

Chapter 36 Trade policies and negotiations

Answers to Knowledge checks

- 36.1** Consumer surplus is reduced partly by a redistribution effect, whereby producers are subsidised for increasing their production, and the government generates tax revenue. Furthermore, consumers pay a higher price for the good, and there is a deadweight loss associated with the policy.
- 36.2** If domestic supply is highly inelastic, the tariff will have little effect on domestic production, as suppliers are unable to respond to the higher price they receive for selling the good. The cost to the consumers will be high, and the effect will be more on price than on domestic output.
- 36.3** Such a measure would slow the paperwork for importing the product and would raise costs for importers while giving an advantage to domestic producers. There was a time when all imports of video recorders into France had to be processed through Poitiers, a small and relatively inaccessible office. This made life difficult for Japanese importers.
- 36.4** A key issue here is incentives. An industry that is insulated from international competition may not have the incentive to learn to become competitive. Once protected, it may expect this protection to continue indefinitely, so will not strive for peak efficiency.
- 36.5** In 2017, when President Trump decided to extend his proposed levy (tariff) on imported steel to include Canada and Mexico (not to mention the EU), this threatened major job losses in Canada and Mexico. The natural response was to retaliate. Economists regard such a trade war, with tariff rates escalating, to be highly damaging for all of the countries involved. The tariffs were later removed to allow trade negotiations to resume.
- 36.6** A customs union has a common tariff barrier against non-members.
- 36.7** Member states either share a common currency or have permanently fixed exchange rates, which means that they cannot pursue independent monetary policies with a common interest rate.
- 36.8** This is trade creation.
- 36.9** Richer countries may be reluctant to allow developing countries free access to their markets if this means that their own farmers suffer. There may be strategic reasons for ensuring that agricultural production continues. The Common Agricultural Policy was partly introduced for this reason.

Answers to Exercises and Case studies

Exercise 36.1

If a tariff has been in place and is removed by the authorities, there will be an impact on consumers, producers and the government. The impact puts into reverse the effects that were identified for the imposition of a tariff, so:

- a** Consumers will benefit from a lower price of the good, and will gain consumer surplus.
- b** Producers will lose the additional produce surplus that they had enjoyed while being protected from foreign competition.
- c** The government will lose out because of the tariff revenues that they previously received.

Notice that this could be a painful adjustment for producers and the government. The producers are likely to put pressure on the government to resist the removal of protection. The government will find that they are losing revenue, but may be under pressure to provide assistance to workers who lose their jobs in the previously protected sector.

Exercise 36.2

The clear story told by Figure 28.3 (*see* page 383 of the book) is that the share of manufacturing employment in the UK fell substantially over the period between 1997 and 2017, whereas service sectors expanded significantly. This fall in the relative position of the manufacturing industry is known as a process of deindustrialisation.

When it first became apparent that this was happening, some commentators argued that this would be bad for the country, because an industrial base was essential for economic prosperity. However, if the UK's comparative advantage lies in the service sector, then there is no obvious reason why this should not be exploited. The service base of the economy can provide a solid foundation for the economy.

Exercise 36.3

It is difficult for me to comment on this, as I don't know when you will be tackling the exercise. Hopefully, the UK is coping well with the process...

Case study 36.1

The European Union

- a** The key benefits that were expected from the establishment of the EU were in terms of transactions costs, economies of scale and intensified competition. You should be able to explain why these benefits were expected, and why they are difficult to observe.
- b** With a single currency, the implementation of monetary policy is in the hands of the European Central Bank (ECB), and member countries have to accept the interest rate set by the ECB. When countries as diverse as Germany and Greece face significantly different circumstances, it is unlikely that a single interest rate will be appropriate for both. Given Germany's stronger position in the EU, it is likely that Greece will be the country to suffer — which is what has happened.
- c** As the EU expanded, the possibilities for trade creation will have expanded — but the dangers of trade diversion are also present.

Case study 36.2

Tariff retaliation

- a** The best joint position for the two countries would be where both imposed no tariffs. Each country would gain 100, a total of 200.
- b** The worst possible state would be where both countries imposed a high tariff. Each country would then gain 40, a total of 80.
- c** If Country B imposes no tariff, Country A maximises its gain by imposing a medium tariff, therefore making 125, with Country B making only 50.
- d** With Country A imposing a medium tariff, Country B will respond by setting a high tariff, which maximises its gain.
- e** Once Country B has imposed a high tariff, Country A's optimum strategy is also to set a high tariff, so that each country gains 40.
- f** What has happened here is that once one country has imposed a tariff, the ensuing tariff war escalates until both countries impose high tariffs, therefore producing the worst possible joint outcome for the two countries. This is the nature of tariff wars, and could so easily happen when the trading partners of the USA begin to retaliate with their own tariffs.

Answers to end-of-chapter questions

A Multiple-choice questions

- 1 c. Introducing a customs union
- 2 d. A common external tariff
- 3 a. The replacement of more expensive domestic production or imports with cheaper goods produced by trading partners within the trading bloc

B Knowledge and understanding questions

- 4 A free trade area is a group of countries that agree to remove tariffs, quotas and other restrictions on trade between the member countries but have no agreement on a common barrier against non-members.

A full explanation of a free trade area	2 marks
A vague or partial explanation of a free trade area	1 mark

- 5 Trade creation is the replacement of more expensive domestic production or imports with cheaper output from a partner within the trading bloc.

An explanation of trade creation	up to 2 marks
A diagram showing trade creation	up to 2 marks

- 6 Trade diversion using a tariff is the replacement of cheaper imported goods by goods from a less efficient trading partner within a bloc.

An explanation of trade diversion using a tariff	up to 2 marks
A diagram showing trade diversion using a tariff	up to 2 marks

- 7 Benefits may include:

- To avoid dependence on imports
- To avoid 'unfair' competition
- To protect an 'infant' industry
- To avoid unemployment

	Benefit one	Benefit two
Good explanation	3 marks	3 marks
Limited explanation	2 marks	2 marks
Identified	1 mark	1 mark

C Stimulus response question

- 8 a Economic union is a set of trading arrangements that are the same as for a common market, but additionally there is a common currency (or permanently fixed exchange rates between the member countries).

A full explanation of economic union	2 marks
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A vague or partial explanation of economic union	1 mark
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b

AO1 Knowledge	1 mark
AO2 Application	1 mark
AO3 Analysis	5 marks
AO4 Evaluation	5 marks

Knowledge (1 mark) is likely to include:

- Economic union

Application (1 mark) is likely to include:

- Application to Albania and the EU

Analysis (5 marks) is likely to include:

Analysis of the advantages of membership of the EU, for example:

- Trade creation
- Free movement of goods, services and labour
- EU regulations

Evaluation (5 marks) is likely to include:

- Evaluation that Albania may not experience the advantages of EU membership
- Evaluation over which advantage is likely to be most important
- Evaluation that EU membership has more disadvantages than advantages for Albania

A judgement of the potential advantages to Albania of membership of the EU economic union

D Essay question

9

AO1 Knowledge	6 marks
AO2 Application	6 marks
AO3 Analysis	6 marks
AO4 Evaluation	7 marks

Knowledge (6 marks) likely to include:

- Free trade
- The World Trade Organization (WTO)

Application (6 marks) is likely to include:

- Application of the role of the WTO

Analysis (6 marks) is likely to include:

Analysis of the role of the WTO in promoting freer world trade, for example:

- Encouraging free trade

- Encouraging globalisation
- Encouraging the negotiation of trade agreements
- Settling disputes between nations

Evaluation (7 marks) is likely to include:

Evaluation of why the WTO may be unsuccessful in promoting freer trade, for example:

- Political influences
- Can increase prices, especially in less developed economies
- WTO rules can favour large multinational organisations over smaller producers

Evaluation of other, more important organisations/ways of promoting freer trade.

A judgement of the role of the WTO in promoting freer world trade