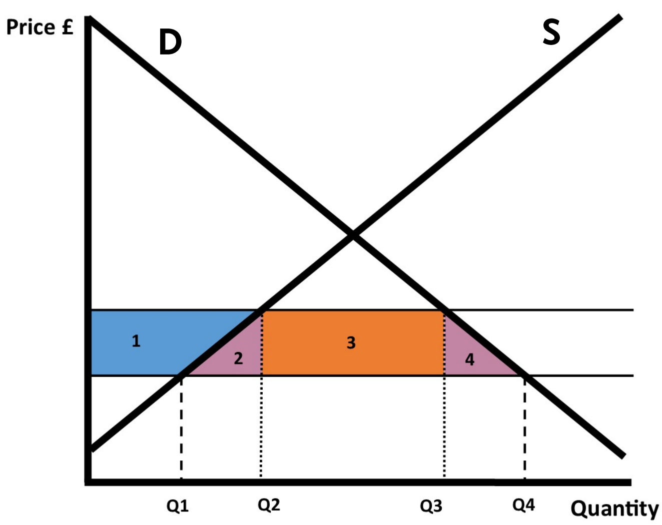
AQA Economics A-Level: 4.2.6.2 Trade

Edexcel Economics A-Level: 4.1.6 Restrictions on free trade, 4.1.5 Trading blocs and the World Trade Organisation (WTO).

Definitions:

- **Free Trade** - When goods and services can be bought and sold between countries without restrictions e.g. tariffs and quotas
- **Trade Creation** - The removal of barriers to trade, such as tariffs, to create more international trade and increase the consumer surplus within an economy.

Trade Creation Diagram:



Reminders:

Consumer surplus is the difference between what consumers are willing to pay and what they have to pay. It is shown by the area above the price and below the demand curve.

Producer surplus is the difference between the minimum price producers are willing to supply the good or service at, and the price they can sell it. It is shown by the area above the supply curve and bellow the price.

Elasticities: These will impact the size of the net welfare gain from the removal of trade barriers. Higher elasticity means the net gain will be larger.

Explaining the diagram:

- Initially UK firms supply the quantity Q2, and global firms supply the quantity (Q3 - Q2). This means that there is government tax revenue of area 3.
- With the removal of tariffs UK firms supply quantity Q1 and global firms supply quantity Q4-Q1.
- This represents a loss in domestic producer surplus and tax revenue of area 1 and 3 respectively.
- Because of the lower prices, there is an increase in consumer surplus of area 1+2+3+4.
- Therefor there is a total increase in Welfare of areas 2+4.

Economics in the real world

Student resources

A-level

Adam Smith Institute

Benefits of Trade:

- **Dynamic gains:** By facilitating specialisation, trade increases the rate of economic growth. Countries are able to focus investment into specific industries, and benefit from internal and external economies of scale.
- **Static Welfare gains:** Free trade increases choice for consumers, furthermore, as shown in the trade creation diagram, the removal of barriers to trade reduces costs, increasing consumer welfare.
- **Competition:** By increasing free trade there are higher levels of competition. Ensuring firms keep prices down and avoid inefficiencies.
- **Bilateral trade agreements:** The cutting of tariffs is beneficial on its own. But it can also encourage other countries to follow suit, further improving the outcomes for both nations.
- **International cooperation:** As countries trade with each other the costs of war increase, acting as a significant deterrent for conflict.

Costs of trade:

- **Infant Industries:** International competition will force developing industries to compete with larger international firms. This can prevent industries from ever developing, as in their early stages they are unable to compete with the larger, more efficient competition.
- **Unemployment:**

1. As labour is not perfectly mobile, when certain industries decline due to the increased competition from foreign firms, unemployment is likely to occur.
2. International trade and the subsequent decline of certain industries can cause structural unemployment and a negative regional multiplier. An example of this is the regional decline in the north of England with the closer of the mines

- **Dependency:** Free trade can cause countries to become overspecialised into certain industries, leaving their economy susceptible to shocks. This can be things such as fluctuations in the price of oil, or environmental factors effecting agricultural yields.

Considerations

Mobility of Factors of production: This will impact the level and duration of unemployment caused by the removal of trade barriers. If labour is perfectly mobile there will be no unemployment.

International stability: Trading in an unstable international environment can lead to supply chain issues, due to things such as wars or sanctions.

Elasticities: These will effect the size of the welfare gain caused by trade creation.