Edexcel Economics (A) A-level

Theme 4: A Global Perspective

4.1 International Economics

Detailed Notes

4.1.1 Globalisation

Characteristics:

- Globalisation refers to the **growing interdependence of countries** and the **rapid rate of change it brings about.**
- The OECD defines globalisation as the 'geographic dispersion of industrial and service activities, for example research and development, sourcing of inputs, production and distribution and the cross border networking of companies, for example through joint ventures and the sharing of assets'.
- It can also be defined as the **increasing integration of the world's local, regional and national economies into a single international market**.
- There is movement towards free trade of goods and services, free movement of labour and capital and free interchange of technology and intellectual capital.

Factors contributing to globalisation:

- **Improvements in transport infrastructure and operations** have meant there are quick, reliable and cheap methods to allow production to be separated around the world.
- **Improvements in IT and communication** allow companies to operate across the globe
- **Trade liberalisation** and reduced protectionism has made it cheaper and more feasible to trade; this has been occurring since 1945. The breakdown of the **soviet bloc** and the opening of **China** has shown a whole area of the world for business to expand into.
- **International financial markets** have provided the ability to raise money and move money around the world, necessary for international trade.
- **TNCs** (large companies operating around the world) have led to globalisation by acting to increase their own profit as they want to take advantage of low labour costs. They sell and produce their goods all around the world and have the power to lobby governments.

Impacts of globalisation:

Consumers:

- Consumers have more **choice** since there are a wider range of goods available from all around the world, not just those produced in the UK.
- It can lead to **lower prices** as firms take advantage of comparative advantage and produce in countries with lower costs, for example low labour costs.

- In other cases, it is leading to a **rise in prices** since incomes are rising and so there is higher demand for goods and services.
- Many consumers worry about the **loss of culture**.

Workers:

- In terms of employment, **some people have gained whilst others have lost.** There have been large scale job losses in the western world in manufacturing sectors as these jobs have been transferred to countries such as China and Poland.
- **Increased migration** may affect workers by lowering wages but migrants can also provide important skills and an increase in AD which increases the number of jobs.
- International competition has led to a fall in wages (or reduced growth) for low skilled workers in developed countries whilst increased those in developing countries.
- The wages for high skilled workers appear to be increasing, since there is more demand for their work; this is increasing **inequality**.
- TNCs tend to provide training for workers and create new jobs.
- Those working in **sweatshops** will see poor conditions and low wages, but this is better than other alternatives.

Producers:

- Firms are able to source products from **more countries** and sell them in more countries. This **reduces risk** since a collapse of the market in one company will have a smaller impact on the business.
- They are able to employ low skilled workers much cheaper in developing countries and can **exploit comparative advantage** and have **larger markets**, both of which can increase profits.
- Firms who are **unable to compete** internationally will lose out.

Government:

- The government may be able to receive **higher taxes**, since TNCs pay tax and so do the people they employ. However, they could lose out through **tax avoidance**.
- TNCs also have the power to **bride and lobby** governments, which could lead to corruption.
- If the government uses the correct policies, they can maximise the gains and minimise the losses.

Environment:

- The increase in world production has led to **increased demand for raw materials**, which of which is bad for the environment.
- Increased trade and production has also led to **more emissions**.

- However, globalisation means the world can work together to tackle climate change and share ideas and technology.

Economic growth:

- Globalisation increases **investment** within countries; the investment of TNCs represents an injection into the economy, and which will have a larger impact due to the multiplier. It creates an incentive for countries to make supply-side improvements to encourage TNCs to operate in their countries.
- TNCs may bring **world class management techniques and technology** which can have knock on benefits to all industries as these techniques and technologies are available for them too.
- Trade will increase output since it allows exploitation of comparative advantage.
- However, the power of TNCs can cause **political instability** as they may support regimes which are unpopular and undemocratic but that benefit them or could hinder regimes which don't support them
- **Comparative cost advantages will change over time** and so companies may leave the country when it no longer offers an advantage which will cause structural unemployment and reduce growth.

Synoptic point:

Globalisation has clear microeconomic effects: it has impacts on consumers and producers as well as leading to negative externalities for the environment. It has also contributed to the increasing contestability of markets.

4.1.2 Specialisation and trade

Absolute and comparative advantage:

The theory of comparative advantage states **that countries find specialisation mutually advantageous if the opportunity costs of production are different**. If they are the same, there will be no gain from trade. **Absolute advantage** exists when a country can produce a good more cheaply in absolute terms than another country. **Comparative advantage** exists when a country is able to produce a good more cheaply relative to other goods produced.

Numerical approach:

Example one: In this situation, Spain has an absolute advantage over umbrellas whilst UK has an absolute advantage over cars (A). If countries didn't specialise and produced both (B), they would spend half their time on each. However, if they specialised, they could produce more. (C)

A	UMBRELLAS		CARS
UK	70	OR	140
Spain	140		80

B	UMBRELLAS	CARS
UK	35	70
Spain	70	40
Total	105	110

C	UMBRELLAS	CARS
UK	0	140
Spain	140	0
Total	140	140

Example two: In this situation, Spain has an absolute advantage in both. However, if they specialised they can still produce much more. The UK has a comparative advantage in cars as they are only 1/3 worse at producing cars and ½ as good at producing wine, and so they should specialise in cars. Spain should put most effort into producing umbrellas (80%) and produce some cars. This will lead to an increase in total production in both cars and umbrellas.

A	UMBRELLAS		CARS
UK	70	OR	80
Spain	140		120

B	UMBRELLAS	CARS
UK	35	40
Spain	70	60
Total	105	100

C	UMBRELLAS	CARS
UK		80
Spain	112	24
Total	112	104

Example three: This is another example of comparative cost advantage. The USA has an absolute advantage in both but the UK should specialise in cars, since they can produce 50% of the USA output for this but only 1/3 of the vans. The USA could spend 70% of their time producing vans and 30% producing cars- these numbers are chosen simply because these allow table C to demonstrate that specialisation produces more than working independently (B).

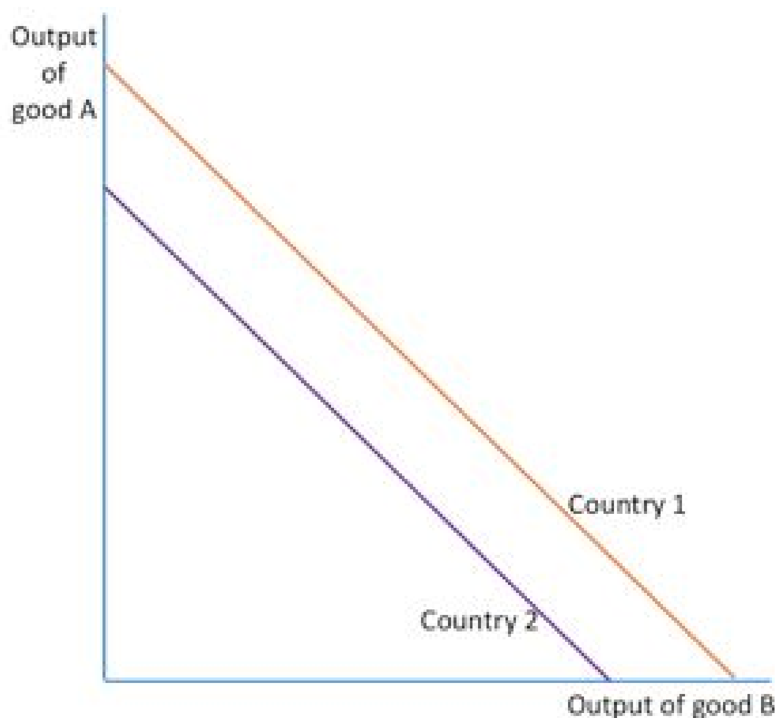
A	CARS	OR	VANS
UK	100		200
US	200		600

B	CARS	VANS
UK	50	100
US	100	300
Total	150	400

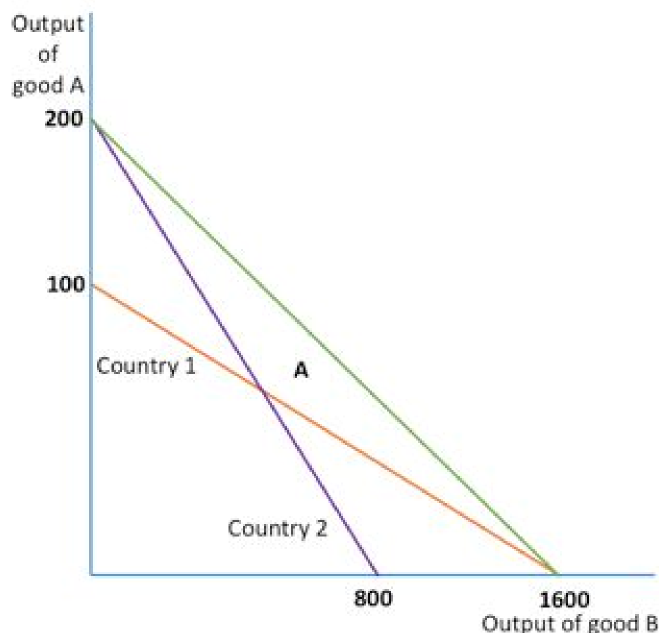
C	CARS	VANS
UK	100	0
US	60	420
Total	160	420

The aim of these tables is to prove that specialisation (table C) is better than each country working individually. The percentages are worked out through method of trial and improvement.

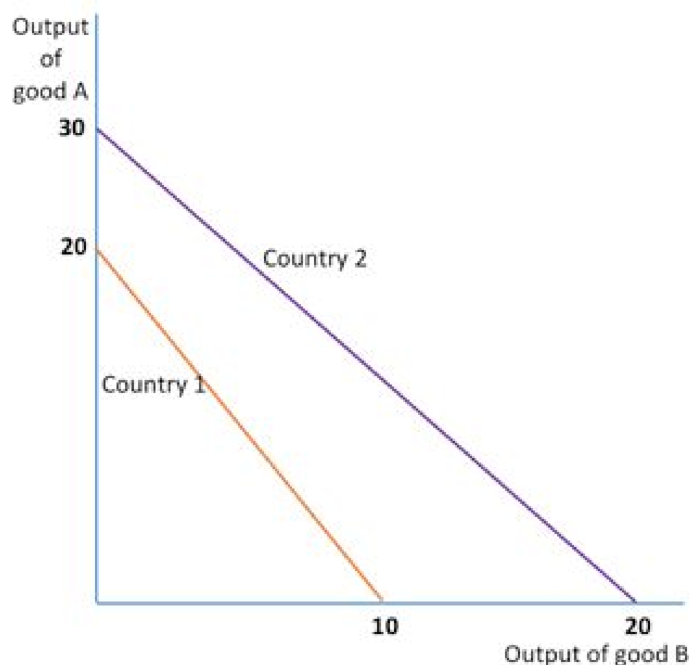
Diagrammatic approach:



Example one: On top of this, questions can be asked in the context of the PPF. Country 1 has an absolute advantage in both as they can produce more of both. However, trade is not worthwhile because they have the same opportunity cost since the gradients of the lines are the same.



Example two: Country 1 has an absolute advantage in producing good B and country 2 has absolute advantage in good A. Specialisation is worthwhile since the opportunity cost is different. This creates the new green PPF, since they maximum they can produce is 200 and 1600. If they produce at a rate of 1:1, they produce on the line but they can produce anywhere in the area between all three lines, A. Both countries are able to produce beyond their PFF, which shows both have benefitted from specialisation.



Example three: Country 2 has an absolute advantage in producing both goods, but country 1 has comparative advantage in producing good A. The opportunity cost in the UK of 1 of good B is 1.5 of good A and the opportunity cost in Italy is 2 of good A. Italy has a comparative advantage in producing good A; UK in good B.

Assumptions and limitations of the theory:

- Comparative advantage assumes there are **no transport costs**, and these could lower or prevent any comparative advantage.

- It also assumes **costs are constants** and that there are no economies of scales. Economies of scale help to increase the gains from specialisation.

- In the model, goods are assumed to be **homogenous**, which is unlikely to hold in real life. The fact products aren't homogenous makes it difficult to conclude that a country has a comparative advantage as their products can't be perfectly compared.

- It also assumes that **factors of production are perfectly mobile**, there are no tariffs or other trade barriers and there is perfect knowledge.

- Whether trade takes place will depend on the **terms of trade** between the countries.

Advantage and disadvantages of specialisation and trade:

Advantages:

- Comparative advantage shows how **world output can be increased** if countries specialise in what they are best at producing, this will increase global economic growth.
- Trading and specialising allows countries to benefit from **economies of scale**, which reduces costs and therefore decrease prices globally.
- **Different countries have different factors of production** and so trade allows countries to make use of factors of production, or the things produced by these factors, which they otherwise may have been unable to.
- Trade enables consumers to have **greater choice** about the types of goods they buy, and so there is greater consumer welfare.
- Trade also means there is **greater competition**, which provides an incentive to innovate. This creates new goods and services and new production methods, increasing consumer welfare and lowering costs respectively.
- Countries which isolate themselves for political reasons, like North Korea, have found that their economies tend to stagnate.

Disadvantages:

- However, trade can lead to **over-dependence,** where some countries become dependent on particular exports whilst others become dependent on particular imports. This can cause problems if there are large price falls in the exports of if imports are cut for political reasons.

- It can cause **structural unemployment**, as jobs are lost to foreign firms who are more efficient and competitive. The less mobile the workforce, the higher the chance that changes in demand due to trade will reduce output and employment over long periods of time. This is a big problem in the UK as some areas such as Manchester suffer from unemployment as their traditional industries declined, for example ship-building.
- The **environment will suffer** due to the problems of transport as well as the increased demand for resources e.g. deforestation.
- Countries may suffer from a **loss of sovereignty** due to signing international treaties and joining trading blocs, for example in the EU.
- They may see a **loss of culture** as trade brings foreign ideas and products to the country.

4.1.3 Pattern of trade

The UK used to be the 'workshop of the world', exporting huge amounts of goods but the 1970s and 1980s saw a process of deindustrialisation with exports of services becoming increasingly important. The UK's entry to the EU led to an increase in trade with Europe.

Factors influencing the pattern of trade:

- **Comparative advantage:** Countries will trade where there is a comparative advantage to trading. A change in the comparative advantage will affect the trade pattern. There has been a recent growth in the exports of manufactured goods from developing countries to developed countries. This is because developing countries have gained an advantage in the production of manufactured goods, due to their lower labour costs, so production shifted abroad. The deindustrialisation of countries such as the UK has meant the manufacturing sector has declined. This means that production of manufactured goods has shifted to other countries, such as China, whilst the UK now focuses more on services, such as finance. This has led to the industrialisation of China and India. Their share of world trade has risen and the volume of manufactured goods that they export has increased. However, since China's population is now ageing, their wage competitiveness has fallen. This is also due to the rise of the middle class in China, who demand higher wages and consume more.

- **Emerging economies:** Countries grow at different rates and when they grow, they are likely to need to import more goods and services than before as well as exporting more to pay for this. Emerging economies shift the trade pattern by taking up a larger proportion of a country's imports and exports than they had previously. One example of this is China. International trade is arguably more important for developing countries than developed countries: it contributes towards 20% of LDC economies

compared to 8% of the US economy. The collapse of communism has meant that more countries, especially developing countries, are participating in world trade.

- **Trading blocs and bilateral trading agreements:** These increase the level of trade between certain countries and so influence the pattern of trade because trade increases between these countries and decreases between others. Joining the EU meant that the UK traded a lot more with European countries than previously, and less with countries outside the EU.

- **Relative exchange rates:** The exchange rate affects the relative prices of goods between countries. Prices are an important factor in determining whether consumers buy goods and so a change in price will affect the pattern of trade. It can be argued that the UK's trade deficit with Europe is due to the strength of the pound. China have kept their currency weak in order to increase their trade surplus by making exports more competitive.

4.1.4 Terms of trade

The terms of trade measures the **rate of exchange of one product for another when two countries trade.** It tells us the quantity of exports that need to be sold in order to purchase a given level of imports.
Movement in the terms of trades is said to be **favourable** if the terms of trade increase as the country can buy more imports with the same level of exports. This is called an **improvement** in the terms of trade. It is **unfavourable** if they decrease, when export prices fall or import prices rise. This is called a **deterioration**.

Calculation of terms of trade:

It is measured in the form of an index because it is calculated from the weighted average of thousands of different export and import prices e.g. changes in the price of oil have larger impacts on the terms of trade than changes in the price of a Rolls Royce.

(average export price index/average import price index) x100

Factors influencing a country's terms of trade:

- An improvement in the terms of trade will be caused by a rise in export prices or a fall in import prices. A deterioration will be caused by a fall in export prices or a rise in import prices.

- In the short run, **exchange rates, inflation and changes in demand/supply of imports or exports** affect the terms of trade since these affect the relative prices of imports and exports.
- In the long run, an **improvement in productivity** compared to a country's main trading partners will decrease the terms of trade since export prices will fall relative to import prices. This can be caused by new technology, more efficient labour etc.
- Another long run factor is **changing incomes.** This affects the pattern of demand for goods and services. For example, a rise in world income causes a rise in demand for tourism and so a country with a strong tourist industry, such as Spain, may see a rise in prices in that industry and hence an increase in their terms of trade. The Prebisch-Singer hypothesis suggests the long run price of primary goods declines in proportion to manufactured goods, which means those dependent on primary exports will see a fall in their terms of trade.
- In general, **anything which affects the price of a country's imports or exports will affect its terms of trade.**

Impacts of changes:

- If PED of exports and imports is inelastic, a favourable movement in terms of trade would improve the current account on the **balance of payments** whilst if it is elastic, a favourable movement would worsen the current account.
- An **improvement in the terms of trade is likely to lead to a fall in GDP** and a rise in unemployment, since if it is caused by a rise in export prices, exports will fall and if it is caused by a fall in import prices, imports will rise. Both of these causes a reduction in production within the country and so a fall in jobs and output. However, a **long term decline in the terms of trade suggests a long term decline in living standards** as less imports can be bought.
- It is important to look at the cause of the change. If an improvement has occured due to increased demand for exports, then this will be beneficial for the country. If a deterioration is caused by an improvement in international competitiveness, this will also be beneficial. The **export and import revenues** are more important than the price alone. For an improvement to be beneficial, export revenues must increase.

4.1.5 Trading blocs and the World Trade Organisation

Types of trading blocs:

A regional trading bloc is a group of countries within a geographical region that protect themselves from imports from non-members. They sign an agreement to reduce or eliminate tariffs, quotas and other protectionist barriers among themselves. They are a form of integration. Examples include NAFTA (North America), the EU, ASEAN (Asia) and MERCOSUR (South America). Most regional trade agreements take the form of **bilateral agreements**, between one single country and another single country. Some agreements are multilateral or plurilateral agreements, between at least three countries.

- **Preferential trading areas (PTA):** These are where tariff and other trade barriers are reduced on some but not all goods traded between member countries.

- **Free trade areas (FTA):** These occur when two or more countries in a region agree to reduce or eliminate trade barriers on all goods coming from other members. Each member is able to impose its own tariffs and quotas on goods it imports from outside the trading bloc.

- **Customs unions:** A customs union involves the removal of tariff barriers between members and the acceptance of a common external tariff against non-members. This means that members may negotiate as a single bloc with third parties such as other trading blocs or countries.

- **Common markets:** This is the first step towards full economic integration and occurs when members trade freely in all economic resources so barriers to trade in goods, services, capital and labour are removed. They impose a common external tariff on imported goods from outside the markets. For a common market to be successful there must also be a significant level of harmonisation of micro-economic policies, common rules regarding monopoly power and anti-competitive practices and the removal of custom posts. There may also be common policies affecting key industries such as the Common Agricultural Policy (CAP). The main goal of a common market is to establish a single market, the same way in which there is a single market within an individual economy.

- **Monetary unions:** These are two or more countries with a single currency, with an exchange rate that is monitored and controlled by one central bank or several central banks with closely coordinated monetary policy. Some examples include the EU, the West African Economic and Monetary Union and the Economic and Monetary Community of Central Africa.

The Eurozone:

- The European Central Bank distributes notes and coins, sets interest rates, maintains a stable financial situation and manages the foreign currency reserves.
- In the EU, the governments agreed not to exceed a fiscal deficit of more than 3% and not to have a National Debt of more than 60%.
- For a monetary union to be successful, there should be free movement of labour, capital mobility and wage and price flexibility, fiscal transfers from one country to another when a country is performing poorly, and countries should share the same business cycle. The main problem for the EU is the lack of automatic fiscal transfers, for example these would have helped Greece, Spain and Portugal following the financial crisis of 2007-08.

Monetary unions are good since they mean prices are fixed as all currencies are the same and there are reduced exchange rate costs. It becomes easier for prices to be compared across the union and so MNCs are less able to price discriminate.

However, there are financial costs involved with starting the new currency and there would be costs if the union broke up. There is a loss of policy independence, countries are unable to change the value of their currency and what is good for one country may not be good for another.

- An **economic union** is the final step of economic integration. There will be a common market with coordination of social, fiscal and monetary policy.

Costs and benefits:

Advantages:

There are two main types of benefits: static benefits from the gains of specialisation, and dynamic benefits from increased competition and the transfer of resources.

- Free trade encourages increased specialisation, and this increases output, according to **comparative advantage**. This specialisation also helps firms to benefit from **economies of scale**, causing lower prices and costs, a dynamic advantage.
- Firms may be able to grow much larger by creating a **larger customer market**, but this may be difficult given different customer markets in different countries. It will be easier for some products, such as basic chemicals and cars, than for other products and easier between some countries, such as France and the UK, than between others, such as Iran and UK. Economies of scale will be increased further over time as companies expand.
- Firms inside the bloc are **protected** from cheaper imports from outside, for example those in the EU are protected from Chinese imports.

- Another dynamic benefit may be **competition,** as the removal of barriers means domestic industries face greater competition. This encourages innovation and lower prices, leading to improvements in productive and allocative efficiency.
- The increased trade may **create more jobs** if it leads to an increase in output.
- There will be **increased choice** for consumers.

Disadvantages:

- Countries are no longer able to benefit from trade with countries in other blocs and the blocs are likely to **distort world trade**, reducing the benefits of specialisation. Inefficient producers within the bloc are protected from efficient producers outside the bloc, called **trade diversion**.
- There may be a **reduction in competition** as inefficient firms are driven out of the business and the market becomes oligopolistic.
- One dynamic loss may be the **loss of resources**, as the most successful countries will attract capital and labour (since both are free in a common market) and so this **heightens regional inequalities** as the richest countries experience faster rates of growth. Firms may set up factories etc. in the poorer countries, as labour is cheaper, and therefore this will help them to grow but will also mean that they lose the most skilled labourers to more successful countries as this is where the best jobs are based.
- There could also be **retaliation** as the creation of one regional trading bloc will lead to the creation of others and this can lead to trade disputes.
- Creating and maintain trading blocs can **distract governments from the gains of signing full free trade agreements**. Bilateral trade agreements can bring very little gain to the two countries making the agreement but can take up significant government resources.
- They **distribute the gains from trade unequally**, with developed countries often gaining most and developing countries being impacted little.
- They may be weak if they cover a very **limited range of goods**.
- They lessen **national sovereignty**.
- Trading blocs can be seen as '**second best' solutions** in a world with protectionism. Economic efficiency would be maximised if there were no barriers to trade

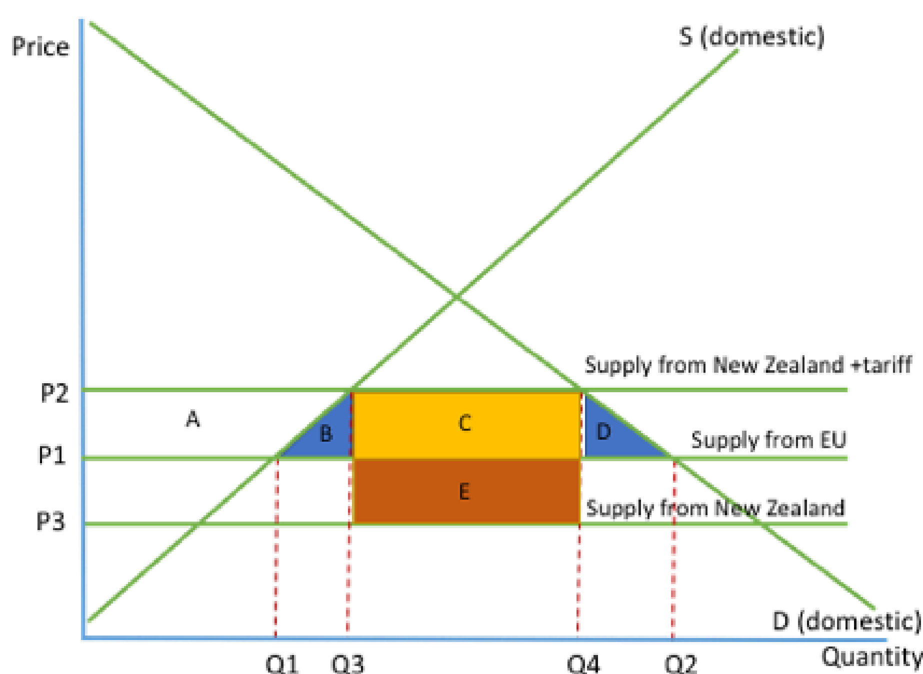
Synoptic point:

Some of these impacts are clearly microeconomic impacts e.g. economies of scale, impacts on the labour market, enhanced competition, low prices, more choice etc.

Trade creation and diversion: The costs and benefits of trading blocs will depend on whether they lead to trade creation or trade diversion. Trade creation is when a country moves from buying goods from a high cost to a lower cost country, whilst trade diversion is when they go from low cost to a higher cost.

- Trade creation is when trade is created by the joining of a trade union. The diagram is the opposite of the tariff diagram, since it removes the tariffs and leads to welfare gain and higher consumer surplus. It is when consumption shifts from a **high cost domestic producer to a low cost partner producer**, so for example when consumption of wine shifted from domestic producers to efficient French producers when we joined the EU.

- However, trade diversion occurs where consumption shifts from a **lower cost producer outside the trading bloc to a higher cost producer within** it. One example could be the UK switching from buying New Zealand butter, which is the cheapest, to European butter when they joined the EU:
  - Before, there would have been the same tariff on both New Zealand and European butter so New Zealand butter would have been bought since it is produced more efficiently and therefore is cheaper.
  - However, joining the EU meant that the tariff on EU butter was removed and so this became cheaper and consumption was switched to the higher cost EU butter. This reduces world-wide efficiency as countries are not buying from the most cost-effective supplier and therefore not fully utilising comparative advantage.
  - For the UK, there will be both gains and losses.



The diagram shows how the UK will buy from the EU without tariffs, rather than New Zealand with tariffs. They will buy Q2-Q1 from the EU. Before, they would have bought Q3-Q4 from New Zealand and gained tax revenue of C+E. The EU producers are gain E in profit, whilst C is switched to consumer surplus. A is producer surplus being switched to consumer surplus and B and D are welfare gain given to consumers. If B+D are greater than E, the UK have gained whilst if they are smaller, the UK has lost out.

- A trading bloc is more likely to lead to trade diversion than trade creation when it has a very **high external tariff** as this will push countries to buy from within the bloc or if there is a **relatively small cost difference** between goods purchased within and outside the block. The higher the tariffs imposed by a country before joining the market, the more likely it is that trade creation rather than diversion will take place.

- If joining a FTA leads to more trade creation than diversion, it is **welfare improving**. If it leads to more diversion than creation, the FTA is **reducing welfare**.

Role of the WTO:

- The World Trade Organisation was set up in 1995 to replace the GATT, which had aimed to reduce protectionism. It has two main aims: to bring about **trade liberalisation** and to ensure countries **act according to the trade agreements** they have signed.

- If a country fails to follow its agreements, a country or group can file a **complaint** and the WTO will attempt to solve the issue through negotiations but the complaint can go to a panel of experts and countries must agree to their rulings. If they reject the ruling, the country which wins the ruling has the legal right to impose **trade sanctions** against the exports of the losing country. One example of a WTO ruling is Boeing being allowed to impose tariffs on Airbus for illegal subsidies in Europe in 2018.

- They hold a series of talks called **'rounds',** the most recent of these is the Doha Round in 2001 which aims to cut protectionism on agricultural goods, reduce tariffs on manufacturing goods, increase access to markets in services, tighten intellectual property rights and give the WTO more power to settle disputes.

- One problem is that for any agreement to take place, **all countries must agree** to it and so any country is able to veto an agreement. This veto may also be politically motivated, for example retaliation against the US for something unrelated.

Possible conflicts with the WTO:

- **Regional trade agreements contradict WTO's principles** as a common external tariff on trade outside the trading bloc introduces protectionism. Customs unions and free trade areas can be seen as violating the WTO's principle since not all trading partners are treated equally.

- However, they can **complement the trading system** and the WTO strives to ensure non-members can trade freely and easily with members of a trade bloc.

- Some might argue the WTO is **too powerful** or that it **ignores the developing countries**, as developed countries do not trade freely with developing countries.
- The protectionist approach of the USA and China currently provides a threat to the WTO system.

4.1.6 Restrictions on free trade

Reasons for restrictions:

- **Infant industry argument:** An infant industry is one that is just being established within a country. They need to be able to build up a reputation and customer base and will have to cover a lot of sunk costs, meaning their AC will be higher. Therefore, the industry would be unable to compete in the international market and so the government protect them until they are able to compete on an equal level. This has worked well in Japan but in general tends to be ineffective as firms grow to be inefficient and the government tend to have a poor record of 'picking winners'. There may be other more effective methods, such as subsidies.
- **Job protection:** Governments may be concerned that allowing imports will mean domestic producers will lose out to international firms, and so there will be job losses within the country. Not only would this have negative economic consequences, it would be politically unpopular.
- **Protection from potential dumping:** Dumping is when a country or company with surplus goods sells these goods off to other areas of the world at very low prices, harming domestic producers in those countries. The government may need to intervene to protect domestic producers who are unable to compete with firms that are willing to make a loss. In China, tariffs are placed on stainless steel tubes from the EU and Japan to prevent from dumping.
- **Protection from unfair competition:** Across the world, different rules apply and this means that producers in different countries can produce at different prices. Domestic producers may be unable to compete with a firm that has very low labour costs or very low health and safety costs due to regulation or with a firm that is heavily subsidised by the government. Some will argue the government should intervene to protect domestic producers from this.
- **Terms of trade:** If a country buys a large amount of imports for a certain good, this will increase demand for that good and hence increase the price. This will worsen the terms of trade and so therefore they can buy less imports with the amount of exports. Restrictions will reduce supply of the good and lead to a fall in the price received by the importer, so improve the terms of trade.

- **Danger of over specialisation:** Some people believe that no country should become totally reliant on another for important products or materials and so it is important to introduce protectionism on these goods to prevent firms and consumers becoming reliant on them.

- There are some other arguments. Sometimes countries may decide to place controls on ‘dangerous’ goods, such as unsafe electrical items or drugs. They may feel too dependent on one industry so introduce barriers to allow others to develop. They not want to become too dependent on another country for something. Many of the tariffs imposed by Donald Trump in in 2018 were on the basis of national security.

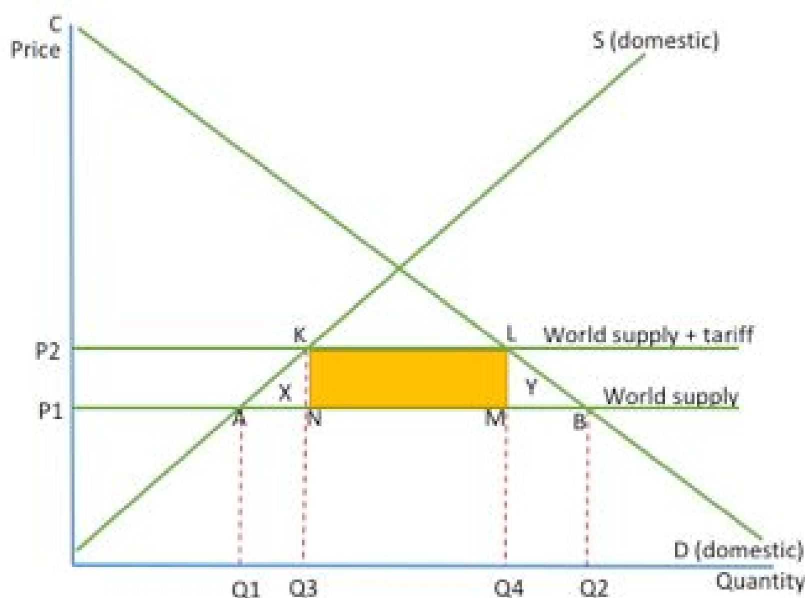
Synoptic point:

There are many microeconomic reasons for protectionism- most of the time it is to protect individual markets and jobs.

Types of restrictions:

Tariffs:

These are **taxes placed on imported goods** which make them more expensive to buy, making people more likely to buy domestic goods.



Price is set at P_1 because of the interaction of demand and supply in the world market. This means domestic producers will produce Q1 whilst consumers will demand Q2. Hence, the country will import Q_2-Q_1 goods meaning that Q1ABQ2 will be spent buying imports. However, the government could introduce a tariff and so price rises to P2. This will mean that

firms produce Q3 and consumers want Q4, so this time only Q3NMQ4 will be spent on imports. The government will also raise revenue of KLMN, the shaded area. However, consumer surplus falls from BP1C to LP2C: KLMN goes to the government and KAP1P2 goes to the producer but the areas X and Y are deadweight loss. Therefore, although tariffs help home producers, raise revenue and reduce the money leaving in imports, they are inefficient as they cause deadweight loss.

Quotas:

These are **limits placed on the level of imports allowed into a country**, meaning people are forced to buy domestic goods if they want that good and the quota is already used up. Like tariffs, a diagram can be used to represent how the imposition of a quota leads to welfare loss. The government could introduce a quota of KL (in the above diagram) and this will have the same effect as introducing a tariff which raises price to P_2. There will be a welfare loss and shift of consumer subsidy to producer subsidy but instead of tax revenue, there will be extra revenue for the exporting, foreign firms.

Subsidies to domestic products:

These are **payments to domestic producers which lower their costs** and help them to be more competitive by enabling cheaper prices. Sometimes subsidies are purely given to goods that are exported whilst other times they are given to firms that have a large proportion of their sales as exports. Subsidies can also be given to domestic firms that compete with imports, usually in the form of indirect subsidies like tax breaks or cheap loans. Research and development subsidies will help the firm to be competitive by ensuring they have the most up to date technologies. One example of this is China, who subsidise their car industry.

Non-tariff barriers:

- Countries can introduce an **embargo**, which is a total ban on imported goods.
- They can introduce **import licensing** when countries/firms need a license to be able to import; by reducing the number of licenses they give out, the government can restrict the level of imports.
- The use of **legal and technical standards** means that some products cannot be sold in the country, for example specific specifications can be imposed for goods or intellectual property laws over patents and copyrights can be introduced. The EU has high standards, which is the main restriction on trade from outside the bloc.
- On top of this, countries can use **voluntary export restraint agreements** where they agree to limit the volume of exports to one another over an agreed period of time to allow domestic producers to grow and establish.

Impact of protectionist policies:

Consumers:

- There are **higher prices** for consumers as they are unable to buy imports at the cheaper price. It tends to raise the price of domestic producers since goods and services needed for the production of these goods may also suffer from import controls and it limits the competition for domestic producers so they have less incentive to be efficient.
- Moreover, they suffer from **less choice.**

Producers:

- Domestic producers tend to benefit from import controls since they have less competition so can sell **more goods at a higher price** than otherwise and they will benefit from measures to increased exports.
- However, they may suffer from higher costs if there are **controls on the imports they need for production**.
- **Foreign producers will lose out** as they are limited in where they can sell their goods. Inefficient, domestic producers are kept in production, whilst efficient, foreign ones lose out.

Workers:

- Evidence suggests that there is **little difference to employment figures**.
- It can be argued that allowing inefficient firms to close would be better for workers in the long run. The market would reallocate resources and **create new jobs,** with greater security.
- Following the steel tariffs imposed in America in 2018, it is estimated that 16 jobs will be lost elsewhere for every job gained in the steel industry. (The Economist)
- However, Argentina have been successful at implementing tariffs which protect jobs

Governments:

- In the short run, governments benefit from protectionist policies as they can gain **tariff revenues** and they are **politically popular**.
- However, it can lead to an **inefficient economy** which stifles growth.

Living standards:

- As the tariff diagram shows, the imposition of import controls results in **deadweight welfare loss.**
- It also causes trade wars since the introduction of restrictions often leads to **retaliation** by other countries. A recent example of this is the US-China trade war,

where each country continues to impose more tariffs on the other's goods. This causes a reduction in trade and a reduction in growth

Equity:

- It has a **regressive effect** on the distribution of income as the rise in price affects the poorer members of society far more than the well off as it is they are no longer able to afford the products.

Recently, there has been a rise of economic nationalism in a number of countries, leading to policies which emphasise the domestic control of the economy, labour and capital formation, one of these is restrictions to free trade. The financial crisis and recession led to distrust of globalisation and pressure to put self-interest above anything else. Countries have found it difficult to lower protectionism since they always expect reciprocity, for example the UK would not lower barriers on US goods if they US were not willing to do the same.

Synoptic point:

Many of the impacts of protectionism are on individuals, for example higher prices for consumers or keeping inefficient producers in business.

4.1.7 Balance of payments

Components of the balance of payment:

A country who participates in foreign trade will be sending and receiving money from other countries and they keep track of these transactions in a balance sheet, called the balance of payments:

- **The current account:** The current account itself is split into different parts: trade in goods, trade in services and income and current transfers. It is looked at in detail in Theme 2.

- **The capital and financial accounts:**
  - The capital account is relatively unimportant as it mainly records transfers of immigrants and emigrants taking money abroad or bringing to the UK, or government transfers such as debt forgiveness to Third World countries.
  - The financial account is more important and is split into three main parts: foreign direct investment (FDI), portfolio investment and other investments. Foreign direct investment is the flow of money to purchase part of a foreign firm (10% of more of the ordinary shares) e.g. BT buying a 15% share in a telecommunications company in Brazil. Portfolio investments are the same

thing but where they buy less than 10% of the company. Other investments include loans, purchasing of currency and bank deposits.

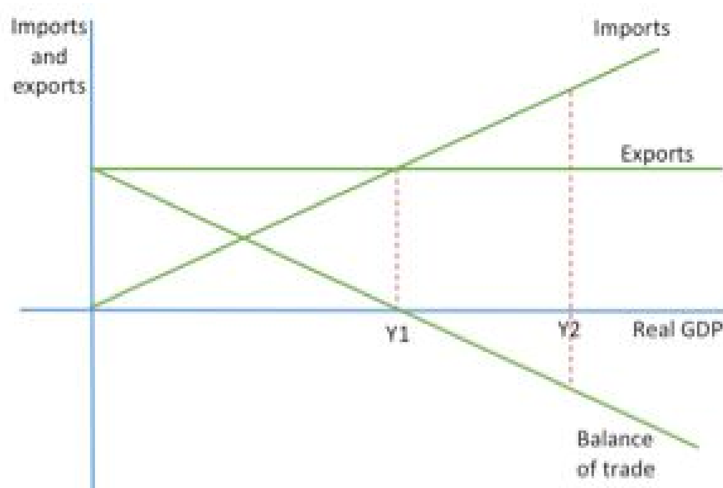
- The balance of payments shows all flows into and out of the country and since total inflows must equal total outflows, the balance of payments must balance. If there is a recorded deficit or surplus, this is a **balancing item**, all the transactions that fail to be recorded by the statisticians.

Causes of deficits and surpluses:

There can be deficits and surpluses on particular part of the accounts; a country can run a deficit on the current account if they are able to have a surplus on the capital account. France and Chile tend to have a current account balance, China and Germany tend to have a current account surplus and Britain and the USA tend to have a current account deficit.

Short term causes:

- It can be caused by **high levels of consumer demand**. If real household spending grows more quickly than the supply side of the economy can deliver, the only way of meeting this demand is by importing those goods and services. High incomes in a country lead to high imports but have no effect on the level of exports.



The diagram shows that an increase in income from Y1 to Y2 causes imports to rise but exports to stay constant, leading to a fall in the balance of trade. At Y1, imports=exports and so the balance of trade is 0 whilst at Y2, there is a balance of trade deficit. Research suggests that UK consumers have a **high-income elasticity of demand for imports** so the deficit tends to grow when the economy enjoys a period of consumption led growth.

- Moreover, it can be caused by a **strong exchange rate** which reduces the UK price of imports and leads to an expenditure-switching effect away from domestically produced output. The high value of the pound improves the terms of trade between the UK and other countries, allowing us to buy and consume more imports with each

pound. It increases the price of exports and so leads to a fall in the value of exports. This assumes that PED is inelastic.

- A high level of **relative inflation** will decrease exports since it will increase their price compared to goods produced by other countries.

Medium term causes:

- As a country loses its **comparative advantage**, people will transfer their purchases to other countries and the UK will need to switch resources to production of other things. Similarly, the growth of cheap imports from countries like China has caused a substitution effect.

Long term causes: Much of the UK's trade deficit is due to structural rather than cyclical factors, due to supply side deficiencies.

- A **lack of capital investment** means firms use older and more out of date technology. This contributes to a **lack of productivity.** Germany has 35% higher productivity per hour worked than the UK. In the UK, productivity is only growing at 1%.

- **Deindustrialisation** in the UK has led to a decrease in the relative importance of industry and manufacturing in the economy. This makes it more difficult to export, since services are harder to export.

- Countries with a large amount of **natural resources** tend to export more, and if they also have a small population (e.g. Saudi Arabia) then they tend to have a current account surplus.

- Some countries are **more competitive** than others, for example high labour productivity or a reputation for high quality.

- Countries with **corruption** and where it is difficult to set up a business tend to find it difficult to export.

In the context of the UK, the main issues are low levels of investment, the impact of the banking crisis on preventing borrowing, low innovation, skills shortages, inefficient monopolies and underperforming businesses and poor infrastructure.

Reducing imbalance:

There are two main causes of deficit: demand side issues and supply side issues. This means there are two main ways to fix it: demand and supply side policies. Expenditure-switching policies can also be used.

Demand side policies:

- Monetary or fiscal policy can be used to reduce AD. This reduces income so reduces demand for imports. It should be effective since there is high income elasticity for imports.

However, they are only **short term** and **limit output** of the economy, causing a reduction in living standards and growth.

Supply side policies:

- They could also use a range of measures to improve **productivity and efficiency** or improve **quality.** This could include competition policy, improving labour or improving infrastructure.

- They can seek and encourage industries to **exploit opportunities in export market overseas** and focus resources on industries where the UK has a **real comparative advantage**, accepting some industries should close. This will be politically unpopular and will cause job losses in the short term.

These are much **longer-term** solutions but will solve the balance of payment issues in the long term rather than temporarily as with aggregate demand.

Expenditure switching policies:

- **Tariffs or quotas** will reduce the attractiveness of imports. However, they are likely to cause **trade wars** as other countries implement protectionist policies and so therefore may even worsen the deficit. These are almost impossible to implement, given trading blocs and the laws of the WTO.

- They could attempt to **control inflation** which will mean that the price of British goods rises slower than those in other countries, meaning that they become more competitive over time. The problem is that it will lead to a fall in demand for domestic goods and so therefore could cause unemployment and a fall in growth.

- They could also **devalue/depreciate the pound** as this will makes exports cheaper and imports dearer. However, this will not always work. (**Marshall-Lerner and J-Curve**). It is not feasible for many countries as they have a **floating exchange rate** and so central banks intervening in the market will only nudge the exchange rate for

a short period of time. The best way to affect the value of the currency is by changing the interest rate, but this has effects on AD and so may not have the intended effect.

These **cannot solve long-term** causes of a deficit.

Synoptic point:

Both macro and microeconomic policies can be used to fix deficit, because it has both microeconomic and macroeconomic causes.

Significance of global trade imbalances:

- Some can argue that a current account imbalance is not much of a problem as long as the capital and financial account is in surplus. However, the financial crisis of 2008 dramatically reduced the amount of capital flowing around the global economy and showed how quickly the position of the capital account can change. The uncertainty around Brexit increased the concern about the balance of payments due to fears over the response of the financial markets.

- Since the late 1990s, there have been concerns about global imbalances which can be measured in two ways: imbalances on the current account and imbalances in assets owned abroad or borrowing owned abroad. The two are linked since if a country has a constant surplus, then it will tend to build up a stock of assets abroad whilst if they have a constant deficit, they will owe more and more to foreign creditors. This may become an issue if imbalances are large.

- Problems arise if foreign investors refuse to lend to a 'country'- but it is an individual or institution which takes the loan and not the country. If they refuse to lend to a bank or the government, this will have much larger impacts than if they refuse to lend to a firm or individual.

- Today, deficits are less of a concern to countries: the US and UK have no problem financing their deficits and borrowing has not built up unsustainable debts.

- Current account imbalances become a problem when governments can't repay their foreign currency debts.

- Countries with large deficits are seen as having a problem, whilst those with large surpluses are seen as being successful but in reality, those with surplus cause just as much instability as those with deficits.

- Current account surpluses cause losses for citizens in a country who don't see the high living standards which they could enjoy from consuming more.

4.1.8 Exchange rates

The exchange rate is the **purchasing power of a currency in terms of what it can buy of other currencies**.

Exchange rate prices can be expressed in various rates:

- The spot exchange rate is the actual exchange rate for a currency at current prices, which can change on a minute and minute basis.
- Forward exchanges rates involve providing a currency at some point in the future for an agreed rate. It is usually used by companies who want to reduce uncertainty and know the actual cost they will pay.
- The bilateral exchange rate is simply the value of one currency against another e.g. £1=$2.
- The exchange rate index (EER) shows the value of a currency against a basket of currencies weighted against the proportion of trade that that country does with each currency and gives an indication of the overall strength of the currency in the market. For example, for the UK, the US Dollar and the Euro would be heavily weighted in the basket of currencies.

Exchange rate systems:

- A **free floating system** is where the value of the currency is determined purely by market demand and supply of the currency, with no target set by the government and no official intervention in the currency markets. Both trade flows and capital flows affect the exchange rate under a floating system. Most systems are floating, including the UK.

Arguments for floating exchange rates: The use of floating exchange rates mean that the central bank does not need to try to maintain a particular exchange rate and therefore will not need to use reserves to buy pounds in the market to keep it at the target. Similarly, interest rates are reserved for domestic monetary policy to control inflation rather than maintaining the exchange rate. Moreover, it is able to partly auto-correct a trade deficit as a large trade deficit will cause a fall in the value of the pound, since supply of pounds is high and demand is low. This fall in the pound will make exports cheaper and imports more expensive so may reduce the trade deficit (assuming the Marshall Lerner condition). It also reduces the risk of currency speculation, since speculation is most attractive when the currency is over or undervalued, and floating exchange rates reduces this because the price is determined by the market.

- **Managed floating** is where the value of the currency is determined by demand and supply but the Central Bank will try to prevent large changes in the exchange rate on

a day to day basis. This is done by buying and selling currency and by changing interest rates. Some examples include the Brazilian Real, Swiss Franc and the Japanese Yen.
  - An adjustable peg system is where currencies are fixed against another but the level at which they are fixed can be changed.
  - Crawling peg systems are a form of this but have a mechanism which allows the value to change.
  - Managed float or dirty float is where the government intervenes to improve macroeconomic stability.

- A **fixed system** is when a government sets their currency against another and that exchange rate does not change. The country can decide to devalue its currency overnight to improve international competitiveness of its industry. One example was the gold standard, where each major trading country made its currency convertible into gold at a fixed rate. Today, no country uses the gold standard.

Arguments for and against a fixed exchange rate: Some argue that a fixed exchange rate is good because it avoids currency fluctuations, which encourages trade and investment as firms/individuals know the true costs of the deal. It reduces the cost associated with trade, as firms have to spend less on currency hedging which is the process of agreeing on forward exchange rates. Also, a stable exchange rate may reduce inflation as there is not a sudden reduction in the value of the currency leading to a rise in imports and therefore inflation. However, it can cause conflict with other objectives. If the currency is falling below the government's set level, they have to intervene by raising interest rates to increase the desire to move hot money into UK or buying sterling using gold or foreign currency reserves to increase demand. The rise of the interest rates will have negative effects on other policies, for example it will decrease growth. It will be easy for the government to set the exchange rate at the wrong rate: if it is too high, then goods become uncompetitive but if too low it could cause inflation due to high import prices. On top of this, there is less flexibility and it is difficult to respond to temporary shocks.

Changes in the currency:

- An **appreciation** of the currency is an increase in the value of the currency using floating exchange rates, whilst **depreciation** is a fall in the value of the currency under floating exchange rates.

- A **revaluation** of the currency is when the currency is increased against the value of another under a fixed system, whilst **devaluation** of the currency is a decrease in the value of one currency against another under a fixed system.

Factors affecting floating exchange rates:

- Floating exchange rates are determined by the **interaction of demand and supply**, and so are affected by changes in demand and supply.

- The **demand for pounds is determined by**: the amount of British goods that foreigners want to buy; the number of foreigners wanting to invest in the UK, visit the UK or place their money in British banks; and the amount of speculation on the pound.

- The **supply of pounds is determined by:** the amount of foreign goods people in the UK want to buy; the number of British firms that want to invest abroad, the amount of British people wanting to go on holiday abroad or place their money in foreign banks; and the amount of speculation on the pound.

- Therefore, in general, the currency is affected by the level of **exports and imports**, the level of **investment,** those going on **holiday** and **speculation.**

- Speculation is the single most important determinant of the short-term price- if speculators fear a fall in the pound, the pound will fall as they will sell their pounds and buy another currency.

- However, in the long term, the currency is determined by **economic fundamentals**: exports, imports and long-term capital flows.

The purchasing power parity theory argues that in the long run exchange rates will change in line with changes in prices between countries. Inflation makes exports less competitive and imports more competitive, causing a fall in the trade balance and so a fall in the pound.

Government intervention:

There are two main methods the government can use to influence the value of their country:

- If they want to increase or decrease demand for their currency, a government can **use interest rates.** An increase in interest rates will strengthen the pound as people will convert their money to pounds to put them in English banks, so demand for pounds will rise. Falls in interest rates will decrease demand for the pound so weaken the currency.

- Also, governments can use **gold and foreign currency reserves** to manipulate the value of their currency. If the value of the pound is too high and they want to weaken it, they can increase supply by buying foreign currency or gold with pounds. To

strengthen the pound, they can increase demand by selling their foreign currency or gold in exchange for pounds. Central banks have found that this method tends to have little impact on currencies in the long term. They are also able to limit supply of currency by introducing currency controls, and by doing so they can fix the value of the currency.

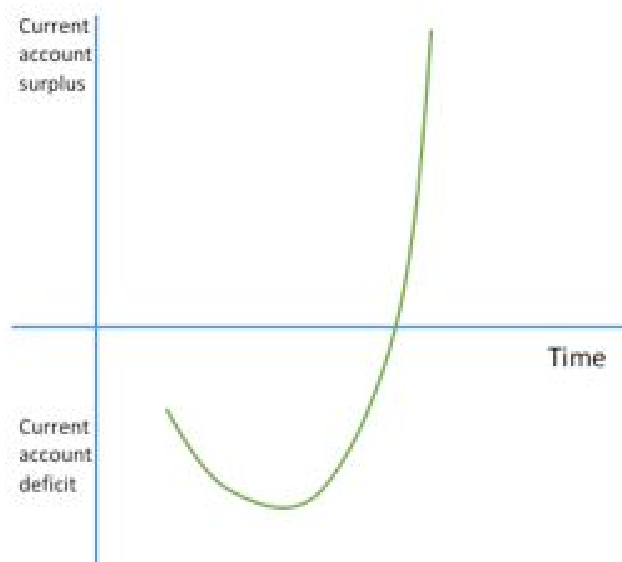
Competitive devaluation/depreciation:

- This is where a country **deliberately intervenes in foreign exchange markets to drive down the value of their currency** to provide a competitive boost to their exporting industries. A weaker currency will encourage exports and discourage imports and therefore the balance of payments should improve assuming the Marshall-Lerner condition. However, the problem is that this can cause inflation and this may reduce competitiveness, leading to a fall in the balance of payments.

- One problem is that **other countries may follow** and reduce their currency as well. This is unlikely if there is a current account deficit but if the country who devalues has a surplus, other countries are likely to retaliate.

Impact of changes in exchange rates:

- **Current account of balance of payments:**
  - The **Marshall-Lerner condition** states that the sum of the price elasticities of imports and exports must be more than one (i.e. elastic) if a currency devaluation is to have a positive impact on the trade balance.
  - The **J-curve** (shown in the diagram) shows how the current account will worsen before it improves. People will not immediately recognise that British exports are cheaper and it will take a while to find a source for them, whilst UK consumers will not see that imports are more expensive and may be unable to switch straight away. Demand tends to be inelastic in the short run. Therefore, the amount sold of each will stay the same but the price of exports will fall, so the value will fall, and the price of imports will rise, so the value will rise. However, in the long term, the current account deficit will fall as demand becomes more elastic.



- **Economic growth and unemployment:** A weaker exchange rate is likely to increase exports, since they become cheaper, and decrease imports so lead to an increase in AD. This will increase employment and economic growth.

- **Rate of inflation:** Falls in the exchange rate will increase inflation as imports become more expensive, causing a rise in prices and a fall in SRAS. Also, the net exports section of AD will increase and so inflation will rise further.

- **FDI:** A fall in the currency may increase FDI because it becomes cheaper to invest. However, if the currency is continuing to fall then this is an indication that an economy has serious economic difficulties which will discourage investment.

Following a depreciation of a currency, companies may decide to keep the price it charges its customers the same. For example, the pound may fall but a UK company selling goods in the US may decide to charge the same price in US dollars to its customers- this means the value of the exports in British pounds has risen. Therefore, changes in currencies will have different impacts depending on the reactions of firms.

4.1.9 International competitiveness

The lower the level of international competitiveness, the more likely that the country will face a current account deficit. For goods to be competitive internationally, they need to be cheap, have good quality, design or after-sales and good marketing.

Measures of international competitiveness:

Relative unit labour costs: Unit labour costs are total wages divided by real output: the cost of employing workers for each unit of good. These are measured in an index number with one year chosen as a base year. Unit labour costs in the UK are compared to other countries. A rise in relative unit labour costs in the UK shows that labour cost per unit is rising faster in the UK compared to other countries and so the UK is becoming less competitive.

Relative export prices: This is the price of UK exports compared to the exports of the UK's main trading partners. A rise in relative export prices means UK export prices have risen more than other countries' export prices and so the UK has become less competitive.

Factors influencing international competitiveness:

- **Exchange rates**: A rise in the pound will cause exports to become more expensive, and thus make UK goods less competitive as their price changes. However, this depends on the elasticity the good and the reaction of the firms as explained in 4.1.8.

- **Productivity:** A rise in productivity will cause a rise in the UK's competitiveness because costs are lower and so prices will fall. Labour productivity is important.

- **Regulation**: High levels of regulation slow down business decisions, making them less adaptable to changes in the global market. It also increases their cost of production. Therefore, regulation reduces competitiveness because of higher costs and slow decision making.

- **Investment:** Investment in infrastructure improves productivity and ensures firms can deliver and produce their product reliably, cheaply and efficiently. Investment in research and development allows firms to develop new products, which increases competitiveness as other countries won't have these products, and new technology, which reduces costs and increases efficiency.

- **Taxation:** High levels of taxation reduce investment and so cause a reduction in international competitiveness in the long term. It can also reduce incentives for individuals to take risk, and thus reduce innovation.

- **Inflation:** Low levels of inflation increase competitiveness since UK goods increase in price by less than goods in other countries and so they become more competitive over time.

- **Economic stability:** If the country is not seen as stable, then there will be little long-term investment and so this will reduce competitiveness overtime.

- **Flexibility:** If the labour market is flexible, this will improve competitiveness as businesses will be able to move labour in response to changes in demand and prevent unnecessary wage rises (a lack of flexibility would mean higher wages had to be offered to get people to move jobs). This keeps costs and prices low. Moreover, flexible and efficient managers will be able to manage change within the company and adapt production when demand for products changes.

- **Competition and demand at home:** A good level of domestic demand will mean that firms in the country will already be producing in large numbers, experiencing economies of scale, and so have low AC curves. Similarly, high levels of competition will mean firms will have to have good quality or cheap products to survive. Both of these mean they will be able to compete internationally.

- **Factors of production:** A country with a lot of good quality factors of production will be able to produce more and better quality goods than a country which has limited or poor quality resources.

- **Openness to trade:** This means trade barriers will be low and so other countries are likely to have low barriers on goods coming from the UK, meaning it is easier and cheaper to export. It also means that firms inside the UK will not suffer from high costs of production due to import barriers.

Benefits and problems of competitiveness:

International competitiveness has some winners and some losers.

- By being competitive, a country will experience **current account surpluses**. This surplus allows them the opportunity to invest overseas and build up a surplus of assets overseas, on which interest, profit and dividends can be earned.

- A competitive economy is likely to attract inflows of **foreign investment**, whether this be by establishing new companies (creating jobs) or buying domestic firms. This will lead to a transfer of knowledge, skills and technology to firms.

- **Employment** is likely to increase because more goods are being produced, since more goods are exported and less are imported, so more are sold internationally and domestically. A rise in demand for labour will lead to a **rise in wages.**

- There will be **economic growth**, both by supply side improvements due to efficiency and investment and by demand side improvements relating to X-M.

- However, the problem with being internationally competitive is that this competitiveness can be **easily lost**. Developing countries who have benefits due to lower costs of labour and costs of materials etc. could see this eroded when they experience export led growth due to their competitiveness. A current account surplus may lead to a **rise in the exchange rate**, reducing their competitiveness. Less competitive countries may implement trade barriers to protect themselves. Despite this, international competitiveness is not always lost with development e.g. Singapore and Germany.

- Countries who are competitive may become **more dependent** on overseas countries and so this may mean they suffer from larger issues if there is a global recession.

Synoptic point:

International competitiveness is dependent on microeconomic and macroeconomic factors. It also has both microeconomic and macroeconomic impacts, for example on the profit of firms and on the balance of payments.