# Globalisation

## Globalisation

**Globalisation:** The deepening of relationships between countries, reflected in an increasing level of cross-border trade and investment and migration
**De-globalisation:** a reversal of the process of globalisation
**Slower globalisation** ('slowbalisation'): slowdown in the speed of globalisation

## Characteristics of globalisation

- Increased trade in goods and services (more WTO members, China & India, Russia); higher trade to GDP ratios
- More capital transfers and capital liberalisation (MNCs/TNCs, FDI, foreign ownership of companies etc)
- Global branding
- Greater specialisation and division of global labour force (outsourcing, offshoring….global sourcing and global supply chains)
- Labour migration (within and between countries)
- Shifting balance of economic and financial power from developed world to emerging markets
- De-industrialisation and structural unemployment in developed economies
- Increased global media presence (internet); greater connectivity
- Greater investment spending on infrastructure & innovation; more integrated global supply chains
- Increasing interdependency of economic agents (producers, consumers, governments and enterprises)

## Multi or trans-national corporations (MNCs/TNCs)

**Multi- or trans- national companies (MNCs or TNCs):** companies that operate in more than one country. The head office might be in the USA, but the manufacturing factories in SE Asia, using raw materials from Africa, while final products are sold in markets across the world.

## Causes of globalisation

- Containerisation and falling transport, freight and travel costs
- Increasing influence of powerful corporations (MNCs/TNCs)
- Lower trade barriers/trade liberalisation
- Increasing size and number of trading blocs
- More FDI flows between countries
- Greater labour migration and the emergence of a global labour force
- Rapid spread of technologies, manufacturing systems and management techniques (knowledge transfers)
- Faster communication and information flows and the emergence of new markets, especially global media presence
- Improvements in infrastructure
- Geopolitical change
- New emerging markets

## Benefits of globalisation

**Economies of scale:** Globalisation encourages both producers and consumers to reap benefits from **division of labour;** greater productive efficiency
**More cost-reducing innovation:** more competitive markets reduces the level of monopoly profits and can incentivise businesses to innovate
**Lower consumer prices/better quality:** greater competition can drive down prices for consumers and may increase range and quality of goods available (increased consumer surplus)
**Faster economic growth:** leads to higher per capita incomes and reduced extreme poverty in many lower income countries.
**Freer movement of labour:** helps to relieve skilled labour shortages & diversifies the workforce, promoting knowledge, technology & management practice transfers boosting innovation
**Increased awareness:** of the long-term global economic challenges from climate change and the impact of wealth & income inequality

# Globalisation

## Costs of globalisation

**Rising inequality:** the gains from globalisation are unequal leading to growing political and social tensions when inequality of income and wealth increases; relative poverty may increase

**Environmental costs:** threats to the global commons including irreversible damage to ecosystems, land degradation, deforestation, loss of bio-diversity and water scarcity

**Macroeconomic fragility:** in an inter-connected world, external shocks in one region can rapidly spread to other centres (this is known as **systemic risk**)

**Trade imbalances:** increasing trade imbalances (both surpluses and deficits) lead to protectionist tensions, more import tariffs and quotas and a move towards managed exchange rates – this can then lead to de-globalisation and slower growth

**Jobs:** Workers may suffer **structural unemployment** from out-sourcing of manufacturing to lower-cost countries and a rise in the share of imports in GDP

**Tax avoidance:** many large MNCs can find ways of avoiding corporation tax and other taxes; the rich can also avoid tac using tax havens, reducing the tax revenue of governments

**Brain drains:** a more mobile global workforce means some countries suffer from emigration, losing their most productive workers.

## Systemic risk of negative global shocks

A more interconnected world is at greater risk from negative economic shocks such as:

- pandemics
- financial crises,
- currency crises
- natural disasters
- extreme weather
- geo-political shocks
- risks from terrorism, commodity price volatility
- unexpected changes in global interest rates

## Causes of de-globalisation

**Protectionism:** measures such as tariffs, quotas, and trade barriers may be used to shield domestic industries from foreign competition.

**Economic Shocks**: Economic downturns/recessions can lead countries to reduce their reliance on global trade, supply chains and investment.

**Changing Trade Agreements:** countries might renegotiate or withdraw from trade agreements that were previously promoting globalisation e.g. Brexit

**Environmental Concerns:** concerns about climate change might lead to prioritisation of local production to reduce the carbon footprint associated with long-distance trade.

**Health Crises:** global health crises, such as pandemics, disrupt travel, trade, and supply chains.

**Economic Nationalism:** governments might adopt policies to protect domestic industries and jobs, even if it means reducing international trade

## Impact of globalisation on developed countries

**Benefits**

- Increased access to foreign markets
- Attraction of foreign investment
- Improved productivity and innovation

**Costs**

- Job displacement/structural unemployment
- Rise in income inequality
- Environmental degradation

## Impact of globalisation on developing countries

**Benefits**

- Increased access to global markets
- Increase in foreign investment
- Increased access to knowledge and technology

**Costs**

- Economic dependence such as primary product dependency
- Exploitation of labour and issues with emigration
- Enironmental degradation

# Specialisation and trade

## Why countries trade

- To increase the availability of resources, goods and services
- To increase choice for consumers/more product differentiation
- To increase efficiency/reduce costs/reduce prices

## International specialisation

**International specialisation:** where countries/regions focus on producing & exporting specific goods or services in which they have a **comparative advantage**, while importing other goods or services that they can acquire more efficiently from trading partners. This specialisation allows countries to allocate their scarce factor resources more **efficiently**, improve overall **productivity**, and hopefully benefit from the **gains of trade across borders**

## Absolute advantage

**Absolute advantage:** a country produces a good at a lower direct costs i.e. if a country using the same factors of production can produce more of a product

| | *Good X* | *Good Y* |
|---|---|---|
| *Country A* | 20 | 10 |
| *Country B* | 5 | 15 |

Together Countries A & B can produce 25 of good X and 25 of good Y *before specialisation*.

- Country A has an absolute advantage in the production of good X, while Country B has an absolute advantage in production of good Y.
- If they specialise where their absolute advantage lies, then A produces 40 of X (but no Y) and B produces 30 of Y (but no X).

They have produced 15 more of X and 5 more of Y by specialising. They can trade and potentially share the gains made.

## Comparative Advantage

**Comparative advantage:** when one country can produce a good or service at a **lower opportunity cost** than another country. It considers where a country is **relatively more efficient or relatively less inefficient** at producing

| | *Good X* | *Good Y* |
|---|---|---|
| *Country A* | 60 | 45 |
| *Country B* | 120 | 60 |

Before specialisation and trade, the countries can produce 180 of X and 105 of Y. This assumes the labour input and other inputs are initially divided equally between the two countries.

## Opportunity cost ratios

In country A, to get 60 more of X means giving up 45 of Y. The opportunity cost of 1X = 45/60 of Y = 0.75; the opportunity cost of 1Y = 60/45 = 1.34.
In country B, to get 120 more X means giving up 60 of Y. The opportunity cost of 1X = 60/120 = 0.5; the opportunity cost of 1Y = 120/60 = 2.
Country A has a **lower opportunity cost** than country B in the production of Y (1.34 compared to 2) while country B has a **lower opportunity cost** of production of X (0.5 compared to 0.75).
Country A has a **comparative advantage** in Y and country B has a **comparative** advantage in X.

## The gains in output after specialisation

| | *Good X* | *Good Y* |
|---|---|---|
| *Country A* | 0 | 90 |
| *Country B* | 200 | 20 |

By specialising in where their comparative advantages lie, their joint output goes up from 180 to 200 of X and from 105 to 110 of Y. They can trade and potentially share these gains.

# Specialisation and trade

## Mutually beneficial terms of trade

The two countries need to find a **mutually beneficial terms of trade** – in other words, a trade of ood X for good Y that benefits both countries. If they trade at **3:2** then both countries can benefit because 3:2 or 1.5X:1Y **lies between the internal opportunity cost ratio** for both countries.

In A, the opportunity cost ratios were 1X:0.75Y and 1Y;1.34X

In B, the opportunity cost ratios were 1X:0.5Y and 1Y:2X

A can now sell 1Y and receive 1.5X in exchange whereas before it received 1.34X

B can now sell 1X and receive 0.67Y in exchange whereas before it received 0.5Y

## After trade and specialisation

After both specialisation and trade, both countries are better off than before. Assuming country A exports 43Y to country B and imports 63X from country B

| | | Good X | Good Y |
|---|---|---|---|
| Country A | | 63 | 48 |
| Country B | | 137 | 62 |

Country A has 3X and 3Y more than before

Country B has 17X and 2Y more than before

Both have gained from specialising where comparative advantage lies and then exchanging at a mutually beneficial exchange rate,, even though B has the absolute advantage in the production of both goods.

## David Ricardo

**David Ricardo** was one of the founding fathers of **classical economics**. He developed the idea of **comparative advantage.** His basic rule: Specialise a country's scarce **factor resources** in goods and services that they are **relatively best at.** This opens **potential gains** from specialisation and trade which leads to improved **economic welfare**

## Comparative advantage underlying assumptions

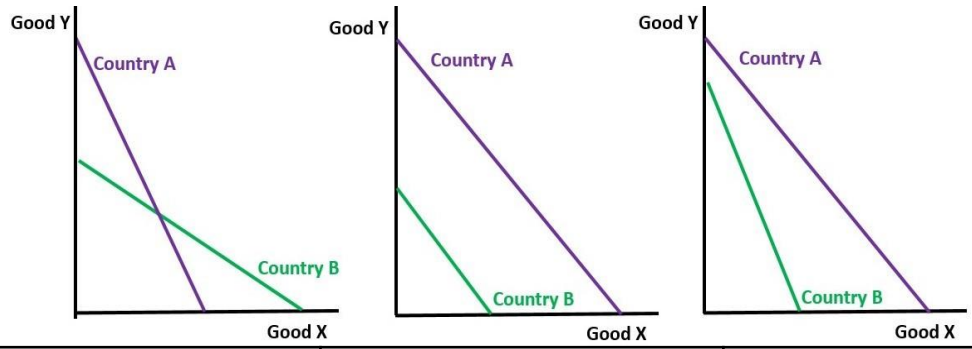
- No transport costs
- No barriers to trade
- Homogenous goods
- No economies of scale
- No environmental costs
- Perfect knowledge
- Factor mobility between uses
- All resources fully employed and all goods and services sold

Many of these assumptions do not hold in the real world, so the gains from trade may be less or more than the theory predicts

## Competitive Advantage

***Competitive advantage:*** when your country/business has **access to technology or innovations** that allow cheaper and/or more efficient production of goods. This gives a cost advantage and, therefore, a price/quality advantage over competitors. It is a more appropriate trade and specialisation concept when considering **highly differentiated** manufacturing goods, for example.

## Using diagrams to show absolute and comparative advantage




| | | |
|---|---|---|
| A has absolute advantage in Y and B has absolute advantage in X | No gains from trade. Opportunity cost ratios are the same. (Parallel) | A has comparative advantage iin X and B has comparative advantage in Y |

# Pattern of trade

## Pattern of trade

**Pattern of trade:** the mix of goods and services that a country and imports and exports in international trade; the range of countries it exports to and imports from

## Factors influencing the pattern of trade

- Absolute and comparative advantages
- Factor endowments - the quantity and quality of the resources a country has or has not got
- Trading bloc and trade agreements
- Globalisation, trade liberalisation, protectionism & FDI flows
- Changes in world incomes and growth rates
- Exchange rate movements
- De-industrialisation & the pace of economic development

## Geographical pattern of trade

**Geographical pattern of trade**: how businesses and consumers in other countries trade with businesses and consumers in a country
**Intra-regional trade:** trade between countries in the same region
**Gravity theory of trade:** countries tend to trade most with other nations in closest proximity

## Commodity pattern of trade

**Commodity pattern of trade:** the type of products (goods and services) traded internationally. It shows if a country has a dependence on primary v manufactured v service exports. As a nation develops **complexity** and **capabilities**, they become capable of supplying and exporting a broader range of products

## The EU's pattern of trade and the USA & China

The EU trading bloc is a customs union and a single market which encourages a high degree of intra-regional trade. 20 countries also share a currency, the Euro. Many countries have either of both China and the USA as a major trading partner because of their economic size.

## The UK's pattern of trade

**Geographical**

- Despite Brexit, 46 per cent of UK exports go to the European Union and 53 per cent of UK imports come from the European Union
- 3.6 per cent of UK exports go to China and 13% of UK imports come from China
- USA is largest single export market for UK with Germany 2nd
- Germany is biggest source of imports (12%), USA on 11% and Netherlands on 7.3%. (2023 data)

**Commodity**

- The UK trades most in petroleum products; road vehicles; pharmaceutical products; industrial machinery; business services; financial services (including insurance); telecommunications; cultural and creative services.

## Pattern of trade and primary product dependency

**Primary product dependency:** where a country's economy heavily relies on the export of raw materials or primary products, such as agricultural goods, minerals, or energy resources.
Export earnings fluctuate with global commodity prices and demand leading to economic instability and hindering economic development.
Examples include oil-exporting countries, agricultural exporters e.g. Cote d'Ivoire & cocoa and mineral-dependent countries e.g Zambia & copper

## Emerging markets and trade patterns

**Emerging Market:** an economy that cannot yet be classified as 'developed' and is investing heavily in its productive capacity.

- Many EMs have followed a path of industrialisation built on rising domestic and inward investment increasing their export capacity and also their demand for primary commodities, affecting trade patterns

## Trading blocs

**Trading bloc:** regional economic groupings/**regional trade agreements**
**RTAs** i.e. groups of countries that trade more freely amongst themselves but may set barriers against non-members
**Bilateral trade agreement:** trade agreement between two countries
**Multilateral trade agreement:** trade agreements between many countries or between a trading bloc and another country/trading bloc

## Types of trading blocs

**Preferential Trading Area** (PTA) such as trade agreements between the EU and the less developed countries
**Free trade area/agreement (FTA):** free trade between members; tariffs and quotas removed;
**Customs union:** free trade between members and a common external tariff (CET) on non-members
**Single (common) market:** free trade and common policies on product regulation, and freedom of movement of the factors of production (capital and labour) and of enterprises and services. The physical (borders), technical (standards) and fiscal (taxes) barriers are removed to allow free movement among the member states – **creates a 'level playing field' for trade by removing NTBs**, which is particularly useful for services trade
**Monetary union:** members of the bloc share a common currency, central bank and interest rate e.g Eurozone

## Free trade areas and rules of origin

A **free-trade area** eliminates tariffs, import quotas, and preferences on most (if not all) goods and services traded between them.
**Examples:** ASEAN, USMCA, EFTA, ACFTA

- Each member can set its own tariff on imports from outside the FTA
- FTA may be undermined by **re-exporting** so this is prevented by **i**mposing tariffs on re-exports and enforce a ***'country of origin rule'*** (i.e. a certain % of goods traded must originate from a member state to qualify for tariff-free internal trade)
- *Rules of Origin*: negotiating and establishing the rules of origin is complex and adds to the costs of firms that trade

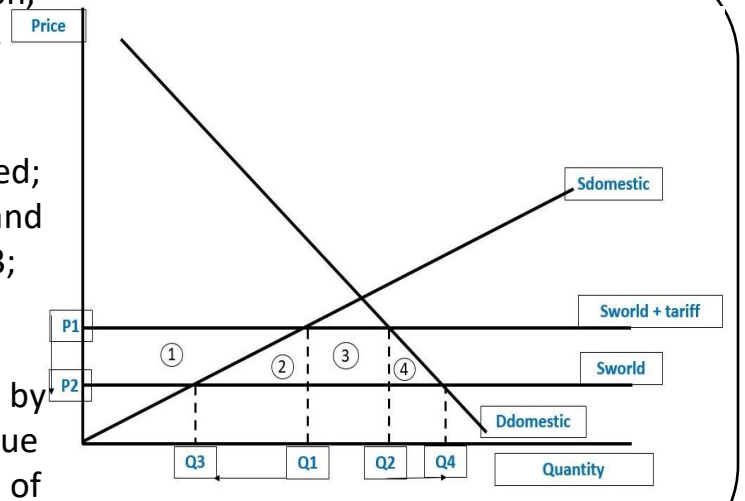
Trading blocs

## Customs union

Free trade between members and the common external tariff (CET) cause:
**Trade creation:** removal of tariffs between members increases trade between businesses within the bloc; more gains from specialisation and trade; greater exploitation of the bloc's countries' comparative advantages
**Trade diversion:** the CET means trade may pivot away from the global lowest-cost producers to the lowest cost producer within the bloc; trade is diverted from outside to inside the bloc
**Examples:** the EU, Turkey & the EU

## Trade creation diagram

Before joining the customs union, price is P1; domestic demand is Q2 and domestic supply is Q1: Q1Q2 of good is imported.
After joining the tariff is removed; new price is P2, domestic demand is Q4 and domestic supply is Q3; imports increase to Q3Q4.
Consumer surplus rises by area 1+2+3+4; producer surplus falls by area 1; government tariff revenue falls by area 3: **net welfare gain** of areas 2+4.




## Single or common market

Common/single market has free movement of goods, services, capital and labour and a common set of rules on standards reducing both tariff and **non-tariff barriers to trade**
**Example:** the EU single market
**Brexit:** the UK left both the EU customs union and single market and negotiated an FTA with the EU called the Trade and Cooperation Agreement

# Trading blocs and WTO

## Trading blocs/RTAs: advantages

**Increased Trade:** RTAs lead to increased trade among member countries, boosting economic growth. More trade creation & gains from trade
**Efficiency Gains:** by reducing trade barriers, resources are allocated more efficiently; more dynamic efficiency and tech transfer
**Economies of Scale:** larger markets allow for economies of scale, reducing production costs.
**Political Cooperation:** RTAs can promote political cooperation and peace among member countries; pooled sovereignty can increase global influence

## Trading blocs/RTAs: disadvantages

**Trade Diversion:** RTAs can lead to trade diversion, where members start trading more with each other but less with non-members.
**Complexity:** compliance with different rules and regulations within the RTA can be complex and expensive for businesses; may be some diseconomies of scale
**Exclusion:** non-member countries can face trade disadvantages, potentially causing international tensions.
**Inequality:** may benefit more efficient states at expense of weaker ones
**Loss of Sovereignty:** deeper integration may require members to cede some sovereignty in trade policy.

## Factors influencing the potential success of a trading bloc

- Economic size of the bloc
- Number of members in the bloc
- How integrated the bloc is
- The flexibility and willingness to change over time as global economic balance of power alters
- The unity of purpose within the member states
- The strengths and weakness of the economies of members
- How evenly the benefits of membership are spread across the members

## World Trade Organisation

The key functions of the WTO are:
**Negotiation:** facilitating trade negotiations among member countries to reduce trade barriers.
**Dispute Settlement:** resolving trade disputes through a rules-based system
**Monitoring:** monitoring trade policies and practices of member countries to ensure they comply with WTO rules.
**Technical Assistance:** providing technical assistance to developing countries to help them participate in global trade.

## Possible conflict between trading blocs and the WTO

**Trade Discrimination:** RTAs may discriminate against non-members, potentially violating WTO's most-favoured-nation principle.
**Trade Diversion:** if RTAs lead to trade diversion, they can be seen as contrary to the WTO's goal of reducing trade barriers globally.
**Inconsistent Rules:** conflicting rules between RTAs and WTO agreements can create legal and practical challenges.
**Preferential Treatment:** WTO rules generally favour non-discrimination, while RTAs provide preferential treatment to member countries.
**Dispute Resolution:** disputes can arise when WTO and RTA rules conflict, requiring resolution mechanisms to reconcile differences.

## Challenges faced by the WTO

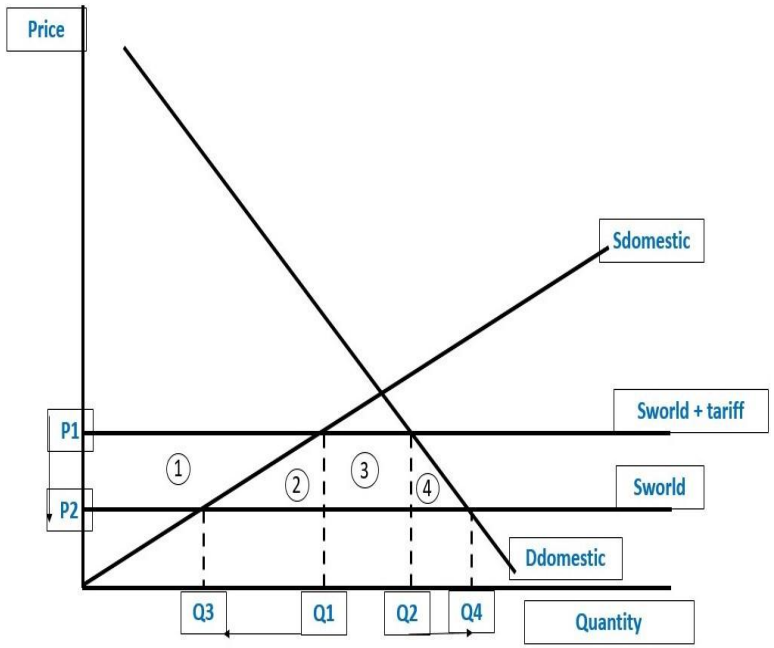
**Multilateral Negotiations Gridlock:** there have been numerous disagreements among member countries on various issues such as **farm subsidies** and special treatment for developing countries.
**Rise of Bilateral and Regional Agreements:** done outside the framework of the WTO. leading to a complex web of overlapping trade rules and regulations.
**Diverging Development Goals:** developing and developed countries have differing priorities and expectations from the WTO.
**Digital Trade and E-Commerce:** the rapid growth of digital trade and e-commerce presents challenges for the WTO, as existing trade rules and agreements may not adequately cover these areas.

# Restrictions on trade/protectionism

## Types of restrictions on trade

**Tariff:** tax on imports (ad valorem or specific)
**Quota:** physical limit on the quantity of imports allowed
**Subsidy:** payments by the government to reduce the costs of producers, increases supply and reduces the price
**Non-tariff barrier (NTB):** barriers such as import quotas, tough environmental and product standard rules, trade embargoes and export subsidies
**Rules of Origin:** rules of the national source of the traded goods e.g. a minimum % for locally-sourced components

## Impact of a tariff on a market




Before the tariff, price is P2; domestic demand is Q4 and domestic supply is Q3; imports are Q3Q4. After imposing the tariff; new price is P1, domestic demand is Q2 and domestic supply is Q1: Q1Q2 of good is imported. Consumer surplus falls by area 1+2+3+4; producer surplus rises by area 1; government tariff revenue rises by area 3: **net welfare loss** of areas 2+4.

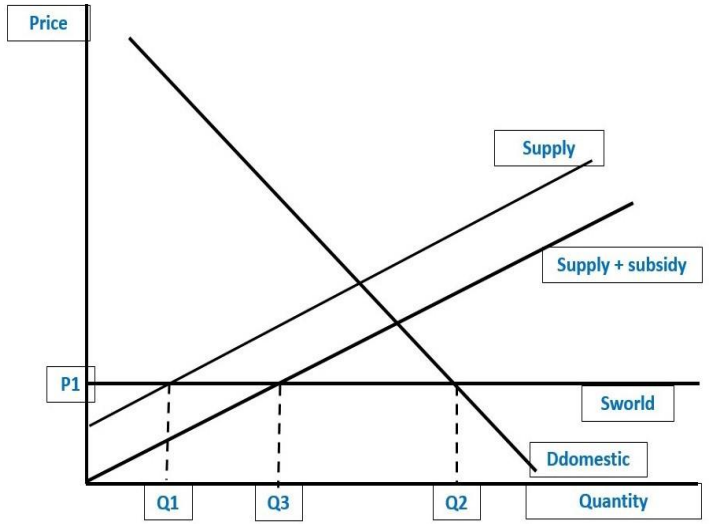
## NTBs

**Intellectual property laws** such as patents and copyright protection
**Technical barriers to trade** including labelling rules and stringent sanitary standards. This raises product compliance costs for exporters
**Preferential state procurement policies** – where government favour local producers when finalising contracts for state spending projects
**Domestic subsidies** – aid for businesses facing financial problems –for example, subsidies for car manufacturers or loss-making airlines.
**Financial protectionism** – when a government instructs state-owned banks to give priority/cheaper loans to domestic businesses
**Managed exchange rates** – government intervention in currency markets to change the relative prices of imports and exports

## Tariffs v quotas

The impact of a quota is similar to a tariff; restricting supply of imports increases the market price. A quota that raises the price by the equivalent amount as the tariff has the same welfare effects as a tariff except there is no gain in government tax revenue (areas 2+3+4 = net welfare loss)

## Impact of subsidy on imports




Before the subsidy, imports are Q1Q2. Subsidy shifts domestic supply to right. Imports fall to Q2Q3. At the subsidised price, more domestic suppliers can compete with the world producers.

# Reason for restrictions on trade/protectionism

## Arguments for protectionism

**Protecting Domestic Industries:** trade restrictions can shield domestic industries from foreign competition, preventing job losses and maintaining national self-sufficiency in critical sectors.

**National Security:** trade restrictions may be used to safeguard national security interests; export of certain technologies or goods could be restricted to prevent them from falling into the wrong hands.

**Diversify:** an economy that is too dependent on one product.

**Infant Industry Argument:** governments may protect emerging or "infant" industries until they can compete internationally; tend to be temporary trade barriers, like subsidies or tariffs, providing domestic industries time to grow

**Sunset industry argument:** use tariffs to slow the decline of older sectors and limit risks of structural unemployment.

**Anti-Dumping Measures:** duties are imposed when foreign companies sell products below their production cost in the domestic market, harming domestic producers protecting local industries from unfair competition.

**Environmental and Health Concerns:** restrictions prevent the import of products that do not meet domestic environmental, health, safety and quality standards.

**Balance of Payments improvement:** trade restrictions can be used to improve a country's balance of payments by reducing imports through tariffs or quotas can help reduce trade deficits that use up foreign currency reserves

**Raise tax revenues:** this is especially important for many developing countries who have a limited domestic tax base).

## Benefits of protectionism

- Domestic industries become **more competitive** with better products for consumers
- Protects domestic industries and helps them grow; may **create jobs**
- Can **protect jobs**, prevent structural unemployment
- Governments can gain some **tax revenue** from tariffs
- Can be used to **improve the current account balance** on the Balance of Payments
- Can **protect citizens** from dangerous products, protect national security and help promote self-sufficiency in strategic industries

## Problems with protectionism

**Higher prices for consumers:** protectionist policies often lead to higher prices for imported goods due to tariffs or quotas.

**Less choice for consumers:** trade restrictions can limit or prevent some goods being imported

**Lower living standards:** living standards may fall as the availability and affordability of goods decreases; many protectionist measures reduce welfare

**Over-reliance on protection:** can lead to inefficiencies in supply, reducing competitiveness in the long term.

**Danger of retaliation/trade war:** protectionist policies may strain diplomatic relations and lead to retaliation by trading partners.

**Increase in income inequality:** if trade restrictions benefit specific industries or groups while imposing costs on others; they may also affect global income distribution by limiting opportunities for developing countries to export

**Shadow markets:** incentives to by-pass controls

## Issues with free trade

**Job Losses:** free trade can lead to job losses in industries where other countries have a comparative advantage; when cheaper imports flood the market, this can lead to layoffs and unemployment.

**Wage Suppression:** free trade can lead to downward pressure on wages, as companies might move production to countries with lower labour costs.

**Income Inequality:** free trade can exacerbate income inequality within countries;

## Trade barriers and inequality

- Protectionism tends to benefit high-income earners and harm low-income earners because of higher prices are regressive
- Job losses caused by trade barriers also disproportionately affects low-income workers, though jobs for some could be protected.
- Trade barriers can lead to less competition in certain sectors, allowing companies to have more pricing power; higher profits could be shared with workers via higher real wages.

# Balance of Payments

## Balance of Payments

A country's **balance of payments** account records all the flows of money between the residents of that country and the rest of the world. It has three key parts:

- Current account
- Capital account
- Financial account

**Export (X)** = a UK produced good or service sold overseas resulting in an **INFLOW** of income to the UK; it is a CREDIT or positive on the UK current account on the balance of payments; an injection into the circular flow

**Import (M)** = an overseas produced good or service purchased by UK citizens resulting in an **OUTFLOW** of income from the UK; it is a DEBIT or negative on the UK current a/c on the BoP; a withdrawal from the circular flow

**Net exports** = X-M

**Trade balance**

- If the value of X exceeds the value of M, there is a **trade surplus** (net injection, boost AD)
- If the value of M exceeds the value of X, there is a **trade deficit** (net withdrawal, reduces AD)
- If the value of M equals the value of X, there is **an equilibrium in trade or balance in trade**

## Current account on the Balance of Payments

**Current Account:** The current account records the transactions related to a country's trade in goods, services, primary and secondary income

**Trade Balance:** The balance of trade accounts for the difference between the value of a country's exports and imports of goods

**Services balance**: The balance in trade for services, such as tourism, financial services, transportation, and consulting.

**Primary Income:** Income includes net flows of earnings from investments, such as dividends, interest, and profits,

**Secondary income:** Net transfers of money or goods between countries, such as foreign aid, remittances from expatriates, and gifts.

## Capital account on the Balance of Payments

The **capital account:**

- Records financial transactions that involve the **acquisition or disposal of non-financial assets**, such as real estate, patents, and copyrights, between a country and the rest of the world.
- It also includes **capital transfers**, which involve the transfer of assets for specific purposes, like debt forgiveness.

## Financial account on the Balance of Payments

The **financial account:**

- Records transactions related to **financial assets and liabilities**, including foreign direct investment (FDI), portfolio investment, banking flows (such as hot money) and changes in foreign exchange reserves.
- It details how a country's residents and entities interact with foreign assets and liabilities.

## The balance of payments always balances

As a set of accounts all debits must be matched with credits.

- Any deficit on the current account will be offset by a surplus on the capital & financial accounts.
- ***A 'balancing item' ensures any discrepancy between current account, capital account and financial account is solved.***

## Current account deficit v budget deficit

**BE CAREFUL NOT TO CONFUE THESE DEFICIT TERMS!**

**Current account deficit:** when the value of exports is less than the value of imports in goods, services, primary and secondary income; a net withdrawal from the circular flow (X<M); AD shifts left, ceteris paribus, slowing growth.

**Budget deficit:** when the government spends more than it receives in tax revenue; a net injection into the circular flow (G>T); AD shifts right, ceteris paribus, encouraging growth

# Balance of Payments

## Current account deficit

**Current account deficit:** The value of exports of goods and services, investment incomes and transfer inflows is lower than spending on imported goods and services, investment income outflow and outward transfers.

- A net outflow of income from a country's circular flow (X<M)
- A current account deficit can be a sign of economic weakness, as it means that the country is relying on borrowing from abroad to finance its consumption.
- However, a current account deficit can also be the result of strong economic growth or investment in importing new capital goods.

## Financing a current account deficit

To finance a current account deficit, a country needs to:

- Attract inflows of FDI, portfolio investments, hot money, savings which may need higher interest rates or better rates of return
- Use up foreign currency reserves
- Sell assets/property to foreign investors
- Find ways to increase its international competitiveness

## Causes of a current account deficit

**Cyclical causes of current account deficit:** when an economy is booming, rising real incomes boost consumer spending increasing demand for imports, causing a wider trade deficit; and vice versa in an economic downturn

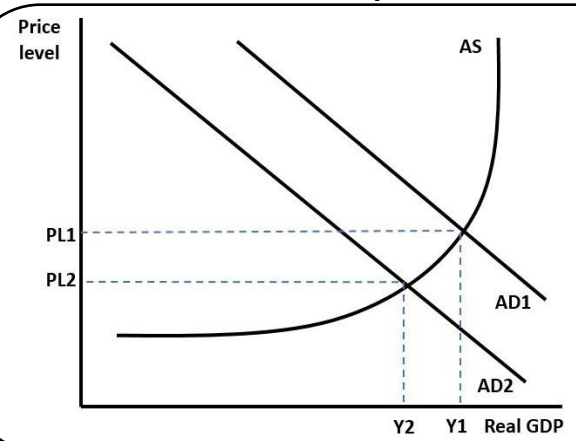
**Structural causes of current account deficit:** arise from supply-side weaknesses such as relatively low capital investment, low productivity & research and businesses not operating at the cutting edge of innovation

**Short run causes** (often cyclical): fall in value of exports, a boom in consumer spending or a broader economic boom (more imports); an appreciation of the exchange rate (less price competitive as exports prices rise and import prices fall

## Causes of a current account deficit

**Long term causes (often structural):** low rates of capital investment which limits the overall productive capacity and cost competitiveness of key export industries; relatively high cost & price inflation contrasted with trade partners; weaknesses in non-price competition such as branding & innovation; long-term decline of previously dominant export sectors such as deindustrialisation in manufacturing, decline in extractive sectors, loss of comparative advantage

## Consequences of a current account deficit




- Fall in AD since (X-M) is negative – leading to fall in real output (Y1 to Y2), slower GDP growth
- Drag on GDP growth might then lead to weaker investment & jobs
- Possible negative multiplier effect
- Large external deficit likely to lead to a depreciating exchange rate

## Does a current account deficit matter?

It depends on:

- its size relative to GDP
- its persistence
- what has caused it
- how easy it is to finance it

## Current account surplus

- Net injection into economy
- Positive export multiplier effects
- Trade surplus allows net exporting of capital
- Trade surplus enables additions to foreign currency reserves.
- Inflationary if there is no spare capacity
- Creates trade deficits elsewhere in world which may need correcting, more protectionism
- Pressure on currency to appreciate
- If surplus is due to high saving/low consumption, SoL may not be as high as it could be

# Correcting a current account deficit

## Reducing a current account deficit

**Correcting a deficit may require:**

- Deflationary policies to reduce AD and spending on imports
- Depreciation/devaluation of the currency: to restore price competitiveness
- Direct controls: on imports via tariffs, quotas etc.
- Supply-side improvements: to improve both price and non-price competitiveness

## Expenditure-switching policies

**Expenditure-switching policies**: policies designed to **change the relative prices of exports and imports**.

- An exchange rate depreciation can improve the price competitiveness of exports and make imports more expensive when priced in a domestic currency
- A tariff can make imported goods relatively more expensive than domestic ones.
- Lower relative inflation makes exports more competitive relative to imports

## Expenditure-reducing policies

**Expenditure-reducing policies:** contractionary monetary and fiscal policies designed to **lower real incomes and aggregate demand** and thereby cut the demand for imports.

- Higher direct taxes
- Cuts in real government spending on welfare
- Cuts in real government spending on public services
- An increase in interest rates to lower demand for credit and increase saving

These deflationary polices might a conflict with other macroeconomic objectives such as maintaining low unemployment and ensuring a steady rate of economic growth.

## Supply-side policies

- Infrastructure projects in improving transport networks, telecoms to increase supply-side capacity and productive efficiency
- Incentives to promote enterprise/start-ups/new export businesses
- Privatisation/deregulation to increase productivity & efficiency
- Investment in education to improve a country's human capital
- Protecting property rights to drive a faster rate of innovation/ideas
- Tax incentives to attract foreign direct investment from companies who subsequently export goods and services

## Effectiveness of different policies

Depends on the root causes of the current account deficit

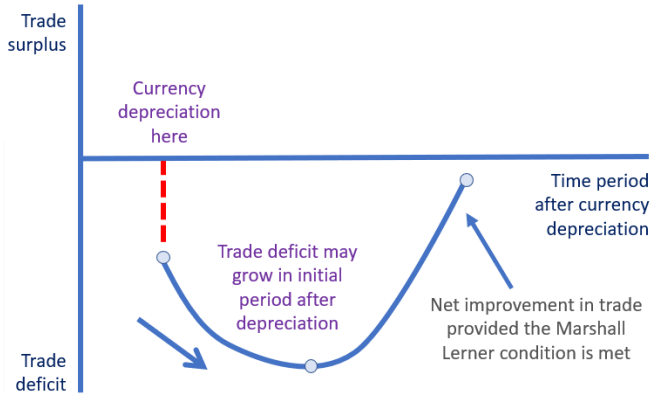
- If consumer boom caused it, then deflationary policies may work well
- If it is a structural deficit, then supply-side policies work better
- If it is a lack of price competitiveness, a depreciation may work well

## Will a depreciation/devaluation improve the trade deficit?

A depreciation reduce export prices and increase import prices; this could increase net export demand and the trade deficit improves.
BUT the response to these relative price changes depends on the PED for X and PED for M. According to the **Marshall-Lerner condition**, the absolute value of the sum of the PED for X + PED for M must be greater than or equal to 1 for a depreciation to improve the current account.

## J-curve effect

In the short run, PEDs are low, trade deficit worsens; but over time the PEDs rise and the Marhsall-Lerner condition is met. The J-curve shows the time lag between a depreciation or devaluation and an improvement in the trade balance.



# Exchange rates

## Exchange rate

**Exchange rate**: the price of a currency in terms of another. It is determined by demand and supply in FOREX markets

**Bilateral exchange rate:** one currency in terms of one other currency. eg £1 = $1.05

**Multilateral exchange rate:** one currency in terms of a group of other currencies e.g. ***effective or trade-weighted index*** *= a weighted average exchange rate expressed as an index (Base year =100)*

**Real** effective exchange rate is adjusted for relative inflation rates

## Factors influencing the demand for a currency

Demand for a currency is **an inflow of money into an economy**. Demand for currency is derived from the need to have currency to buy exports, inwards investment, etc.

- Buying **exports** of goods and services
- Overseas **portfolio inflows** into property, shares and bonds
- **Hot money** flowing into a country's banking system
- Inflows of **foreign direct investment** (FDI)
- **Speculative buying** of a currency by market traders

## Factors influencing the supply of a currency

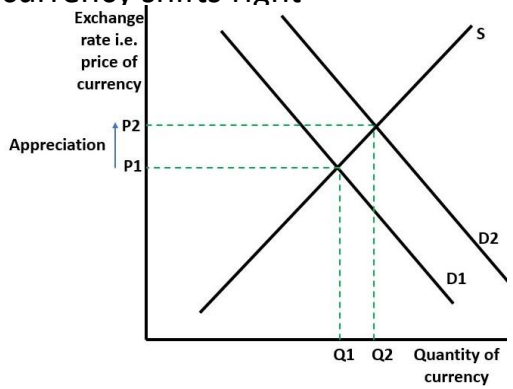
Supply of a currency is an **outflow of money into an economy.** The supply of a currency is determined by domestic demand for imported goods and services from abroad, outwards investment etc. Economic agents sell their currency to get the currency they need for these international transactions

- Domestic spending on **imported goods and services**
- **Outflow of portfolio flows** in property, shares and bonds
- **Hot money** flowing out of a country's banking system
- **Outflows** of foreign direct investment (FDI)
- **Speculative selling** of a currency by market traders

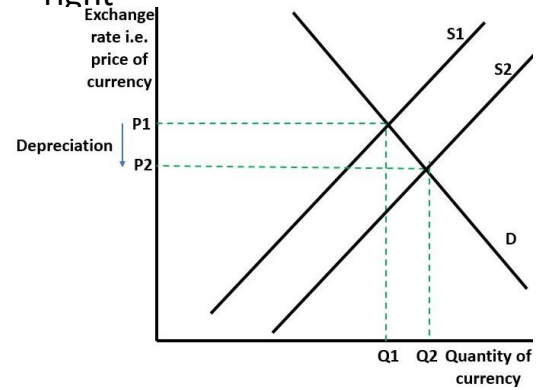
## FOREX market diagrams

**Equilibrium exchange rate:** the rate which **equates demand and supply** for a particular currency against another currency. Changes in the equilibrium exchange rate happen when there are **changes in currency demand and supply**

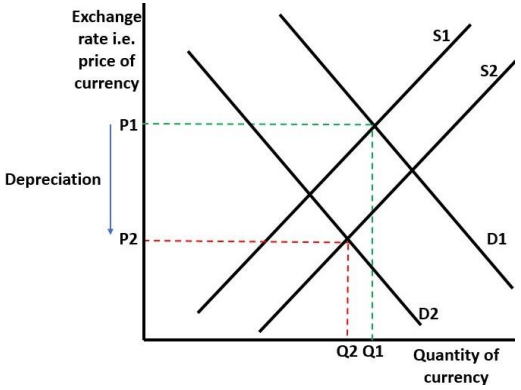
**Impact of an increase in exports or inward investment** – demand for currency shifts right



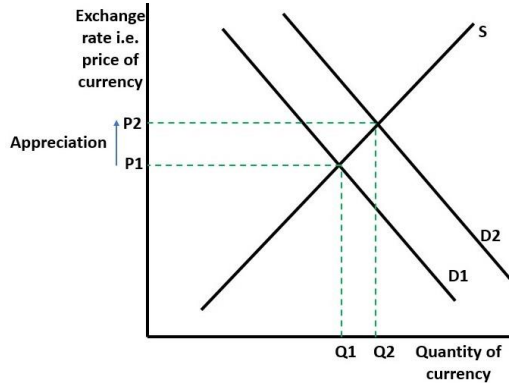

**Impact of an increase in imports or outward investment** – supply shifts right




**Impact of a fall in interest rates** – demand shifts left and supply shifts right (double shift)




**Impact of speculation** – if currency is appreciating, speculators may buy in = demand shifts right



# Exchange rate systems

## Types of exchange rate systems

- Freely floating
- Managed floating
- Semi-fixed (adjustable/crawling peg)
- Fully fixed (hard peg) Currency board (hard peg)

## Freely floating exchange rate

- Currency value is set **purely by demand and supply** of the currency i.e. market forces.
- Currency can either **appreciate** (rise) or **depreciate** (fall)
- **No intervention by central bank**
- There is no target for the exchange rate
- The external value of currency is **not an explicit target of monetary policy;** interest rates are not set to influence the value of the currency)

## Managed floating exchange rate

- Central bank gives freedom for market exchange rates on a day-to-day basis, supply and demand factors drive the currency's value
- Central bank may **intervene** occasionally
  - Buying to support a currency (selling their FX reserves or selling to weaken a currency (adding to their FX reserves)
- Currency becomes a key target of domestic monetary policy
- Higher exchange rate to control inflationary pressures
- "Managed depreciation" to improve competitiveness & trade balance

## Fixed exchange rate

- Central bank pegs the currency value to one or more currencies
- The central bank must hold enough foreign exchange reserves to intervene in currency markets when needed to maintain the fixed currency peg
- Pegged rate becomes the official rate
- There might be unofficial trades in shadow currency markets
- Adjustable peg: occasional realignments may be needed (must be officially sanctioned with the agreement of the IMF) leading to either a devaluation or revaluation

## Currency board

- A currency board: country's domestic currency is fully backed by a foreign reserve currency or specific foreign asset, typically held in a **fixed** exchange rate relationship.
- Domestic currency is issued only when there are corresponding foreign currency reserves to back it up, and the currency in circulation is **fully convertible** into the foreign reserve currency at the established fixed exchange rate.
- The currency board **must hold foreign currency reserves** equal to the total amount of domestic currency in circulation.

## Exchange rate terms

**Depreciation** (currency falls in value in a floating system) v **devaluation** (currency's value is deliberately reduced in a fixed system)
**Appreciation** (value rises in a floating system) v **revaluation** (currency increased in a fixed system)

## Advantages of floating exchange rate systems

**Independent Monetary Policy**: Interest rates and QE decisions can be used to influence domestic economy, not constrained by exchange rate considerations.
**Shock Absorption:** Free-floating exchange rates allow countries to absorb external economic shocks more effectively to help rebalance the economy.
**Reduced Speculative Attacks:** Since exchange rates are determined by market forces, speculative attacks on a currency are less likely
**Automatic 'correction' of trade imbalance:** If a country is running a large trade deficit, its currency's depreciation can over time make its exports more price competitive and imports more expensive, leading to a narrowing of the deficit.
**Currency reserves:** The central bank does not need to hold large foreign currency reserves because there is no specific currency target, financial capital can flow freely across countries seeking the best returns

# Exchange rate systems & the Terms of Trade

## Disadvantages of floating exchange rate system

**Exchange Rate Volatility:** this causes uncertainty for businesses reducing international trade and investment.
**Currency Risk:** Volatility introduces currency risk for businesses and investors.
**Inflation Pass-Through:** Exchange rate fluctuations can lead to changes in import prices, which can impact domestic inflation.
**Loss of Exchange Rate as a Policy Tool:** While countries gain monetary policy autonomy, they lose the ability to manage the exchange rate as a deliberate policy tool.

## Advantages of fixed exchange rate systems

**Price Stability:** A fixed system provides price stability helping control inflation; provides a predictable environment for businesses and consumers.
**Reduced Exchange Rate Risk:** Fixed exchange rates eliminate the currency risk associated with fluctuating exchange rates.
**Discipline on Monetary Policy:** constrains a country's central bank from pursuing an independent monetary policy. This can prevent excessive money supply growth and associated inflationary pressures.
**Foreign Investment:** A stable exchange rate can attract foreign investment. because there is less risk associated with currency fluctuations.

## Disadvantages of fixed exchange rate system

**Lack of Flexibility:** a fully fixed system cannot respond to external economic shocks. Interest rate may be needed to keep exchange rate fixed rather than affect domestic economic indicators
**Balance of Payments Issues:** Persistent imbalances can lead to pressures on the currency peg.
**Speculative Attacks:** Fixed exchange rate systems can be vulnerable to speculative attacks if investors believe that the currency is overvalued or if there are concerns about the country's ability to maintain the peg.
**Dependence on Reserves:** To maintain a fixed exchange rate, a country needs to have sufficient foreign exchange reserves.

## Terms of trade

The **terms of trade** measures the rate of exchange of one product for another when two countries trade.

**Terms of Trade Index (ToT)** = 100 x Average export price index / Average import price index

If a country can buy more imports with a given quantity of exports, its terms of trade have IMPROVED. If the ToT index falls, this is said to be a DETERIORATION as fewer imports can be bought for every export sold.

The terms of trade fluctuate in line with changes in export and import prices. The exchange rate and the rate of inflation can both influence the direction of any change in the terms of trade:

- A depreciation will cause a DETERIORATION in the ToT
- An appreciation will cause a IMPROVEMENT in the ToT

## Changes in the terms of trade

**Standard of living:** improvement in ToT makes imported food, medicines, etc; a long term decline in the ToT would reduce the standard of living
**Technology and capital goods:** improvement in ToT makes imports of technology/capital more affordable; but a deterioration in the ToT has the reverse effect
**Prebisch-Singer Hypothesis**: ToT are likely to deteriorate over time for primary product producers because there is a low YED for primary goods, while productivity in production rises; implications for developing countries that are primary product dependent if it holds.
**Price competitiveness:** Deterioration in ToT may not be a concern if it is caused by a depreciation that increases international price competitiveness

# International competitiveness

## International competitiveness

**International competitiveness:** sustained ability to sell goods and services profitably at competitive prices in a foreign country

**International price competitiveness:** producing goods/services at lower price than international competitors

**International non-price competitiveness:** producing goods/services that are better quality, better designed, have faster delivery, better after-sales service…than international competitors

## Measures of international competitiveness

**Relative unit labour costs:** ULCs are the labour cost per unit of output; a measure that takes into account the costs of employing workers and their productivity

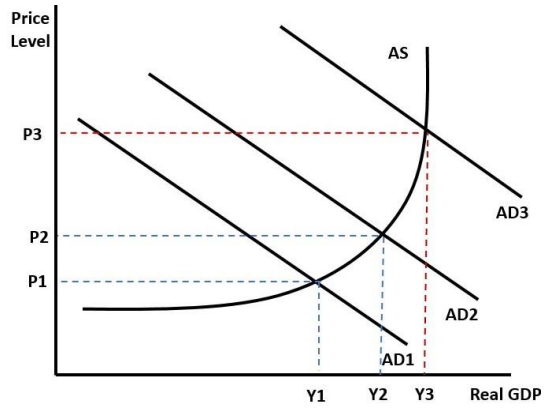
**Relative export prices**: if a country's exports become cheaper relative to its competitors, it becomes more price competitive

**The global competitiveness index:** an indicator that takes into account a whole range of factors that influence both price and non-price competitiveness

## Benefits of international competitiveness

- Stronger trade performance (trade surplus/smaller deficit)
- Export-led growth (multiplier effect) increasing real incomes; higher standard of living
- Lower unemployment
- Increase in FDI

*Diagram shows export-led rise in AD from AD1 to AD2 with export multiplier effect AD2 to AD3; real GDP increases from Y1 to Y3, but there may be some demand-pull inflation*




## Being internationally uncompetitive

- Larger trade deficit constraining economic growth and lowering the standard of living
- Economic decline/stagnation as industries cannot compete effectively: more structural unemployment as uncompetitive industries may shed jobs
- Income inequality may grow as a lack of competitiveness can exacerbate income inequality because some industries decline while others thrive.

*A lack of international competitiveness can cause a wider trade deficit, increasing unemployment with negative multiplier effect and slower economic growth*

## Strategies to improve international competitiveness

- Stable macroeconomic environment
- Competitive exchange rate
- Low & stable inflation
- Strong financial & legal institutions
- Competitive tax environment
- Investment in human capital; more education & training; better healthcare
- Inward migration of skilled workers
- Improvement in management to boost worker productivity
- Increased research and development (R&D) and innovations
- Market competition to raise productivity
- Support enterprise; make it easier to start up a business; reduce business red tape
- Investment in critical infrastructure (transport, energy, communication networks)
- Balanced growth across economy's regions
- Use of supply-side policies to increase productivity, incentives and competition

# Poverty

## Absolute v relative poverty

**Absolute Poverty:** If income is too low to ensure basic needs (food, shelter, clothing, access to clean water, sanitation facilities, education & information) are met.

**Poverty line** e.g. World Bank – living on less than $2.15 a day

**Relative Poverty:** Living below a certain threshold in a particular threshold, e.g. in UK, a household on less than 60% of median income is relatively poor; or not being able to afford what is normal in the society you live in

## Causes of poverty

- Unemployment/worklessness/homelessness
- Working poor/low paid work/underemployment
- Single parenthood/family structure
- Lack of education/skills
- Old age/longevity/pensioner poverty
- Cuts to welfare benefits
- Poorer quality public services/poor health
- Rising income and/or wealth inequality
- Discrimination
- Lack of opportunity/lack of access to finance/credit

***Poverty is often multi-causal – it is a combination of several issues that cause poverty for households and the people in them***

## Poverty types

**Child Poverty:** Children living in households with an income below 60% of the median income

**Persistent poverty:** Persistent poverty is defined as experiencing relative low income both in the current year and at least two out of the three preceding years

**Pensioner poverty:** Poverty for those after retirement and dependent on a pension income experience financial hardship

**Fuel poverty:** A household that spends at least 10 percent on its fuel costs

## Effects of poverty

**Health Disparities:** Poverty often restricts access to healthcare; poor living conditions, inadequate nutrition, and lack of preventive healthcare contribute to higher rates of illnesses

**Limited Education Opportunities:** Poverty can hinder access to quality education, leading to lower educational attainment and limited skills development

**Unemployment and Underemployment:** Challenge in finding stable and well-paying employment opportunities; jobs may not fully use skills or have limited hours

**Housing Insecurity & Homelessness:** Poverty can lead to substandard living conditions, including overcrowded housing, lack of basic amenities, and exposure to environmental hazards.

**Food Insecurity:** Lack of access to nutritious food leading to malnutrition and related health issues; may need to use food banks

**Social Exclusion:** Individuals living in poverty may face social stigma and discrimination, leading to feelings of isolation from mainstream society restricting participation in social and cultural activities, limiting opportunities for personal development and social integration.

**Cycle of Poverty and limited upward mobility:** Poverty can become a cycle, as children born into impoverished families may face similar challenges, perpetuating the cycle across generations.

**Increased Crime Rates:** Involvement in criminal activities as individuals may resort to illegal activities due to economic desperation.

## Anti-poverty policies

- Topping up low pay with tax credits - working WTC and child CTC
- Increasing the NMW
- Increases in real value of child benefit CHB and other benefits
- Minimum income guarantees for pensioners (& triple lock)
- Training programmes to get youths & long-term unemployed back to work
- Expansion of childcare schemes for low-income parents who want to return to work.
- Support for key workers to get a mortgage and move on to the housing ladder
- Charity work/Food banks
- Redistribute income/wealth

***Impact on efficiency and equity can vary depending on policy used; as poverty is multi-causal, a range of policies is likely to be more effective***

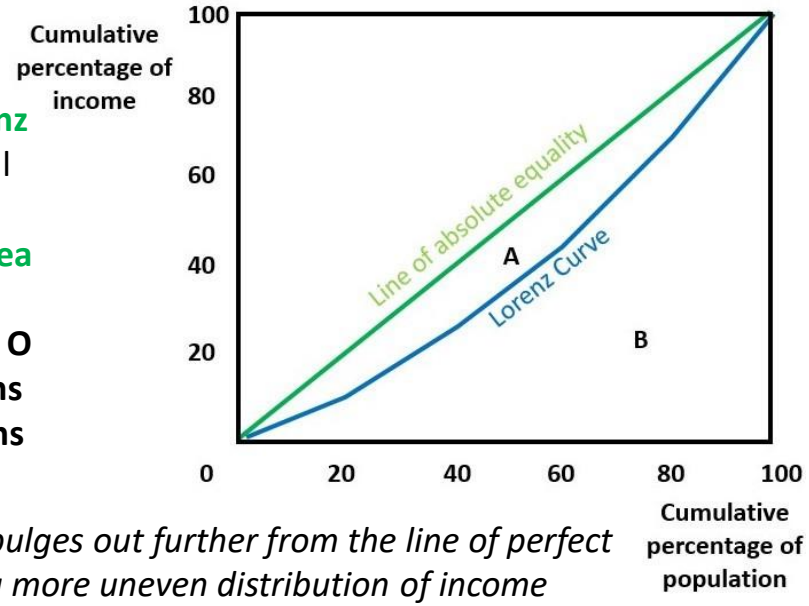
# Distribution of income and wealth

## Income & Wealth Inequality

**Wealth:** a stock of people's assets, including property, equities, material goods, private pension funds etc
**Income:** a flow from wages, dividends, rents
**Income inequality:** uneven allocation of income from employment, investments & savings, pensions, rent
**Wealth inequality:** uneven allocation of assets inc. property, financial assets, private pensions & rent
*Wealth distribution is more unequal than income distribution in the UK and globally*
**EQUALITY:** each individual or group of people is given the same resources or opportunities - a ***POSITIVE concept***
**EQUITY: fairness -** each person has different circumstances; the resources and opportunities are allocated to reach more equal outcomes - a ***NORMATIVE concept***

## Lorenz curve & Gini Coefficient

The green line is the line of perfect equality.
The blue line is the **Lorenz curve** showing the actual income distribution.
The **Gini coefficient = area A/areas A+B. The Gini coefficient lies between O and 1 (or 100%); 0 means perfect equality; 1 means perfect inequality**




*A Lorenz curve that bulges out further from the line of perfect equality shows a more uneven distribution of income*

## Differing views on inequality

- Inequality acts as an **incentive** to work hard and take risks; passed on to future generations; part of capitalism
- One human much the same as another; income should be distributed more evenly as people have **similar needs**

## Income & Wealth Relationship

The relationship between income and wealth can perpetuate inequality:
- Wealth can generate more income, such as rent on properties, dividends on shares....
- Higher income allows people to build up more wealth by buying up more assets

## Using the Gini coefficient to measure inequality

A useful 'snapshot' measure of inequality, but...
- Countries can have the same Gini coefficient and very different income distributions
- Statistics may be pre-tax, when a progressive tax system helps create a fairer distribution
- Different countries use different stats, making comparisons more difficult.

## Causes of inequality

- Wage disparities: wage differentials, a low minimum wage
- Employment insecurity: gig economy, zero hours contracts
- Educational disparities: skills gaps, access to education opportunities
- Housing market dynamics: renting or home ownership
- Financial assets and investments: inheritance, access to finance
- Tax policies: progressive v regressive taxation; tax avoidance & evasion
- Globalisation: global market forces; offshoring and outsourcing
- Social and economic discrimination; gender and ethnic pay gaps, glass ceiling etc
- Pension disparities: state pension only v those with private pensions
- Social welfare safety nets: cuts to benefits; below inflation increases; welfare caps
- High pay awards to CEOs and managers; % pay rises benefit highest paid more

# Distribution of income and wealth

## Economic costs of inequality

**Reduced Economic Growth:** *Underutilisation of talent and* human capital, as individuals from lower-income backgrounds may not have equal access to opportunities. Widening income gaps can lead to reduced consumer spending, negatively impacting economic growth.

**Wealth Concentration:** restricts entrepreneurship opportunities for individuals from lower-income backgrounds, hindering economic dynamism and slowing down innovation and economic progress.

**Workforce Productivity:** Health disparities can lead to decreased workforce productivity and economic output. Income inequality can contribute to job dissatisfaction and reduced productivity among workers.

**Public Expenditure:** Higher levels of inequality may necessitate increased spending on social welfare programs *Strain on Public Services:* Unequal access to education and healthcare may lead to increased demand for public services, straining resources.

**Human Capital Development:** Inequality may lead to a loss of potential talent/skills, as individuals from disadvantaged backgrounds may not have the same opportunities for education and training. Inequality can perpetuate across generations, creating a cycle of limited human capital development.

## Social costs of inequality

**Health Disparities:** Lower-income individuals may have less access to healthcare services, leading to more stress & poorer physical and mental health outcomes.

**Educational Inequities:** Children from lower-income families may face challenges in accessing quality education, resulting in lower educational attainment and less social mobility,

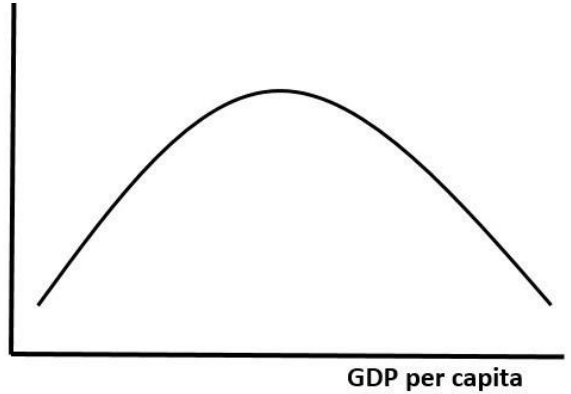
**Social Cohesion:** More social tensions in communities and greater mistrust of the 'system'

**Crime and Violence:** Inequality can increase crime and & social unrest

**Political instability:** Loss of trust in institutions and risk of corruption

## Kuznets curve

**The Kuznets curve** suggests that as a country develops from a largely subsistence economy and industrialises, income inequality increases as workers move from low-productivity, low-paid agricultural jobs to higher-productivity, better-paid manufacturing jobs.




At some point, income inequality starts to fall back, as governments have more resources (more tax revenue as per capita income rises, for example) to redistribute income and provide a better welfare safety net and better public services.

## Policies to reduce inequality

- Higher marginal tax rates on income & wealth
- Increases in the statutory (legal) minimum wage
- Rise in the relative level of cash welfare benefits
- Measures to increase employment rates
- Subsidies on energy bills, tuition, childcare etc.
- Rent controls to tackle unaffordable housing
- Laws to tackle discrimination in labour market
- Universal Basic Income (UBI)

## Free market v interventionist view

- Free market economists might argue that policies such as lower taxes to drive faster growth can help to reduce income inequality because of the **trickle-down effect** where growth creates extra jobs and lifts per capita incomes.
- Critics of this view argue that the evidence for trickle-down effects is weak and that **proactive pro-poor government interventions are needed** to make a significant difference to inequality.