country than in another, capital gravitates to the more profitable country, making better use of capital resources. Factor mobility across countries improves the allocation of resources.

However, the development of a common market requires even greater policy co-ordination among members than in a customs union, and requires the willingness of member governments to give up some of their policy-making authority to an organisation with powers over all the member governments. Both these requirements can be difficult to accomplish, and need a long time for all countries to make the necessary policy changes to achieve co-ordination. For this reason there are far fewer common markets in the world than free trade areas and customs unions.

Increased competition and other possible advantages of trading blocs

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

Economic integration over the long term can be expected to bring about many of the benefits of free trade (see page 354), including the following.

Increased competition

The removal of trade barriers results in increased competition among producers in member countries. With low or no barriers, imports increase, forcing domestic producers to compete with lower cost producers from other countries. Trade barriers, on the other hand, protect inefficient domestic producers. Increased competition offers major advantages in terms of production by more efficient producers, lower prices for consumers and improved allocation of resources.

Expansion into larger markets

This is an obvious benefit arising from the ability of firms to sell beyond their national boundaries, increasing their exports and leading to greater economic growth.

HL

Economies of scale (higher level topic)

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

This follows from the above point. In a small market a firm cannot take advantage of economies of scale since a firm cannot grow large enough so that its long-run average costs begin to fall substantially. When an economy opens itself up to free trade with other countries, its exports are likely to increase (assuming it is a relatively efficient producer), and as the size of the market expands, the firm can achieve lower costs of production on average (economies of scale), lower prices for consumers and greater export competitiveness. Economies of scale are one of the major benefits of free trade.

HL

Lower prices for consumers and greater consumer choice

The elimination of trade barriers (along with increased competition and economies of scale) results in lower prices for consumers. In addition, increased imports mean a greater of variety of goods from which consumers can choose.

Increased investment

Enlarged markets often give rise to increased investment by firms that want to take advantage of the larger market size. This investment may be internal, that is, by firms originating from a country within the trading bloc, or external, originating from a country outside the bloc (by multinational corporations). A major incentive for outsider firms to invest within the bloc is that they escape the tariff or other protection imposed by the trading bloc on imports from outside. Therefore, an incentive faced by countries forming trading blocs is to attract investments by multinational corporations.

Better use of factors of production: improved resource allocation

If a trading bloc develops into a common market, which involves free movement of factors of production, this also results in better use of these within the bloc. As discussed above, unemployed workers in one country may seek a job elsewhere where there are more employment opportunities. Capital can also move freely in search of greater profits.

Improved efficiency in production and greater economic growth

The elimination of trade barriers, leading to a better utilisation of resources and improved efficiency in production, allow for more rapid economic growth.

Political advantages

Greater economic integration is likely to result in a reduced likelihood of hostilities between countries whose economies become more interdependent through increased trade, investment, labour and financial flows.

Possible disadvantages of trading blocs

Trading blocs may not be the best way to achieve trade liberalisation

Many economists believe that while the establishment of trading blocs with free trade between members may be an improvement over trade protection, trading blocs are inferior to the WTO's multilateral approach of reducing trade barriers towards all countries. Trading blocs involve an increasing amount of discrimination, violating the WTO's non-discrimination principle (see page 413 above).

Trading blocs may create obstacles to the achievement of free trade on a global scale

Some economists believe that the break-up of the world trading system into many blocs can create trade conflicts between different blocs that may slow down the process of global trade liberalisation. Trading blocs may enjoy free trade and all its benefits *within the bloc*, but trade barriers on non-members may result in limiting rather than increasing trade *on a global scale*. This would lead to a worse global allocation of resources, lower global output, a weakened role for the WTO, and a risk of breaking up the global economy into many regional trading blocs.

Unequal distribution of gains and possible losses

Countries forming a trading bloc are unlikely to gain equally from the operation of the trading bloc, and this creates the potential for conflicts between the members and makes it difficult to reach agreements. It is also possible for some countries to gain while others become worse off in some respects. The same applies to gains and losses *within* the member countries, as some stakeholders are likely to gain while others lose. These are issues we will come back to in Chapter 17 when we evaluate preferential trade agreements as a trade strategy to achieve economic growth and development (page 490).

Test your understanding 15.1

1 **(a)** What are preferential trade agreements? **(b)** What is the difference between bilateral, regional and multilateral trade agreements?

2 **(a)** Why do trading blocs violate the WTO's principle of non-discrimination? **(b)** Why do you think the WTO permits the formation of trading blocs?

3 **(a)** Define a free trade area, customs union, and common market, and explain the differences between them. **(b)** How do these illustrate an increasing degree of economic integration?

4 **(a)** Explain the role of competition in trading blocs. Why is increased competition an advantage? **(b)** Identify further advantages and disadvantages of trading blocs.

5 Why do you think countries that want to form a trading bloc usually start by forming a free trade area, gradually moving towards a customs union, and eventually towards a common market?

Trade creation and trade diversion (higher level topic)

- Explain the concepts of trade creation and trade diversion in a customs union.[2]

The benefits of trading blocs discussed above are long-term (or 'dynamic') benefits. In addition, there are short-term (or 'static') benefits, as well as possible costs, which are measured in the concepts of trade creation and trade diversion. Any type of trading bloc can lead to trade creation, or trade diversion, or both, depending on the particular country and the particular product.

Trade creation

When a trading bloc is established, patterns of trade between countries change, since trade between the members is encouraged through the lowering of trade barriers, while trade with non-members is discouraged through the maintenance of trade barriers. **Trade creation** refers to the situation where higher cost products (imported or domestically produced) are replaced by lower cost imports after the formation of a trading bloc.

Consider an example. Suppose Cottonia and Microchippia both produce cotton. Cottonia has a comparative advantage in cotton; it has a lower cotton price, and therefore Microchippia imports cotton from Cottonia. Initially, Microchippia imposes tariffs on its cotton imports, this way protecting its own cotton producers. Then Cottonia and Microchippia form a bilateral trade agreement, and tariffs on

[2] The IB syllabus refers specifically to trade creation and trade diversion as arising in customs unions. However, they can arise in any type of trading bloc.

HL cotton are abolished. Microchippia's cotton imports increase (corresponding to an increase in Cottonia's cotton exports), and its domestic production of cotton decreases. This is a case of *trade creation*, because higher cost domestic cotton production in Microchippia is partly replaced by lower cost imports of cotton.

Note that since trade creation involves the removal of tariffs, its benefits include getting rid of the disadvantages that come with imposing tariffs (see pages 366–67). The decrease in Microchippia's domestic production of cotton leads to greater efficiency in production, and together with the increase in consumption made possible by more imports, there is greater allocative efficiency.

Trade diversion

Trade diversion refers to the situation where lower cost imports are replaced by higher cost imports from a member after the formation of the trading bloc.

Suppose Cottonia, Robotia and Microchippia all produce cotton. Cottonia is the lowest cost producer of the three, followed by Robotia, and then by Microchippia, which is the highest cost producer. Initially, Microchippia imposes a tariff on all imports of cotton, regardless of country of origin. Since Cottonia is the lowest cost producer, Microchippia imports from Cottonia and not from Robotia (Cottonia's cotton price plus the tariff is lower than Robotia's price plus the tariff). Microchippia then decides to form a trading bloc with Robotia. It therefore eliminates the tariff on cotton from Robotia, and maintains the tariff on cotton from Cottonia. The result is that it now becomes cheaper for Microchippia to import cotton from Robotia rather than Cottonia. Microchippia's imports have shifted from a lower cost producer, Cottonia, to a higher cost producer, Robotia; this is therefore a case of *trade diversion*.[3]

The possibility of trade diversion resulting from a trading bloc is an additional argument *against* trading blocs, and *in favour* of multilateral (WTO) trade liberalisation. The reason is that trade diversion cannot occur with multilateral reduction or elimination of trade barriers. Trade diversion occurs when an importing country is forced to import from a higher cost producer within a trading bloc, whereas before it joined the trading bloc it was importing from a lower cost producer elsewhere. If all countries reduce their barriers at the same time, it is not possible for lower cost imports to be replaced by higher cost imports; the importing country will simply import from lower cost producers who sell at lower prices. HL

Trade creation has the effect of increasing social welfare, while trade diversion reduces it. Therefore, whereas a trading bloc creates free trade for the members, it may or may not improve the allocation of resources. Resource allocation will improve only if trade creation effects are larger than trade diversion effects. Yet, you should remember that trade creation and trade diversion refer to short-term (static) benefits and costs of trading blocs, in contrast to long-term (dynamic) benefits discussed in the previous section. It is generally believed that the long-term benefits for the members of trading blocs are more important than the short-term effects. According to some studies, the long-term effects may be five or six times more important than the short-term ones. Therefore, even if a trading bloc leads to trade diversion over the short term, it is possible that the long-term positive effects will more than compensate countries for possible short-term losses.

Test your understanding 15.2

1. Explain the difference between trade creation and trade diversion.
2. Why is it not possible for trade diversion to occur in the context of multilateral (as opposed to bilateral or regional) trade agreements?
3. Distinguish between short-term (static) and long-term (dynamic) benefits of trade.

Monetary union

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

The meaning of monetary union and the example of European Monetary Union (EMU)

Monetary union involves a far greater degree of integration than a common market, and occurs when the member countries of a common market adopt a common currency and a common central bank responsible for monetary policy. A monetary union has been formed by a number of the countries of the

[3] A full analysis of trade diversion is actually a little more complicated, because trade diversion comes with some benefits. However, this discussion is beyond the scope of this book.

Advantages of economic integration

- **Greater efficiency.** Resource allocation is more efficient when artificial barriers to trade are eliminated and goods and services are produced in the nation with the lowest domestic opportunity cost.
- **Higher real incomes.** Cheaper imports lead to higher disposable incomes for consumers in nations that trade, improving the quality of life and the variety of goods and services available.
- **Larger export markets.** A broader consumer base allows domestic industries that are able to compete internationally to increase their output, hire more workers, and expand to meet the demands of the international marketplace.

On the other hand, increased economic integration can have some detrimental effects, which are also the disadvantages of free trade in general.

Disadvantages of economic integration

- **Fall in employment in certain industries.** Increased competition from producers abroad may force some domestic firms to shut down or move their operations overseas, reducing domestic employment.
- **Exploitation of workers.** At lower levels of economic integration in which labour regulations are not common between nations, disparities in the working conditions and wage rates between nations may create an environment in which low-skilled labour is exploited in the nations with large populations of low-income, low-skilled workers.
- **Environmental effects.** Environmental regulations may also differ between nations in a free trade area, which may cause producers to open factories in countries with the lowest standards, increasing pollution and greenhouse gas emissions overall.
- **Rising trade imbalances.** If economic integration causes a nation's imports to rise faster than its exports, then large current account imbalances between countries could result, as was the case with the US and Mexico following the signing of NAFTA.

Loss of economic sovereignty

At the higher levels of integration, such as a monetary union, member nations must give up the ability to control their own monetary policies. This reduces a country's ability to manage demand in its domestic economy by raising or lowering interest rates or manipulating the exchange rate of its currency relative to its trading partners' currencies. Since no single nation in a monetary union can determine the level of interest rates or the exchange rate on its own, control of the nation's macroeconomy is to some extent essentially handed over to a multinational central bank, a sacrifice many nations are not eager to make.

This explains why some of the nations in the EU are not currently seeking to become a part of the eurozone. Giving up its own currency prevents a country from increasing its attractiveness to foreign consumers and investors by keeping domestic interest rates low and the value of its currency weak.

24.5 Trade creation *vs* trade diversion (HL only)

Learning outcome

- (HL only) Explain the concepts of trade creation and trade diversion in a customs union.
- (HL only) Explain that different forms of economic integration allow member countries to gain from economies of scale.

To further evaluate the effects of economic integration, we must look more closely at the impact trading blocs have on overall efficiency in the allocation of resources. In fact, it is not always the case that economic integration through bilateral or multilateral trading blocs increases *overall* efficiency in the use of the world's resources. Trading blocs do create trade between member nations, but this may come at the expense of overall efficiency if increased trade between nations causes diversion of trade from other, more efficient, lower-cost nations.

Nations that join a trading bloc experience increased trade with other nations in the trading bloc, which improves the efficiency with which resources are allocated between member nations. However, the full effect of economic integration must be examined to determine whether what results is *trade creation* or *trade diversion*. The latter occurs when a trade agreement between two or more nations diverts trade from non-member nations to member nations.

Trade creation

Trade is created if the formation of a trading bloc, bilateral or multilateral, shifts production of certain goods or services from a high-cost country to a low-cost country, thus improving efficiency, increasing the overall level of output and increasing international trade.

Take, for instance, the effect on the US television industry when NAFTA was signed. TVs had been produced in the US for decades when Mexico and the US agreed to eliminate tariffs under their free trade agreement in 1994. Since NAFTA was signed, the TV industry in the US has all but disappeared. Americans are consuming more televisions than ever, but many of those TVs are now produced in Mexico rather than in domestic factories. NAFTA created more global trade and increased the level of output of televisions as production moved from a high-cost nation (the US) to a low-cost nation (Mexico).

Trade creation is when a free trade agreement shifts production of certain goods or services from a high-cost country to a low-cost country.

Trade diversion

Trade diversion occurs if the formation of a trading bloc between two or more nations results in the production of a good or service transferring from a nation with a lower opportunity cost to one with a higher opportunity cost. Such a scenario may seem unlikely, but it occurs rather commonly at the higher levels of economic integration, such as in a customs union.

When two or more nations agree to eliminate barriers to trade between themselves, but to maintain common external tariffs on all other nations, it is possible that the result will be the diversion of trade from low-cost producers to high-cost producers.

Take, for instance, the European Economic Area (EEA), which includes the 27 countries of the EU plus Norway, Switzerland and Liechtenstein. All 30 countries in the EEA are middle- or high-income nations that have agreed to eliminate tariffs between all member nations. However, the EEA has common tariffs on non-member nations, many of which are low-income countries that may have a comparative advantage in the production of certain goods over high-income EEA nations. Due to the nature of agreement between member nations, the existence of external tariffs could increase trade between one European nation and another at the expense of trade with low-cost nations.

For example, Poland, a middle-income country with a comparative advantage in the production of intermediate manufactured goods such as auto parts, joined the EEA in 2004. As a member of the EEA, Poland enjoys duty-free exports to Germany, its largest trading partner, also a nation with a large auto industry. Germany most likely began importing more auto parts from Poland after its entry into the EEA in 2004 than it had before, since

Trade diversion occurs if the formation of a trading bloc between two or more nations results in the production of a good or service transferring from a nation with a lower opportunity cost to one with a higher opportunity cost.

What criteria can be used to assess the benefits and the costs of increased economic integration? Might increased economic integration ever be considered undesirable?

these goods could now be obtained duty free. But if this increase in trade with a middle-income European neighbour came at the expense of trade between Germany and a lower-cost non-European nation, such as China, then trade was not created, it was diverted.

Assume China had been producing auto parts at even lower cost than Poland, then Poland joined the EEA and all German tariffs on Polish goods were eliminated. Since Chinese goods are still subjected to tariffs in Germany, demand for Chinese output in Germany would fall following the elimination of tariffs on Polish goods. In this way, European economic integration under the EEA may have diverted, rather than created, international trade from a low-cost producer (China) to a higher-cost producer (Poland). When trade is diverted due to the formation of a trade bloc, overall allocative efficiency is reduced.

CASE STUDY

NAFTA keeps Mexico's economy afloat

In the global economic slump, exporting nations have suffered as incomes in Europe and North America stagnate. But Mexico is confounding the trend. In 2009, Mexico's exports shrank, but they recovered quickly in 2010, its share of the American import market growing to its highest level ever – 12.2%.

Mexico has many advantages over other exporting nations. Geographical proximity to its largest trade partner means low shipping costs despite rising oil prices. NAFTA allows Mexican imports to enter the US tariff-free, a major advantage that Chinese exporters do not enjoy. Despite Chinese producers' other cost advantages, the tariffs on Chinese goods give Mexican producers an edge in the US market. Chinese paving stones, for example, cost $5.20 per square metre compared to $5.29 for Mexican ones. But the 8.5% US tariff levied on Chinese paving stones makes them more expensive than Mexican ones. The same is true for other Mexican goods including cloth, glassware, chemicals and cars.

For over two decades, China's major advantage has been low labour costs; but this is changing – factory-workers' wages are now rising at double-digit rates. Mexico offers highly skilled labour in many industries and the wage gap with the US remains large – Mexico is increasingly appealing to American importers.

At present, 80% of Mexican exports go to the US, despite trade agreements with many other nations. One downside for the Mexican export sector is in the fine print of trade agreements with some European nations: Mexican goods entering Europe tariff-free must have originated in Mexico (or the EU). But many exporters rely on parts from the US, so they do not qualify for tariff-free access to European markets. However, as Mexican parts manufacturers expand, this may change and new markets open to Mexican exporters.

Sixteen years after NAFTA was signed, Mexico has benefited greatly from its free trade relationship with the US. But for its exporters (and the millions of workers they employ) to benefit from further trade with Europe and reduce their dependence on the American market, Mexican industry must produce more of the parts that go into the finished products.

HL EXERCISES

1. According to the case study above, how does Mexico's ability to export paving tiles tariff-free to the US benefit Mexico? How does it harm China?
2. Would you describe the effect of NAFTA on trade between the US, Mexico and China as an example of trade creation or trade diversion? Use evidence from the case study to support your answer.
3. Why is Mexico not able to take full advantage of its free trade agreements with countries other than the US (e.g. the EU)? What does the article suggest as a strategy for Mexico to begin enjoying the full gains of its existing free trade agreements?
4. How will continued economic integration help Mexico? Discuss the impact of FTAs on Mexican firms and Mexican households.