Edexcel Economics (A) A-level

Theme 4: A Global Perspective

4.1 International Economics

Summary Notes

4.1.1 Globalisation

Characteristics of globalisation:

Globalisation is the ever increasing integration of the world's local, regional and national economies into a single, international market.

It involves the free trade of goods and services, the free movement of capital and labour and the free interchange of technology and intellectual capital.

With the spread of globalisation came more trade between nations and more transfers of capital including FDI (foreign direct investment). Moreover, brands developed globally and labour has been divided between several countries. There is more migration and more countries participate in global trade, such as China and India, as well as higher levels of investment. Additionally, countries have become more **interdependent,** so the performance of their own country depends on the performance of other countries. This could be seen in 2008 and 2009, when the effects of the global credit crunch spread across the globe.

Factors contributing to globalisation in the last 50 years

Trade in goods:

- Developing countries have acquired the capital and knowledge to manufacture goods. The efficient forms of transport make it easier and cheaper to transfer goods across international borders. Some developing countries have the cost advantage of cheaper labour, so MNCs move their production abroad. This causes developed countries to trade with these developing countries, so they can access the same manufactured goods.

Trade in services:

- For example, the trade of tourism, call centre services, and software production (particularly from India) has increased from developing countries to developed countries.

Trade liberalisation:

- The growing strength and influence of organisations such as the World Trade Organisation (WTO), which advocates free trade, has contributed to the decline in trade barriers.

Multinational Corporations (MNCs):

- MNCs are organisations which own or control the production of goods and services in multiple countries. They have used marketing to become global, and by growing, they have been able to take advantage of economies of scale, such as risk-bearing economies of scale. The spread of technological knowledge and economies of scale has resulted in lower costs of production.

International financial flows:

- For example, the flow of capital and FDI across international borders has increased. C Also, the foreign ownership of firms has increased. There has been more investment in factories abroad.
- The removal of capital controls has facilitated this increase.

Communications and IT:

- The spread of IT has resulted in it becoming easier and cheaper to communicate, which has led to the world being more interconnected. There are better transport links and the transfer of information has been made easier.

Containerisation:

- This has resulted in it becoming cheaper to ship goods across the world. This causes prices to fall, which helps make the market more competitive. Containerisation means that goods are distributed in standard sized containers, so it is easier to load and cheaper to distribute using rail and sea transport. This helps to meet world demand.
- However, it is mainly MNCs which have been able to exploit this, and it could result in some structural unemployment.

Impacts of globalisation and global companies on:

Individual countries

There could be trade imbalances between countries. For example, the US runs a large current account deficit with China, who has a large current account surplus.

Within individual countries, there could be income and wealth inequalities if the benefits and costs of globalisation are not evenly spread. Inequality between countries can also increase, as some countries gain more from globalisation than others.

Culture could spread across the globe. Some might say this has weakened culture and that there has been a loss of cultural diversity due to global brands. However, others will argue that the spread of culture has been positive and helped to improve their quality of life.

Governments

Some governments might lose their sovereignty due to the increase in international treaties. Individual states would find it hard to resist the force of them, and if countries become members of organisations, they will have to abide by their rules.

Producers and consumers

Consumers and producers can earn the benefits of specialisation and economies of scale as firms become larger.

Firms operate in a more competitive environment, which encourages them to lower their average costs and become more efficient. This makes goods cheaper.

Producers can also make their average costs lower by switching production to places with cheaper labour. The spread of technology has resulted in firms being able to employ the most advanced machines and production methods.

Globalisation leads to a general increase in world GDP, which increases consumer living standards and helps lift people out of absolute poverty. However, it is hard to calculate the proportion of growth which was due to globalisation.

This rise in average consumer incomes could offset some of the lower costs of production for firms. This is especially due to increased demand from China, which has contributed to the increase in price of commodities, and therefore pushed up the price of raw materials.

Some consumers gain more from globalisation than others. Globally, there are fewer people in extreme poverty, but this has not been the case in Sub-Saharan Africa. There could be increased inequality.

Consumers could take advantage of a wider range of goods and services because of the increased availability of goods and services. However, some services might become homogenised, such as hotels.

- **Workers**

Workers can take advantage of job opportunities across the globe, rather than just in their home country.

However, there could be structural unemployment. For example, in the UK after the collapse of the ship building and mining industries, there was a lot of structural unemployment. This is because it was more efficient for manufacturing to occur abroad, so production shifted to lower labour cost nations.

However, it could be argued that countries would have had the change from agriculture to manufacturing to services anyway, and globalisation simply sped it up.

When production shifts to lower labour cost countries, the creation of jobs could be seen as either beneficial or harmful. On one hand, MNCs could be exploiting their labour and providing poor working conditions in, for example, sweatshops. On the other hand, working in a sweatshop might provide a higher, more stable income than any alternatives, such as agriculture.

- **The environment**

Although industrialisation and increased consumer living standards might lead to more pollution through increased production and increased car use, consumers might show more concern towards the environment as their average incomes increase.

Some of the negative impacts on the environment could include deforestation, water scarcity and land degradation.

Increased trade leads to higher emissions from the movement of the goods.

Synoptic point:

Globalisation has clear microeconomic effects because of its effects on consumers and producers as well as the negative externalities it leads to. It has also contributed to the increasing contestability of markets.

4.1.2 Specialisation and trade

Absolute and comparative advantage:

Countries can specialise in the production of certain goods. For example, Norway is one of the world's largest oil exporters. Countries trade to get the goods and services they are unable to produce.

A country has **absolute advantage** in the production of a good or service if it can produce it using fewer resources and at a lower cost than another country.

Comparative advantage occurs when a country can produce a good or service at a lower opportunity cost than another country. This means they have to give up producing less of another good than another country, using the same resources. It is occurs when their opportunity cost of production is lower.

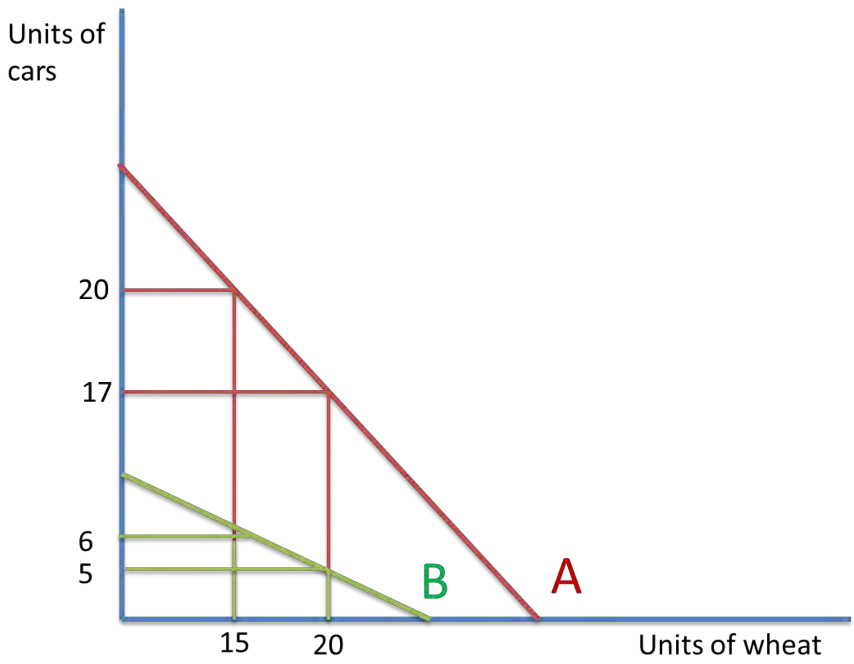
Comparative advantage diagram and numerical analysis

Country A can produce 30 units of wine and 10 units of wheat with their resources, and country B can produce 32 units of wine and 20 units of wheat.

	Wine	Wheat
Country A	30	10
Country B	32	20
Total	62	30

It can be seen that country B has an absolute advantage in producing both products (it can produce more of both with the same resources). The greatest difference between the productions is with wheat, so country B should produce wheat and country A should produce wine.

The opportunity cost of production is reflected in the gradient of the PPF. If more of one good is produced, less of the other good can be produced.



From the diagram, it can be seen that to increase production of wheat by 5 units, A has to give up 3 units of cars (20 to 17). However, B only gives up 1 unit of cars (6 to 5). Therefore, B has a lower opportunity cost of producing wheat, so B should produce wheat (it has a comparative advantage in wheat). For each unit of wheat, the opportunity cost ratio for A is 3/5, whilst for B it is 1/5.

Assumptions and limitations relating to the theory of comparative advantage

The theory of comparative advantages assumes a perfectly competitive market. In reality, this is likely to be different, which results in the full benefit of specialisation not happening. Specialising fully could also lead to structural unemployment, since workers might not gain the transferable skills they need to change between sectors, or they are simply unable to change.

Comparative advantage does not consider the exchange rate when considering the cost of production for both countries. Therefore, if the price of one good increase, it is more worthwhile producing that good, even if the country has a comparative advantage in the other good.

Moreover, comparative advantage is derived from a simple model with two countries; the global trade market is significantly more complex than this.

It can be argued that comparative advantage is no longer a relevant concept. Countries do not only produce a handful of goods and services, like the theory suggests. Rather, a wide variety of goods and services are produced, and there is very little specialisation. This is helped by the advancement of technology.

Advantages and disadvantages of specialisation and trade in an international context

Advantages:

- Greater world output, so there is a gain in economic welfare.
- There could potentially be higher quality, since production focusses on what people and businesses are best at.
- Consumers have a greater variety of goods and services to choose from.
- Lower average costs, since the market becomes more competitive, which reduces prices.
- There is an outward shift in the PPF curve.
- More opportunities for economies of scale

Disadvantages:

- Less developed countries might use up their non-renewable resources too quickly, so they might run out.
- Countries could become over-dependent on the export of one commodity, such as wheat. If there are poor weather conditions, or the price falls, then the economy would suffer.
- There could be more structural unemployment, since production moves abroad.
- Some countries might become stuck in the production of one good or service, so they cannot develop further.

4.1.3 Pattern of trade

Factors influencing the pattern of trade and changes in trade flows between countries:

Comparative advantage

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. China and India now take a much larger proportion of world trade.

Impact of emerging economies

The collapse of communism has meant that more countries, especially developing countries, are participating in world trade. International trade is arguably more important for developing countries than developed countries.

As economies emerge, they take up a larger proportion of exports, since many develop through export-led growth. They also import more, since rising incomes means that consumers demand more goods and services.

Growth of trading blocs and bilateral trading agreements

With more trading blocs, trade has been created between members, but diverted from elsewhere. Trade creation occurs when a country consumes more imports from a low cost producer, and fewer from a high cost producer. Trade diversion occurs when trade shifts to a less efficient producer. They shift trade from one group to another.

The policies of developed countries have limited the ability of developing countries to export primary commodities. For example, the EU Common Agricultural Policy (CAP) means domestic farmers receive subsidies to encourage production and lower costs so farmers in other countries find it hard to compete with them.

Changes in relative exchange rates

The exchange rate affects the relative prices of goods between countries, which is an important factor in determining whether consumers buy goods. A rise in the exchange rate of a country will decrease its exports and shift trade to another country.

4.1.4 Terms of trade

Calculation of terms of trade:

The terms of trade measures the volume of imports an economy can receive per unit of exports. It is calculated by the index price of exports over the index price of imports.

Terms of trade above 100 are improving, whilst those below 100 are worsening.

An example calculation is:

- The index price of exports increases by 15%. The index price of imports increases by 20%.

  The terms of trade are (115/120) x 100 = 95.83. This means that the terms of trade has reduced, so the economy gets fewer imports per unit of exports.

Factors influencing a country's terms of trade:

In general, anything which affects the price of a country's imports or exports will affect its terms of trade. Therefore, it is affected by the demand and supply for its imports and exports. An increase in the price of exports or a decrease in the price of imports will cause an improvement in the terms of trade; this is said to be favourable. A decrease in export prices or rise in import prices will lead to a deterioration of the terms of trade; an unfavourable movement.

Exchange rates, inflation and changes in tastes impact the demand and supply in the short run. In the long run, productivity impacts terms of trade.

Incomes effect the terms of trade since it impacts the demand for goods and services. For example, a rise in world income leads to a rise in demand for tourism so a country with a strong tourist industry would see an improvement in terms of trade as the price of exports increase.

If a country employs a protectionist measure, then the terms of trade will improve because imports are restricted. This is providing other countries do not retaliate.

The impact of changes in a country's terms of trade:

Improving terms of trade mean the economy can import more goods for each unit of export. This can help reduce the effects of cost-push inflation, since import prices are falling relative to export prices. It could also help improve standards of living for consumers in the country.

Worsening terms of trade means that for every import, the country has to export more. It could make the price of new technology more expensive, which might limit productivity. It could lead to a fall in living standards, and because it is more difficult to earn foreign currency, it becomes harder to pay foreign debt.

The impact on the balance of payments depends on the elasticity of demand and the Marshall Lerner condition (4.1.8). If goods and services are price elastic, an improvement in the terms of trade will lead to a worsening on the current account.

4.1.5 Trading blocs and the World Trade Organisation (WTO)

- **Types of trading blocs (regional trade agreements and bilateral trade agreements):**

- **Free trade area**

This is where countries agree to trade goods with other members without protectionist barriers. For example, the North American Free Trade Agreement (NAFTA) is a free trade area, as is the European Free Trade Association (EFTA).

They allow members to exploit their comparative advantages, which increases efficiency.

- **Customs union**

Countries in a customs union have established a common trade policy with the rest of the world. For example, they might use a common external tariff. They also have free trade between members. The European Union is an example of a Customs Union.

- **Common market**

This establishes free trade in goods and services, a common external tariff and allows free movement of capital and labour across borders. When the EU was established, it was a Common Market. EU citizens can work in any country in the EU.

- **Monetary unions, including conditions necessary for their success:**

This is sometimes called a currency union. Members of a monetary union share the same currency. This is more economically integrated than a customs union and free trade area. The Eurozone is an example of this.

A common central monetary policy is established when a monetary union is formed. The single European currency, the Euro, was implemented in 1999 to form the Eurozone.

Monetary unions use the same interest rate. The Euro, for example, floats against the US Dollar and the Pound Sterling. Member nations are required to control their government finances, so budget deficits cannot exceed 3% of GDP. This is one of the four convergence criteria countries have to meet in order to join the Euro. The other three are:

- Gross National Debt has to be below 60% of GDP
- Inflation has to be below 1.5% of the three lowest inflation countries
- The average government bond yield has to be below 2% of the yield of the countries with the lowest interest rates. This ensures there can be exchange rate stability.

The optimal currency zone is created when countries achieve real convergence. Member countries have to respond similarly to external shocks or policy changes. There has to be flexibility in product markets and labour markets to deal with shocks. This could be through the geographical and occupational mobility of labour, and wage and price flexibility in labour markets. Fiscal transfers could be used to even out some regional economic imbalances.

Costs and benefits of regional trade agreements:

Trade creation and trade diversion

With more trading blocs, trade has been created between members, but diverted from elsewhere. Trade creation occurs when a country consumes more imports from a low cost producer, and fewer from a high cost producer. Trade diversion occurs when trade shifts to a less efficient producer. Usually, a country might stop importing from a cheaper producer outside a trading bloc to a more expensive one inside the trading bloc. Moreover, protectionist barriers are often imposed on countries who are not members, so trade is diverted from producers outside the bloc to producers within the trading bloc. The UK trades mainly with the EU, at the expense of former trade links in the Commonwealth. If a trade agreement leads to trade creation, it is welfare improving and is beneficial. If it leads to trade diversion, it is welfare reducing.

Reduced transaction costs

Since there are no barriers to trade or no border controls, it is cheaper and simpler to trade.

Economies of scale

Firms can take advantage of a larger potential market in which to trade. By specialising, firms and countries can exploit their comparative advantages, and the gains of efficiency and advanced technology can be reaped.

- **Enhanced competition**

Since firms operate in a more competitive market, they become more efficient and there is a better allocation of resources. There could be the long run benefits of dynamic efficiency too, although these benefits are not always spread evenly across each member.

- **Migration**

By being a member of a Customs Union, the supply of labour is increased, which could help fill labour shortages. However, this might mean some countries lose their best workers.

- Trading blocs can be seen as **second best solutions** to complete free trade. They bring about many of the benefits of free trade but often distribute the gains unequally, with developed countries gaining the most and developing countries gaining little.

Synoptic point:

Some of these impacts are clearly microeconomic impacts, for example economies of scale, the impacts on the labour market, enhanced competition, lower prices etc.

Role of the WTO in trade liberalisation:

The WTO promotes world trade through reducing trade barriers and policing existing agreements. It also settles trade disputes, by acting as the judge, and organises trade negotiations.

Every member of the WTO must follow the rules. Those who break the rules face trade sanctions. In addition to trade in goods, the WTO covers the trade in services and intellectual property rights.

They hold a series of talks called rounds, where they attempt to come to agreements. The problem is that all countries must agree to any new rules so every country has the power to veto an agreement.

As of 2015, there are 161 member states in the WTO.

Possible conflicts between regional trade agreements and the WTO:

Trading blocs might distort world trade or adversely affect those who do not belong to them. There could be an inefficient allocation of resources as a result of policies such as the EU CAP.

Conflicts between blocs could lead to a rise in protectionism. A common external tariff contradicts the WTO's principles, since although there is free trade between members, protectionist barriers are imposed on those who are not members.

Some countries might argue that the WTO is too powerful, or that it ignores the problems of developing countries. This could be since developed countries do not trade completely freely with developing countries, which limits their ability to grow.

Setting up a customs union or a free trade area could be seen to violate the WTO's principle of having all trading partners treated equally. This is especially if a common external tariff is applied. However, they can complement the trading system and the WTO strives to ensure that non-members can trade freely and easily with the members of a trade bloc.

4.1.6 Restrictions on free trade

- **Reasons for restrictions on free trade:**

- Protectionism is the act of guarding a country's industries from foreign competition, by imposing restrictions on free trade.

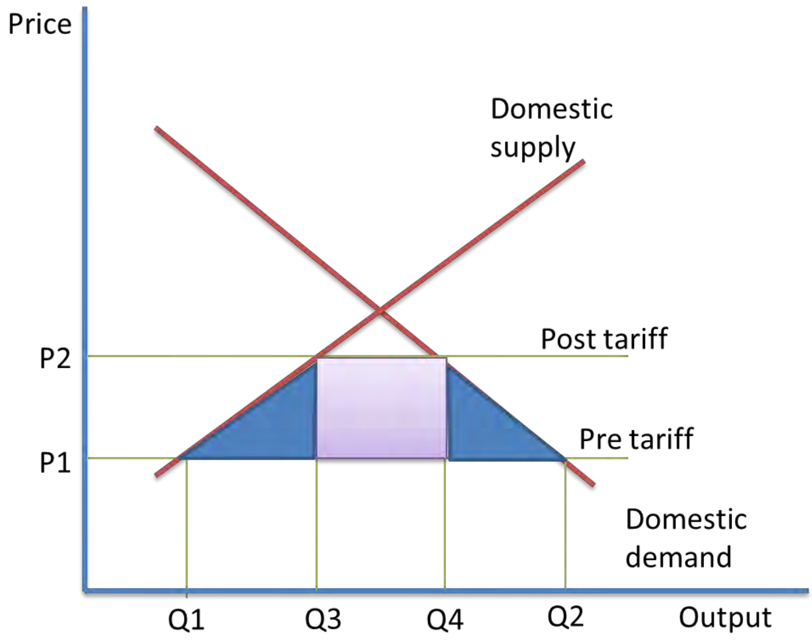
- If a country employed several protectionist measures, then a trade deficit would reduce. This is because they will be importing less due to tariffs and quotas on imports.
- Infant industries might need protecting. These are industries which are relatively new and need support. Protectionism is usually short term until the industry develops, at which point the industry can trade freely. It is based on the concept of new industries facing high start-up costs, which fall as the industry develops. In order to help the industry survive, it receives support.
- Protectionism could be used to correct market failure. It can deal with demerit goods and protect society from them.
- Governments might want to protect domestic jobs and avoid them being offshored.
- Some countries might impose trade restrictions as a form of retaliation against trade barriers imposed by other countries.

- **Types of restrictions on trade:**

  - **Tariffs**

Tariffs are taxes on imports to a country. It could lead to retaliation, so exports might decrease. The impact of tariffs is that the quantity demanded of domestic goods increases, whilst the quantity demanded of imports decreases.

Tariffs result in higher prices for consumers and a loss in consumer surplus.



The tariff diagram illustrates the effects of imposing a tariff. The original quantity of imports is Q2 – Q1, and the new quantity of imports is Q4 – Q3.

The purple shaded rectangle shows the revenue the government gains from imposing the tariff. This could help finance government expenditure.

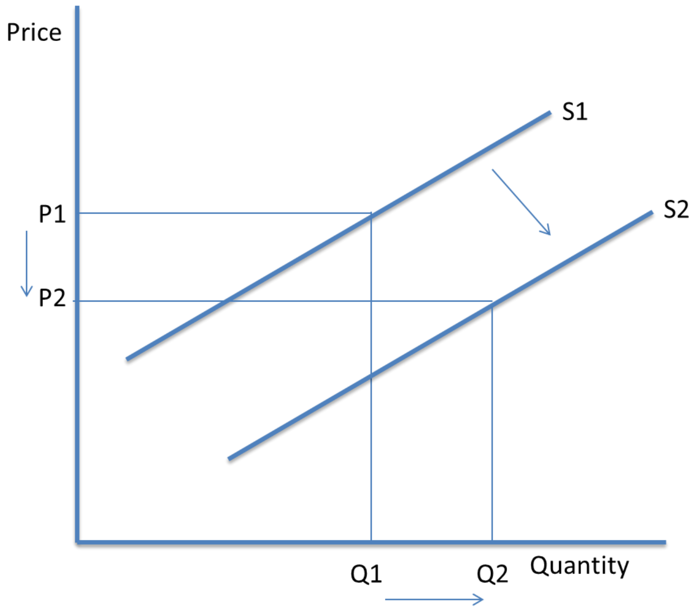
The two blue triangles show the area of deadweight loss of welfare, as a result of the tariff.

- **Quotas**

A quota limits the quantity of a foreign produced good that is sold on the domestic market. It sets a physical limit on a specific good imported in a set amount of time. It leads to a rise in the price of the good for domestic consumers, so they become worse off.

- **Subsidies to domestic producers**

This makes domestic goods relatively cheap compared to imports. It encourages domestic production to increase, as shown by a right shift in the supply curve, and the average price falls.



However, it depends how the subsidy is spent. In the EU, the Common Agricultural Policy subsidises domestic farming. This helps the UK retain some sort of primary sector. The subsidy might encourage a surplus to be produced, which could be wasteful. It also depends on government finances, and it should be considered whether the industry is worth subsidising or not.

Non-tariff barriers

- ### Voluntary export restraints (VERs)

This is when two countries make an agreement to limit the volume of exports to one another over a period of time. They are used when governments want to protect domestic industries from competing imports.

It is usually suggested by the exporting country, to avoid even less flexible trade barriers being imposed.

- ### Embargoes

This is the complete ban on trade with a particular country. It is usually politically motivated.

- **Excessive administrative burdens ('red tape')**

Excessive administration increases the cost of trading, and hence discourages imports. It makes it difficult to trade with countries imposing red tape, and is particularly harmful for developing countries which are unable to access these markets. It is harder to notice this type of protectionism.

- **Impact of protectionist policies on consumers, producers, governments, living standards and equality:**

- Protectionism could distort the market and lead to a loss of allocative efficiency. It prevents industries from competing in a competitive market and there is a loss of consumer welfare. Consumers face higher prices and less variety. By not competing in a competitive market, firms have little or no incentive to lower their costs of production.

- It imposes an extra cost on exporters, which could lower output and damage the economy.

- Tariffs are regressive and are most damaging to those on low and fixed incomes, which could increase income and wealth inequality. However, taxes could raise more revenue for the government, which could be used to redistribute income to the poor or improve public services.

- There is a risk of retaliation from other countries, so countries might become hostile.

- Protectionism could lead to government failure.

- It means that inefficient, domestic producers are kept in production whilst efficient, foreign ones lose out. It would be best to switch the resources to where they could be used more efficiently.

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 payments

The balance of payments is a record of all financial transactions made between consumers, firms and the government from one country with other countries.

It states how much is spent on imports, and what the value of exports is.

Exports are goods and services sold to foreign countries, and are positive in the balance of payments. This is because they are an **inflow** of money.

Imports are goods and services bought from foreign countries, and they are negative on the balance of payments. They are an **outflow** of money.

The balance of payments is made up of:

- **The current account:**

  This includes all economic transactions between countries. The main transactions are the trade in goods and services, income and current transfers.
  Income transfers are from the net earnings on foreign investment as well as net cash transfers. They include salaries and dividends.
  Current transfers are transfers that have no return, such as aid and grants. It includes the payments the UK makes for being a member of the EU. They have traditionally been negative for the UK, due to these contributions and because of overseas aid.

- **The capital account and financial account:**

  Capital transfers involve transfers of the ownership of fixed assets. The financial account involves investment. For example, direct investment, portfolio investment and reserve assets are part of the financial account.

Causes of deficits and surpluses on the current account

A current account surplus means there is a net inflow of money into the circular flow of income. The UK has a surplus with services, but a deficit with goods.

The UK has a net current account deficit. This means the UK spends more on imports from foreign countries, than they earn from exports to foreign countries. If the deficit is large and runs for a long time, there could be financial difficulties with financing the deficit.

Causes of a deficit:

- **Appreciation of the currency**: a stronger currency means imports are cheaper and exports are relatively more expensive, which means the current account deficit would worsen.
- **Economic growth:** when consumer incomes increase, demand increases. This could increase demand for imports. This is especially true of a country such as the UK, where consumers have a high propensity to import.
- **More competitive:** if a country becomes more internationally competitive, such as with lower inflation or if there is economic growth in export markets, exports should increase. This could cause the current account deficit to improve, or increase the current account surplus.
- **Deindustrialisation:** In the UK, the manufacturing sector has been declining since the 1970s. The goods that the UK previously made domestically now have to be imported, which worsens the deficit.
- **Membership of trade union:** The UK has traditionally had negative current transfers, since fees are paid for membership of the EU.

By definition, where there is a current account surplus, there is a capital and financial account deficit. A current account deficit means there will be a capital and financial account surplus.

Measures to reduce a country's imbalance on the current account

- If there is a deficit on the current account, income tax could be increased. This will reduce the amount of disposable income consumers have, which will reduce the quantity of imports. However, it might also impact domestic growth, since consumers will also spend less on domestic goods.
- Governments could also reduce their spending. This would reduce AD and lead to less imports. It forces domestic firms into increasing exports, which helps improve the disequilibrium.
- Fiscal policy could be effective in the short term, but not so much in the long term. As soon as the policy measures end, household are likely to revert their expenditure back on imports.

- If taxes are imposed on trading partners, there is the risk of retaliation, which could reduce demand for exports, too.
- Governments might have imperfect information about the economy, so it could lead to government failure.
- If there is a current account deficit, the bank might lower interest rates to cause depreciation in the currency. This causes exports to become cheaper, but it could be inflationary for the domestic economy. Moreover, hot money might flow out of the country, since investors are not receiving a high return on their investment. However, it is hard to control the supply of money in reality. Moreover, there is a significant time lag with changing the interest rate and seeing an effect.
- Supply-side policies could help increase productivity with increased spending on education and training, which could result in the country becoming mor internationally competitive. This could lead to a rise in exports. However, this incurs significant time lag, so it is not effective as an immediate measure. In the longerm, this can be an effective policy.
- Supply-side policies could also help make the domestic economy attractive to investors.
- The domestic economy could be made more competitive through deregulation and privatisation, which will force firms to lower their average costs. However, privatisation could result in monopolies being formed, which will not increase efficiency.
- If governments provide subsidies to some industries to encourage production, there could be retaliation from foreign countries that see this as an unfair protectionist policy.

Synoptic point:

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

Significance of global trade imbalances

- International trade has meant countries have become interdependent. Therefore, the economic conditions in one country affect another country, since the quantity they export or import will change. A surplus or deficit on the current account could indicate an unbalanced economy, and it could mean the country is too reliant on other economies for their own growth. It could be difficult to attract sufficient financial flows in order to finance a current account deficit. This could make it unsustainable in the long run.

- An imbalance suggests that the UK is reliant on the performance of other countries. If export markets, such as the EU, become weak, UK economic performance will be affected. This was seen during the 2008 financial crisis.
- It could become difficult to finance the deficit in the long run. They become a problem if the government can't repay their foreign currency debt. There is no issue as long as the capital and financial account is in surplus.
- In the Eurozone, current account deficits are of greater concern because the countries have a fixed exchange rate. This means they cannot devalue the currency to restore their level of international competitiveness.
- A surplus indicates low consumer spending and a low savings ratio. It also means consumers are enjoying fewer goods than they otherwise could, lowering living standards.
- The significance depends why they have the deficit. For example some countries may be happy to have a deficit as it allows them to have a financial account surplus and they may need to import essentials.

4.1.8 Exchange rates

Exchange rate systems

The exchange rate of a currency is the weight of one currency relative to another.

Floating:

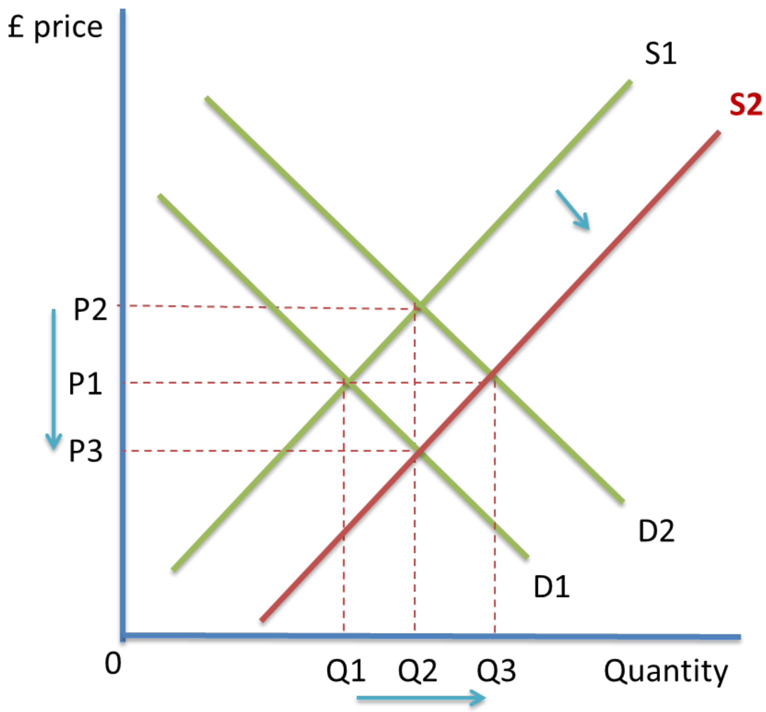
The value of the exchange rate in a floating system is determined by the forces of supply and demand.

In a floating exchange rate system, the market equilibrium price is at P1. When demand increases from D1 to D2, the exchange rate appreciates to P2.

The demand for a currency is equal to exports plus capital inflows. The supply of a currency is equal to imports plus capital outflows.

Fixed:

A fixed exchange rate has a value determined by the government compared to other currencies.



In a fixed exchange rate system, the supply of the currency can be manipulated by the central bank, which can buy or sell the currency to change the price to where they want. In the diagram, the supply has been increased (S1 to S2) by selling the currency so more is on the market (Q1 to Q3). The currency depreciates as a result (P2 → P3), which makes exports more competitive.

Managed:

Managed exchange rate systems combine the characteristics of fixed and floating exchange rate systems. The currency fluctuates, but it doesn't float on a fully free market. This is when the exchange rate floats on the market, but the central bank of the country buys and sells currencies to try and influence their exchange rate.

The Japanese central bank has also attempted to make exports more competitive by manipulating the Yen, even though the Yen floats on the market.

The Indian rupee fluctuates on the market, but the central bank intervenes when it falls outside a set range.

Distinction between revaluation/appreciation and devaluation/depreciation of a currency

Revaluation: This is when the currency's value is adjusted relative to a baseline, such as the price of gold, another currency or wage rates.

Appreciation: when the value of a currency increases. Each pound will buy more dollars, for example.

Devaluation: This is when the value of a currency is officially lowered in a fixed exchange rate system.

Depreciation: when the value of a currency falls relative to another currency, in a floating exchange rate system.

Factors influencing floating exchange rates

Inflation:

A lower inflation rate means exports are relatively more competitive. This increases demand for the currency. This causes the currency to appreciate.

Speculation:

If speculators think a currency will appreciate in the future, demand will increase in the present, since they believe a profit can be made by selling the currency in the future. This can cause an increase in the value of the currency.

Other currencies:

If markets are concerned about major economies, such as the EU, the currency might rise. This happened with the Swiss Franc in 2010 when markets were worried about the EU economy.

Government finances:

A government with a high level of debt is at risk of defaulting, which could cause the currency to depreciate. This is since investors start to lose confidence in the economy, so they sell their holdings of bonds.

Balance of payments:

When the value of imports exceeds exports, there is a current account deficit. Countries which struggle to finance this, such as through attracting capital inflows, have currencies which depreciate as a result.

International competitiveness:

An increase in competitiveness increases demand for exports, which increases demand for the currency. This causes an appreciation of the currency.

Government intervention in currency markets through foreign currency transactions and the use of interest rates

Governments might try and influence their currency, such as by maintaining a fixed exchange rate. For example, China has previously kept the Yuan undervalued by buying US dollar assets to make their exports seem relatively cheaper.

Interest rates:

An increase in interest rates, relative to other countries, makes it more attractive to invest funds in the country because the rate of return on investment is higher. This increases demand for the currency, causing an appreciation. This is known as **hot money.**

Quantitative easing:

This is used by banks to help to stimulate the economy when standard monetary policy is no longer effective. This has inflationary effects since it increases the money supply, and it can reduce the value of the currency. QE is usually used where inflation is low and it is not possible to lower interest rates further.

Foreign currency transactions:

The Bank of England uses this to manage the UK's gold and foreign currency reserves, as well as managing the MPC's pool of foreign currency reserves. It involves buying and selling foreign currency to manipulate the domestic currency. China kept large reserves of the US Dollar by purchasing government bonds, in order to undervalue the Yuan.

Competitive devaluation/depreciation and its consequences

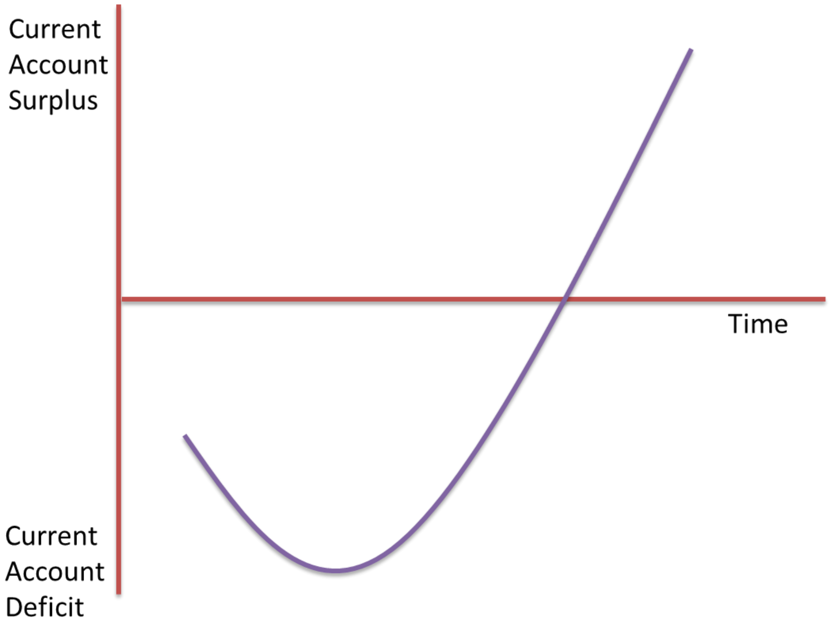
- A devalued currency makes exports cheaper and imports more expensive. It could increase economic growth as a result. However, inflation is likely to increase due to the higher costs of imports and demand pull inflation from the increase in AD.
- The current account is likely to improve since there are fewer imports and more exports.
- When firms know that the value of the currency is lower relative to another currency, it allows for them to plan investment, because they know that they will not be affected by harsh fluctuations in the exchange rate.
- However, the government and the central bank do not necessarily know better than the market where the currency should be and the balance of payments would not automatically adjust to economic shocks.
- It can be costly and difficult for the government to hold large reserves of foreign currencies in order to maintain a devalued currency.
- It also depends on the PED of exports and imports. Inelastic exports will not increase significantly if price falls.
- If the main trading partners are in a recession, then demand for exports is likely to be low, and depreciating the exchange rate is unlikely to affect it.

Impact of changes in exchange rates:

The current account of the balance of payments (reference to Marshall-Lerner condition and J curve effect)

A reduction in the exchange rate causes exports to become cheaper, which increases exports. This assumes that demand for exports is price elastic. It also causes imports to become relatively expensive. This means the UK current account deficit would improve.

The Marshall-Lerner condition states that a devaluation in a currency only improves the balance of trade if the absolute sum of long run export and import demand elasticities is greater than or equal to 1.



The J-curve effect occurs when a currency is devalued. Since devaluing the currency causes imports to become more expensive, at first the total value of imports increases, which worsens the deficit. Eventually, the value of exports decreases, which leads to a reduction in the trade deficit.

When the currency is devalued, there may be a time lag in changing the volume of exports and imports. This could be due to trade contracts and the price inelasticity of demand for imports in the short run, whilst consumers search for alternatives. In the long run, consumers might start purchasing domestic products, for example, which helps improve the deficit.

- **Economic growth and employment/unemployment**

Exchange rate affects AD because they affect the price of exports and imports. If the exchange rate appreciates, AD is likely to fall since imports become cheaper and exports become more expensive. Households are likely to switch from buying domestically produced goods to imports. However, this depends on the inflation rate. A lower domestic inflation rate, compared to other countries, might mean that consumers still purchase domestic goods. It also depends on the price elasticity of demand for domestic goods and imports. The UK has a high marginal propensity to import, so households are still likely to import goods, even if the pound appreciates.

A weaker exchange rate is likely to increase exports. This means that domestic firms can increase their sales and increase their profits. Jobs might be created as a result. If it is cheaper to import goods, because the value of the exchange rate increased for example, then jobs in the domestic industry might be lost since demand falls.

- **Rate of inflation**

A depreciation in the exchange rate is likely to be inflationary due to the increase in the price of imported raw materials. Production costs for firms increase, which causes cost-push inflation. Moreover, since AD will be increasing due to the higher level of exports, there could be upward pressure on the average price level.

- **Foreign direct investment (FDI) flows**

FDI is the flow of capital from one country to another, in order to gain a lasting interest in an enterprise in the foreign country.

A depreciation in the currency means the country's wages and production costs have fallen relative to other countries. This makes the country more internationally competitive and it is likely to attract more FDI.

The effects of exchange rates on imports and exports can be remembered using the acronym SPICED:

Strong
Pound
Imports
Cheap
Exports
Dear

4.1.9 International competitiveness

Measures of international competitiveness

International competitiveness is the ability of a nation to compete successfully overseas and sustain improvements in real output and living standards.

Countries can compete with price and non-price competitiveness. For example, the quality of goods and services and the rate of innovation can change how competitive a country is.

Relative unit labour costs

The unit labour cost is how much labour costs per unit of output.

Generally, the cheaper the relative unit labour costs, the more competitive the country in manufacturing. For example, countries such as China, India and Bangladesh have lower labour costs than countries such as the UK and US, which means that a lot of production requiring manufacturing, such as textiles, clothes and technology, has moved abroad.

However, higher prices could compete if a niche market is targeted or by using product differentiation. Quality is also important: German cars are famous for their quality, so consumers might be willing to pay more for them.

The more productive a country becomes, the lower its unit labour costs. This makes the country more internationally competitive.

Relative export prices

This is the ratio of one country's export prices relative to another country, and it is expressed as an index. The lower the relative export price, the more competitive the country.

Factors influencing international competiveness

Ability to attract FDI from MNCs

If a country can attract more FDI, it increases their productive capacity. This can help produce long term growth and raise living standards. The ability to attract FDI depends on: stability in the economy and financial system; the tax rate; and the potential to trade e.g. UK has free trade with the EU.

Ability to produce or attract entrepreneurs

Entrepreneurs help develop new ideas and stimulate innovation. This keeps a country ahead with technology and gives them an edge in the market, which makes them more competitive.

Ability to attract (skilled) labour from abroad

This might fill a skills gap in, for example, IT or biotechnology, and improves the quality of the labour force. If there is a skills gaps, firms face higher costs.

Unit labour costs

Unit labour costs rise when wages increase at a faster rate than productivity. China's large population means wages are generally low, but the rise of the middle class and consumer spending is pushing wages up. National minimum wages can raise the costs.

Exchange rate

A depreciation in the real exchange rate makes exports relatively cheaper, so the country becomes more internationally competitive.

If the price of imports increases as a result of a devaluation, then the cost of raw materials would increase, which would be particularly damaging to small firms. It could increase the cost of exports as the cost of production rises.

It is important to remember that devaluaing the currency is not a policy relevant for countries with floating exchange rates, such as the UK.

Quantity and quality of skills possessed by a nation's workers

This refers to the skills of human capital. If there are limited skills, the economy cannot expand its productive potential. The more skilled the workforce, the more productive it is. It also means goods and services are of a better quality, which improves international competitiveness.

- **Flexibility of labour**

Part time and temporary contracts help limit a firm's costs, which lowers unit labour costs. Additionally, if the labour market is flexible and geographically or occupationally mobile, it can better respond to economic shocks and changes in demand or supply, which can help improve competitiveness.

- **Economic stability**

If inflation is low and stables, firms are more able to plan their investment and spending, because they know what future prices will be. Deflation or high and uncontrollable inflation makes it hard to plan for the future. For example, the UK government could try and reform the banking sector so it is more resilient to shocks.

- **Tax policies e.g. low income tax**

A lower tax rate provides an incentive to earn more, since consumers and firms know they will keep more of their income. A low income tax might attract more skilled labour, too.

- **Regulation**

Excessive regulation (red tape) can make it hard for firms to invest, and it could raise their average costs of production. Low regulation should help to encourage investment and innovation, so domestic firms can become more internationally competitive.

- **Rate of innovation**

This is calculated by the proportion of GDP invested in new capital. If a country innovates more, they are likely to develop new, more advanced technology that can help them become more competitive. It could increase the quality of the goods and services produced.

It could be argued that non-price factors such as availability, reliability, quality, design and innovation are more important than price factors.

Interest rates

It can be considered whether the UK's low interest rates have helped the international competitiveness of the UK. It has encouraged spending, which increased AD and growth. It also encourages firms to invest. However, it can be seen as a deterrent for foreign investors, since they get a low return on investment.

The increase in AD might cause demand-pull inflation, which could make UK goods more expensive than elsewhere. This might increase imports, if they are cheaper than domestic goods, which could worsen the current account deficit. However, this means the UK has a capital account surplus.

Significance of international competitiveness

Benefits of being internationally competitive

Being internationally competitive is vital in the light of the global economy. It allows countries to export more goods. This will help to increase AD as well as bring about a current account surplus.

If a country becomes more competitive, such as Germany, they can gain a reputation for their exports, which might make them more price inelastic. As a result, they might be able to demand higher prices for their goods and services.

By operating in a competitive market, firms can reach out to more consumers. They will be able to gain more revenue and make a larger profit. This can also help firms gain economies of scale, which can help lower its average costs of production.

Problems of being internationally competitive

The economic importance of education and health spending could be considered. It could help improve the skills and productivity of human capital which can make the country more internationally competitive, but the effectiveness of the spending is questionable. Is the investment better spent elsewhere?

Being innovative is not always successful, and it could lead to funds being wasted.

A lower tax rate might mean the government receives fewer tax receipts, which could limit public spending. It depends on how important public services are to each country, however.

If firms are operating in a competitive environment, infant industries might find it hard to compete, so they are forced out of the market. Also, the supernormal profits of large firms might be eroded away, which could limit the amount of investment in R&D.

Synoptic point

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