Edexcel (B) Economics A-level

Theme 2: The Wider Economic Environment

2.4 Life in a Global Economy

2.4.3 International trade

Notes

Specialisation and international trade

- Specialisation occurs when each worker completes a specific task in a production process. The concept was famously stated by Adam Smith, who showed how, through the division of labour, worker productivity can increase. Firms can then take advantage of increased efficiency and lower average costs of production.

- An extract from *The Wealth of Nations,* Adam Smith:

- "To take an example, therefore, from a very trifling manufacture; but one in which the division of labour has been very often taken notice of, the trade of the pin-maker; a workman not educated to this business … could scarce, perhaps, with his utmost industry, make one pin in a day, and certainly could not make twenty. But in the way, in which this business is now carried on, not only the whole work is a peculiar trade, but it is divided into a number of branches, of which the greater part are likewise peculiar trades. One man draws out the wire, another straights it, a third cuts it, a fourth points it, a fifth grinds it at the top for receiving the head; to make the head requires two or three distinct operations; to put it on, is a peculiar business, to whiten the pins is another; it is even a trade by itself to put them into the paper; and the important business of making a pin is, in this manner, divided into about eighteen distinct operations, which, in some manufactories, are all performed by distinct hands, though in others the same man will sometimes perform two or three of them… But though they were very poor, and therefore but indifferently accommodated with the necessary machinery, they could, when they exerted themselves, make among them about twelve pounds of pins in a day. There are in a pound upwards of four thousand pins of a middling size. Those ten persons, therefore, could make among them upwards of forty-eight thousand pins in a day."

- Smith essentially said that by dividing the production of pins into 18 different tasks, the output of pins could increase significantly. Each worker specialises and output increases. This can help address the problem of scarcity, since resources are used more efficiently.

- Specialisation can be achieved by individuals, businesses, regions of countries or countries themselves.

- **Advantages:**

    - Higher output and potentially higher quality, since production focusses on what people and businesses are best at.
    - There could be a greater variety of goods and services produced.
    - There are more opportunities for economies of scale, so the size of the market increases.
    - There is more competition and this gives an incentive for firms to lower their costs, which helps to keep prices down.

- **Disadvantages:**

    - Work becomes repetitive, which could lower the motivation of workers, potentially affecting quality and productivity. Workers could become dissatisfied.
    - There could be more structural unemployment, since skills might not be transferable, especially because workers have focussed on one task for so long.
    - By producing a lot of one type of good through specialisation, variety could in fact decrease for consumers.
    - There could be higher worker turnover for firms, which means employees become dissatisfied with their jobs and leave regularly.

- **Specialisation in the production of goods and services to trade:**

- 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.

- Countries can exploit their **comparative advantage** in a good, which means they can produce a good at a lower opportunity cost to another.

- **Absolute advantage** occurs when a country can produce more of a good with the same factor inputs.

- **Advantages:**

    - Greater world output, so there is a gain in economic welfare.
    - Lower average costs, since the market becomes more competitive.
    - There is an increased supply of goods to choose from.
    - There is an outward shift in the PPF curve.

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.

Trading blocs

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

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 6% 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 trading blocs:

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.

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. For example, the EU has 500 million people to sell to. 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.

Trade and growth

Free trade is the act of trading between nations without protectionist barriers, such as tariffs, quotas or regulations. World GDP can be increased using free trade, since output increases when countries specialise. Therefore, living standards might increase and there could be more economic growth.

Since WW2, global trade has increased significantly. The increasing number of trading blocs, the rise of emerging markets such as China and India and greater participation from previously communist nations has led to a change in the pattern of trade.

Trading blocs have led to trade creation between members, since there is free trade within the bloc. However, trade has been diverted from outside the bloc, since protectionist barriers are often imposed on countries who are not members.

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.

This has led to the industrialisation of China and India. Their share of world trade has and the volume of manufactured goods that they export has increased.

The collapse of communism has meant that more countries are participating in world trade.

For a long time, China has been running a trade surplus with the US. Since 2006, the US trade deficit has narrowed with China, and China has reduced their trade surplus, too. China has planned this change from export-led growth to growth fuelled by domestic consumption.

After 2008, there was a decline in global trading activity and more protectionism.

Imports and exports: visibles and invisibles

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.

Visibles are physical goods, such as the products of manufacturing. These are most commonly produced by the primary and secondary sectors. Countries such as Germany and Japan are reliant on exports of visibles, such as manufactured goods like cars.

Invisibles are intangible, such as services. For example, financial services, tourism and shipping services are all intangible. These are most commonly produced by the tertiary sector. Invisibles are important for countries such as the UK and Saudi Arabia, which are dependent on exports of financial services.

Impact of cheap imports on standards of living

Cheap imports could result in a loss of jobs in the domestic industry. This has been evident in the textile industry, where production has shifted abroad to countries which can produce textiles more cheaply.

This has increased consumer choice in more developed countries, since consumers can afford more goods. By shifting production abroad to where labour costs are lower, the price of goods has fallen. If production were to shift back to the original country, production costs would increase due to higher labour costs. This would result in higher prices and less consumer choice.

Therefore, cheap imports contribute towards lower rates of inflation and more disposable income in the domestic country.

A high dependence on imported goods suggests the economy is unbalanced. Moreover, it results in a smaller overall value for GDP since imports are subtracted from GDP.

It also suggests a high degree of dependency on the performance of other countries. This increasing interdependence between economies could result in recessions spreading globally. It increases the vulnerability of the economy to external shocks.