IGCSE Economics CIE

YOUR NOTES

6. International Trade & Globalisation

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6.1 International Specialisation

6.1.1 Reasons for National Specialisation

Reasons for National Specialisation

- **Specialisation** occurs on several different levels
  - On an **individual level** where a worker specialises in a particular task
  - On a **business leve**l, e.g. one firm may only specialise in manufacturing drill bits for concrete work
  - On a **regional level** e.g. Silicon Valley has specialised in the tech industry
  - On a **national level** as countries seek to trade e.g. Bangladesh specialises in textiles and exports them to the world

- **The two main factors which allow a country to specialise are:**

1. **Superior resource availability:** If the **quality** of the resource is relatively better than other nations, the country will be able to charge **higher prices** for it. Alternatively, if a country has a **higher quantity** of the resource then it may be able to **lower prices** & drive competitors out of business by specialising in its extraction & sale

2. **Cheaper production methods:** If the country has lower costs of production, then it is very likely that they will be able to lower selling prices & gain a lead in the **international market share**. Some countries are able to produce cheaply using **machinery or technological innovation**, whilst others do so by providing **large labour force** which can perform manual tasks very cheaply

Advantages & Disadvantages of National Specialisation

Pros & Cons of National Specialisation

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Pros	Cons
Greater competition may increase productivity. Higher productivity **lowers cost / unit** for firms, which makes their goods more competitive **internationally (exports)**	International trade is beneficial for the firms that **can compete** globally. However, some industries will be **unable to compete** & will go out of business
Increased exports can result in **economic growth** for the nation	Many firms in an **entire industry** may close leading to **structural unemployment**
Economic growth usually leads to **higher income** and a better standard of living	Specialisation may create **over-dependency** on other countries' resources. This may **cause problems** if conflict arises (For example, Europe's reliance on Russian natural gas during the Ukraine crisis)
Income gained from exports can be used to **purchase** other goods from around the world **(imports).** This increases the **variety of goods** available in a country	Specialisation using a country's **own resources** will lead to resource depletion over time. Specialisation will increase the r**ate of resource depletion**
Global efficiency in the use of scarce resources improves as resources are extracted by nations who have the competitive advantage	As multinational firms grow in size & increase market power, they can **dictate prices & output** in many regions. They are also able to wield their power to influence governments & gain access to raw materials through bribery & corruption
With an increase in specialisation & output, it is possible to generate significant **economies of scale** which further lower production costs	Start-up firms in developing countries **(infant industries)** find it harder to compete due to global competition - the ones that survive often have government support. Global monopolies also exert large amounts of pressure on developing countries

	Over-specialisation in developing economies often occurs as they lack the finance to develop a **diversified product base** & end up over-specialising in commodity products. This makes the country's **GDP** very dependent on the commodity prices

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6.2 Globalisation, Free Trade & Protection

6.2.1 Globalisation

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Globalisation

- **Globalisation** is the economic integration of different countries through increasing freedoms in the cross-border movement of people, goods/services, technology & finance
- This **integration** of global economies has impacted **national cultures**, spread ideas, speeded up **industrialisation** in developing nations & led to **de-industrialisation** in developed nations
- Globalisation has been increasing for thousands of years - it is not a new phenomenon
- Improvements in technology & the **speed of global connections** have exponentially increased the **level of interdependence** between nations in the past 50 years
- Consumers now **source products globally** recognising **global brands** wherever they travel

The Four Main Characteristics of Globalisation

1. Increasing foreign ownership of companies	**2. Increasing movement of labour & technology across borders**
3. Free trade in goods/services	**4. Easy flows of capital (finance) across borders**

Multi National Corporations (MNCs)

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- A **multinational corporation** is business that has production facilities in two or more countries e.g. Apple
- Globalisation has made it easier for firms to do **business on a global scale** & the number & size of MNCs continues to increase
- There are advantages & disadvantages linked to the economic activity of MNCs, both in their home country as well as in their host country

The Advantages & Disadvantages of MNCs

The Advantages of MNCs

1. **Economies of scale:** as they operate globally they are able to increase their output & benefit from lowered costs created by **economies of scale**
2. **Increased profit:** much of their profit is sent back to their home country. This point is debatable as many MNCs have offshore bank accounts & do not bring the profit back home
3. **Create employment:** new jobs are created in host countries each time a new facility is setup & this **raises income** which helps to improve the standard of living in that country
4. **New markets:** MNCs can identify potential markets & begin to sell there
5. **Transportation costs:** MNCs are able to setup facilities closer to their customers which reduces transportation costs
6. **Risk management:** By selling in many national markets, the **risk of failure** is reduced e.g. if Egypt goes through a recession (with sales falling there), then this could be less impactful due to rising sales in a strong German market
7. **Tax incentives:** MNCs are able to increase their profits by setting up in countries with **low corporation tax** - or countries that offer MNCs a tax break (no tax) for their first 5-10 years of operation
8. **Avoidance of protectionism:** MNCs can establish bases in countries that are operating **protectionist**measures & by doing so, they avoid the measures e.g. A Chinese MNC may setup in the USA & produce there, thus avoiding **import tariffs** on their products exported from China to the USA

The Disadvantages of MNCs

Worker exploitation	Resource plundering	Political power
Many MNCs provide **poor working conditions & pay** very low (sweatshop) wages	Many MNCs extract large quantities of **host nation natural resources** providing very little compensation/payment	Many MNCs enjoy revenue that is **higher than the GDP** of the host nation & this gives them immense political power which can be used to their advantage
Reduce competition	**Lack of local knowledge/culture**	**Over reliance on MNCs for jobs**

MNCs are so large that they can **out-compete domestic firms** in the host country. This puts many firms out of business & **reduces competition** in that country & may **increase unemployment**	This may result in **problematic local relationships** or flawed advertising campaigns or product offerings	Many developing nations have an **over-reliance** on MNCs to provide jobs for their citizens. If the MNC leaves it creates significant unemployment
Diseconomies of scale	**Exchange rate fluctuations**	**Negative Externalities**
The challenges of operating a business over different time zones & cultures can create significant **diseconomies of scale**	Unexpected exchange rate fluctuations can have severe impacts on the **costs & profits** of MNCs	MNCs are associated with many **negative externalities of production** in developing countries

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6.2.2 Free Trade

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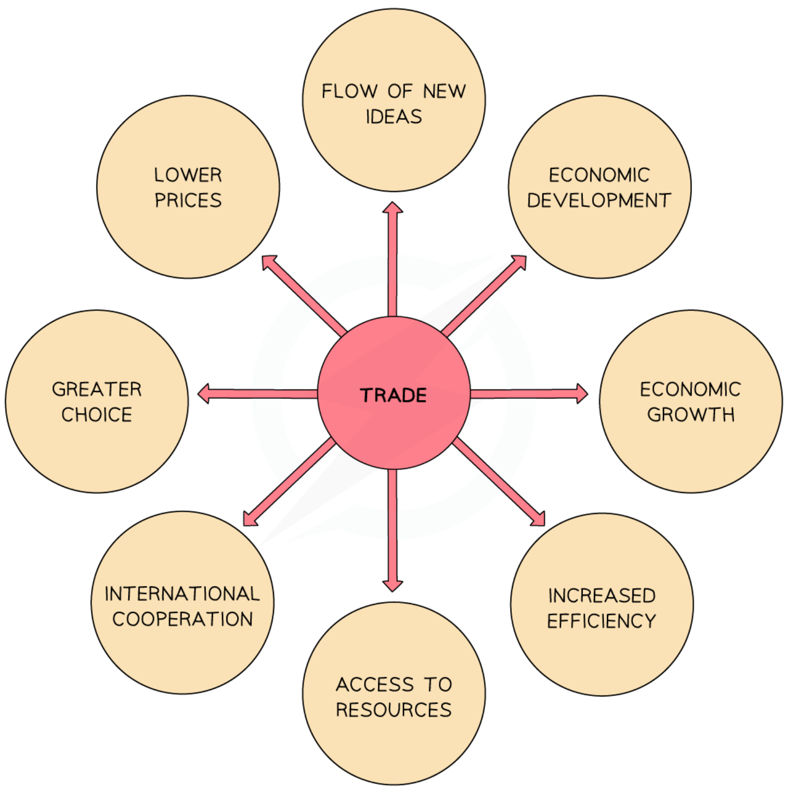
The Benefits of Free Trade

- International trade refers to the **exchange of goods & services** between countries
- International trade involves the exchange of goods/service through **exports** & **imports**
- **International trade** is 'free' when there is no government intervention (quotas, taxes etc.) to reduce or limit trade



The benefits of free trade

- **Greater choice:** with access to a wider variety of goods/services, the standard of living improves
- **Lower prices:** with international competition prices fall giving households the ability to buy more
- **International cooperation:** required for trade helps countries to build better relationships which leads to lower levels of hostilities
- **Flow of new ideas:** innovative ideas & technology can be shared between countries
- **Access to resources:** output can increase & costs of production can fall with increased access to raw materials
- **Increased efficiency:** international competition allows the most efficient firms to emerge & this improves the use of global resources

- **Economic growth:** exports are a key component of the gross domestic product of many countries & an increase in exports can lead to economic growth
- **Economic development:** Increased output leads to lower levels of unemployment which leads to higher incomes & a higher standard of living

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6.2.3 Protection

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Reasons for Protection

- Free trade aims to maximise global output through **national specialisation**
- However, there are numerous **reasons** why countries would seek to **limit free trade** in order to protect themselves from certain outcomes
- This is called **protectionism** & may take the form of import tariffs, export subsidies, the use of quotas or embargoes

Reasons for Protectionism

Reason	Explanation
Infant industries	To protect **new firms** that would be unlikely to succeed at start-up due to the level of global competition. Once established support is removed
Sunset industries	Similar to above, but at the other end of the life cycle, these firms are on their way out & the government chooses to support them to help **limit the economic damage** that would occur if they closed abruptly
Strategic industries	Industries such as energy, defence & agriculture are essential to **self-sufficiency** & security. Being reliant on other countries for these creates vulnerabilities for a nation
Dumping	**Dumping** is anti-competitive & can harm a country's industries
Employment	When firms outsource production to other countries or certain industries are experiencing **structural unemployment** governments will step in to protect jobs
Current Account deficit	When **imports > exports** the amount of money leaving the country to support foreign firms is greater than that entering to support domestic firms. Protectionism aims to correct this **imbalance**

Labour/environmental regulations	Many countries offer **cheap labour & low-cost production** due to poor environmental regulations. Protectionism can help apply **pressure** to bring about change in these countries

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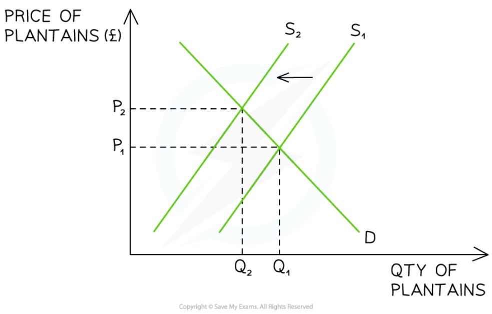
Methods of Protection

- The most commonly used forms of **trade protectionism** include tariffs, subsidies, quotas, embargoes & administrative barriers

1. Tariffs

- **A tariff is a tax on imported goods/services (customs duty)**
- With the price of imports higher, domestic firms find it easier to compete & increase their market share as consumers switch from buying imports to buying domestically produced goods/services
- Less **efficient domestic firms** are now producing at the expense of **more efficient international firms**



A tariff increases the costs of production for domestic firms, resulting in a shift of the supply curve from $S_1 \rightarrow S_2$

Diagram Analysis

- The **pre-tariff** market equilibrium for plantains is seen at P_1Q_1
- **After the tariff** is imposed, costs of production for domestic firms increase (as they pay the tariff when the plantains enter the country) - the supply curve shifts from $\boldsymbol{S_1 \rightarrow S_2}$
- The **new market equilibrium** is seen at P_2Q_2
  - Following the law of demand, the **quantity demanded contracts** from Q_1 to Q_2
  - The price increases from $P_1 \rightarrow P_2$

- **Tariffs** are one of the most widely used forms of protectionism & their impact on stakeholders can be evaluated as follows

An Evaluation Of The Use Of Tariffs To Protect Domestic Firms

Stakeholder	Explanation

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Domestic producers targeted by the government action e.g. steel manufacturers	• **Before the tariff** domestic manufacturers are less competitive & produce less • **After the tariff** was imposed the **targeted domestic manufacturers** increase their output • These firms may need **more workers** to produce the extra output & so unemployment in that industry falls
Domestic producers who have to pay higher prices e.g. car manufacturers who use steel for production	• **Before the tariff** domestic manufacturers are able to purchase the raw materials at cheaper prices • **After the tariff, the costs of production** of domestic manufacturers increase resulting in a fall in output • These firms may require **fewer workers** & so unemployment in several related industries may rise
Foreign producers	• Tariffs decrease demand for their products & so their output falls • With less supply from efficient foreign producers, the **global allocation of resources** is now **more inefficient**
Domestic consumers	• **Before the tariff** domestic consumers consumed more products at lower prices • **After the tariff** domestic consumers consumed **fewer products** at higher prices • The standards of living for consumers worsen as the **value of their income is eroded** as they are paying higher prices
The Government	• **After the tariff** is imposed the government receives **tax revenue** from each unit imported

Exam Tip

One of the most common misconceptions about tariffs is who pays them. The tariff is not paid by the foreign exporting firm. It is paid by any domestic firms that are importing. They pay the tariff to their own government when the goods cross the border.

Quotas, Subsidies, Embargoes & Administrative Barriers

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2. Quotas

- **A quota is a physical limit on imports** e.g. in June 2022 the UK extended their quota on **steel imports** for a further two years in order to protect employment in the domestic steel industry

- This limit is usually set **below the free market** level of imports
  - As cheaper imports are limited, a quota **raises the market price**
  - As cheaper imports are limited a quota **may create shortages**

- Some domestic firms benefit as they are able to **supply more** due to the lower level of imports
  - This may increase the level of employment for domestic firms

An Evaluation Of The Use of Quotas To Protect Domestic Firms

Stakeholder	Explanation
Domestic Producers	• Increases their output • Raises the selling price • Increases their **revenue**
Foreign Producers	• Decreases their output • Compared to a tariff, those firms who manage to export in the quota receive a **higher price** for their sales
Consumers	• Results in higher prices & less choice
Government	• They do not receive any **tariff revenue** (as there is no tariff) • They may receive higher tax revenue at the end of the financial year when domestic firms pay their **corporation tax**
Standards of living	• Reduces for consumers as higher prices erode the **purchasing power** of their income
Equality	• Domestic firms can compete more equally

3. Subsidies to Domestic Producers

- A **subsidy** lowers the cost of production for domestic firms
  - They can increase output & **lower prices**
  - With lower prices their goods/services are **more competitive** internationally

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- The level of exports increases
- The increased output may result in **increased domestic employment**

An Evaluation Of The Use of Subsidies To Protect Domestic Firms

Stakeholder	Explanation
Domestic Producers	• Decreases costs of production • Increases output • Increases **international competitiveness**
Foreign Producers	• Makes it harder for them to compete with domestic firms
Consumers	• Lowers prices
Government	• This costs the government the amount of the subsidy • There is an **opportunity cost** associated with every subsidy provided
Standards of living	• Improves for consumers as they benefit from **lower prices** - their income goes further
Equality	• Domestic firms can compete more equally

4. Embargoes

- An embargo is a complete ban on trade with a certain country usually as the result of political fall out e.g. the USA ran an embargo for many decades on Cuban products

An Evaluation Of The Use of Embargoes To Protect Domestic Firms

Stakeholder	Explanation
Domestic Producers	• Increases output due to less foreign competition
Foreign Producers	• They are unable to legally trade with the country running the embargo • They lose sales & profits • They may go out of business or need to reduce their number of workers

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Consumers	• Prices will rise - & in some cases the product may no longer be available at all
Government	• The government has to spend money enforcing the embargo

5. Administrative Barriers

- There are many strategies that can be used to **create barriers to trade** using less obvious methods than tariffs, quotas & subsidies
  - **Health & safety regulations** e.g. in 2017 the EU put a new health regulation in place regarding the permitted level of *aflotoxins* in nuts. *Aflotoxin* levels are naturally higher in southern hemisphere countries & it effectively blocked the import of southern hemisphere nuts
  - **Product specifications** e.g. Canada specified that all jam imported into Canada needed to be in a certain size of jar. Many countries do not usually manufacture jars in the required size
  - **Environmental regulations** e.g. in November 2021 new regulations were put in place in the EU & the USA to limit the amount of imports of 'dirty steel' - predominantly this is steel produced using coal fired power stations which are prevalent in China
  - **Product labelling** can be expensive for firms to apply & may limit their desire to sell into certain markets

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6.3 Foreign Exchange Rates

6.3.1 Introduction to Exchange Rates

Foreign Exchange Rates (Forex)

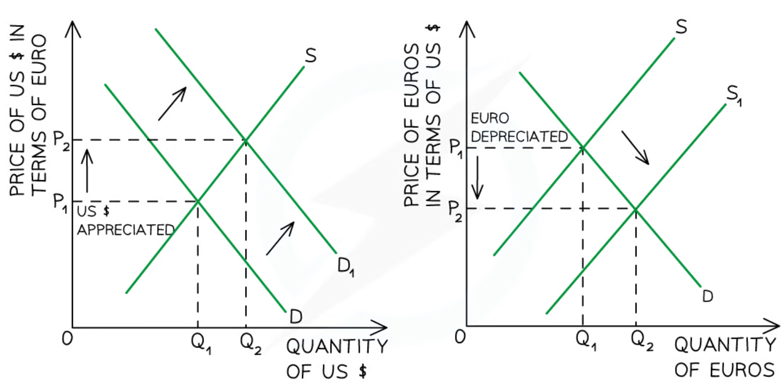
- An **exchange rate** is the price of one currency in terms of another e.g. £1 = €1.18
  - International currencies are essentially **products** that can be bought & sold on the **foreign exchange market** (forex)

- The Central Bank of a country controls the **exchange rate system** that is used in determining the value of a nation's currency

- Two of the main **exchange rate systems** are
  - A **floating exchange rate**
  - A **fixed exchange rate**

1. A Floating Exchange Rate System

- Different currencies can be bought & sold, just like any other product
- The forces of **demand & supply** determine the rate at which one currency exchanges for another
- As with any market, if there is **excess demand** for the currency on the forex market, then prices rise (the currency **appreciates**)
- If there is an **excess supply** of the currency on the forex market, then prices fall (the currency **depreciates**)



The relationship between the US$ & the Euro shows that as Europeans demand the $ it appreciates but by supplying their own currency it depreciates

Diagram Analysis

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- The Euro/US$ market is shown by **two market diagrams** - one for the USD market on the left & one for the Euro market on the right
- The initial **exchange rate equilibrium** is found at P_1Q_1 in both markets
- When Europeans visit the USA, they demand US$ & supply Euros
  - The **increased demand for the US$** shifts the demand curve to the right which results in the value of the $ **appreciating** from $P_1 \rightarrow P_2$ in the USD market & a new market equilibrium forms at P_2Q_2
  - The **increased supply of the Euro** shifts the supply curve to the right which results in the value of the Euro **depreciating** from $P_1 \rightarrow P_2$ & a new market equilibrium forms at P_2Q_2

2. A Fixed Exchange Rate System

- A system in which the country's **Central Bank intervenes** in the currency market to **fix (peg) the exchange rate** in relation to another currency e.g US$
  - When they want their currency to appreciate, they buy it on forex markets using their **foreign reserves**, thus increasing its demand
  - When they want their currency to depreciate, they sell it on forex markets, thus increasing its supply
- Sometimes the peg is at **parity** e.g. 1 Brunei Dollar = 1 Singapore Dollar
- Often the peg is not at parity e.g. Hong Kong has pegged its currency to the US$ at a rate of HK$ 7.75 = US$ 1
- A **revaluation** occurs if the Central Bank decides to change the peg & increase the strength of its currency
- A **devaluation** occurs if the Central Bank decides to change the peg & decrease the strength of its currency

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Evaluating Exchange Rate Systems

- Each exchange rate system has advantages & disadvantages attached

An Evaluation of A Floating Exchange Rate Mechanism

Advantages	Disadvantages
• **Natural fluctuations** in the exchange rate based on demand & supply help to **maintain stable current account balances** • If a currency appreciates, the country's exports fall & imports rise • If a currency depreciates, the country's exports rise & imports fall	• Fluctuations in the exchange rate can **create uncertainty** for firms, leading to a reduction in investment e.g. if a firm provides a quotation to a foreign buyer **based on today's exchange rate**, but the exchange rate then appreciates, the domestic firm will not make as much profit as expected
• Currency appreciation may allow **costs of imported raw materials** to decrease which may help lower prices in the economy	• Currency depreciation may cause **costs of imported raw materials** to increase resulting in **cost push inflation**
• Lower exchange rates **(or a depreciating currency)** may help to **increase economic growth** as export sales increase	• Higher exchange rates **(or an appreciating currency)** may **reduce/slow down economic growth** as export sales decrease
• Government does not need to **monitor & maintain** a fixed exchange rate	

An Evaluation of A Fixed Exchange Rate Mechanism

Advantages	Disadvantages
• Even with an increasing demand for a country's exports, the **price of its exports will remain fixed** as the currency will not appreciate with more demand • This can boost export sales over time e.g. China did this for many years & its products remained artificially cheap to buy	• In order to **maintain the fixed exchange rate,** the Central Bank has to regularly intervene in the currency market by **buying or selling its own currency** • This can be an expensive policy to maintain

• Firms (foreign & domestic) benefit as they can **agree prices with a high level of certainty** as the exchange rate will not fluctuate	• Changing the **interest rate** can also influence the exchange rate • Changing the interest rate **to maintain a fixed exchange rate** can have negative consequences on consumption, investment, lending, saving & borrowing

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6.3.2 Exchange Rate Fluctuations

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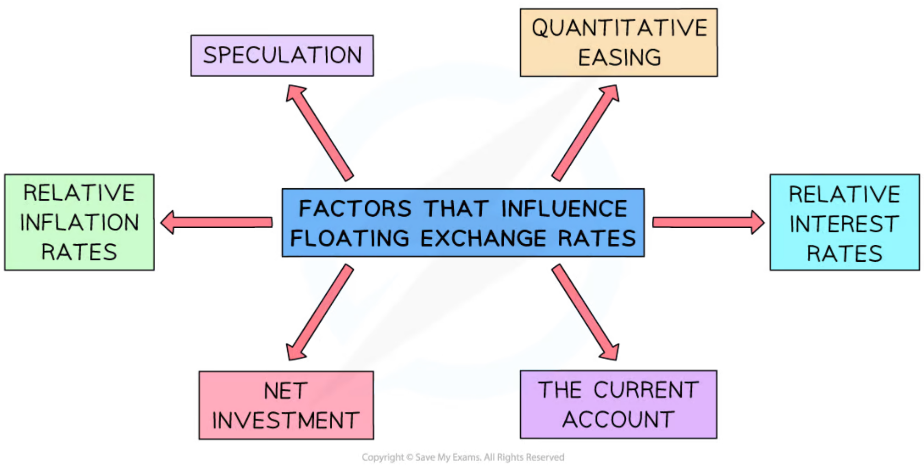
Causes of Exchange Rate Fluctuations

- Numerous factors influence floating exchange rates, resulting in an **appreciation** or **depreciation** of a currency



Factors influencing floating exchange rates

1. **Relative interest rates:** influence the flow of **hot money** between countries. If the UK increases its interest rate, then demand for £'s by foreign investors increases & the £ appreciates. If the UK decreases its interest rate, then the supply of £'s increases as investors sell their £'s in favour of other currencies & the £ depreciates

2. **Relative inflation rates:** as inflation in the UK rises **relative** to other countries, its exports become more expensive so there is **less demand** for UK products by foreigners, which means there is less demand for £s & so the **£ depreciates**

3. **Net investment:** foreign direct investment (FDI) into the UK creates a **demand for the £** which leads to the **£ appreciating**. FDI by UK firms abroad creates a supply of £'s which leads to the £ depreciating

4. **The current account:** UK exports have to be paid for in £'s. UK imports have to be paid for in local currencies, which requires £'s to be supplied to the forex market. Due to this, an **increasing net exports** will result in an appreciation of the £ & falling **net exports** will result in a depreciation of the £

5. **Changes in tastes/preferences:** As global demand for **quinoa** increased as it b**ecame fashionable**, Bolivia's exports of quinoa increased dramatically which put **upward pressure on their currency**. Foreigners demanded the Boliviano in order to pay for the quinoa

6. **Speculation:** the vast majority of currency trades are speculative. Speculation occurs when **traders buy a currency** in the expectation that it will be worth more in the short to

medium term, at which point they will sell it to **realise a profit**

7. **Quantitative easing:** involves increasing the money supply & much of the new supply is used to buy back gilts. Many of these gilts are **owned by foreigners** who then exchange the £s received for their own currency. The increase in the supply of £'s **depreciates the £**

8. **MNCs:** An increase in the number of MNCs globally will result in **more money flows** between countries, each of which influences exchange rates

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Consequences of Foreign Exchange Rate Fluctuations

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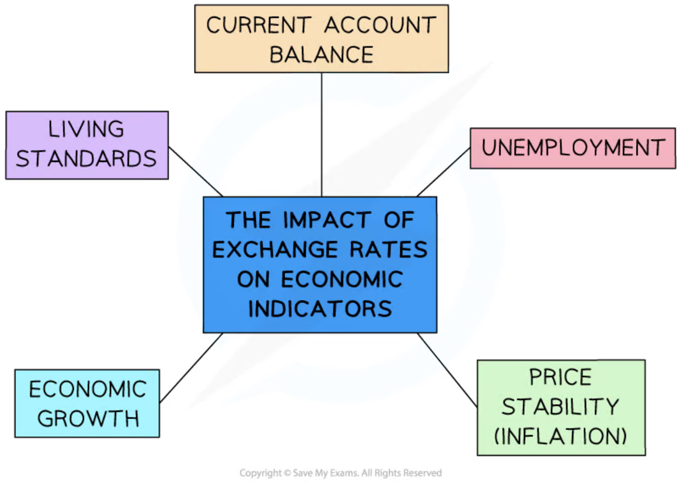
- Changes to exchange rates may have far-reaching impacts on an economy



The impact of changes to exchange rates on an economy

Economic Indicator	Explanation

The Current Account	• From a UK perspective, **the depreciation** of the £ causes **exports** to be cheaper for foreigners to buy & **imports** to the UK are more expensive
	
	• The **extent** to which a currency depreciation improves the **current account balance** depends on the **price elasticity of demand for exports & imports**
	  ◦ This follows the **revenue rule** which states that in order to increase revenue, firms should **lower prices** for products that are price elastic in demand
	  ◦ If the **price elasticity of demand for UK exports is elastic,** then a depreciation of the currency will result in a larger than proportional increase in demand for UK exports, which will rapidly improve any **current account deficit**

Economic growth	• Net exports are a component of **total (aggregate) demand** ◦ A depreciation that results in an **increase in net exports** will lead to economic growth

Inflation	• **Cost push inflation** can be caused by a **depreciating currency** as the price of **imported raw materials** increases with a weaker currency
	• Net exports are a component of total (**aggregate) demand**
	  ◦ A **depreciation** that results in an **increase in net exports** will lead to an increase in total demand
	  ◦ This may lead to an increase in **demand pull inflation**
	• An **appreciation** of the currency will have the opposite effect

Unemployment	• If **depreciation** leads to an increase in exports, **unemployment is likely to fall** as more workers are required to produce the additional products demanded • An **appreciation** of the currency will have the opposite effect

Living standards	• The impact of a **depreciation** on **living standards** can be muted
	  ◦ As imports are more expensive, households face **higher prices & less choice,** which detracts from living standards
	  ◦ Rising exports can decrease unemployment & **increase wages/income** which means an improved standard of living for some households
	• The impact of an **appreciation** on living standards will be the opposite

Foreign direct investment (FDI)	• Depreciation of a currency makes it **cheaper for foreign firms** to invest in the country which can increase investment & real GDP • An appreciation has the opposite effect

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6.4 Current Account of Balance of Payments

6.4.1 Components of the Current Account

The Current Account

- The **Balance of Payments (BoP)** for a country is a record of all the financial transactions that occur between it and the rest of the world

- The **BoP** has two main sections:
  - **The current account:** all transactions related to goods/services along with payments related to the transfer of income
  - **The financial & capital account:** which is not part of your syllabus

- Money flowing into the country is **recorded** in the relevant account **as a credit (+)** and money flowing out **as a debit (-)**
- A **current account surplus** occurs when the credits (money in) are higher than the debits (money out)
- A **current account deficit** occurs when the credits (money in) are less than the debits (money out)

The Current Account of the Balance of Payments

- The Current Account is often considered to be the **most important account** in the BoP
  - It records the **net income** that an economy **gains from international transactions**

An Example of the UK Current Account Balance For 2017

Component	2017
A. Net trade in goods (exports - imports)	£-32.9bn
B. Net trade in services (exports - imports)	£27.9bn
C. Sub-total trade in goods/services (A+B)	**£-5bn**
D. Net income (interest, profits & dividends)	£-2.1bn
E. Current transfers	£-3.6bn
Total Current Account Balance (C+D+E)	**£-10.7bn**
Current Account as a % of GDP	3.7%

- **Goods** are also referred to as **visible** exports/imports
- **Services** are also referred to as **invisible** exports/imports
- **Net income** consists of income transfers by citizens and corporations
  - Credits are **received from UK citizens** who are abroad & send **remittances** home
  - Debits are **sent by foreigners** working in the UK **back to their countries**
  - (Income credits - Income debits) are often referred to as **net primary income**
- **Current transfers** are typically payments at **government level** between countries e.g. contributions to the World Bank

- (Transfer credits - transfer debits) are often referred to as **net secondary income**

- **The current account balance = net trade in goods + net trade in services + net primary income + net secondary income**

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Current Account Calculations

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Worked Example

The table shows a selection of economic data for a country

Data	Value in Euros (€,000m)
Primary income (net income transfers)	150
Secondary income (net current transfers)	-50
Value of exported goods	100
Value of exported services	75
Value of imported goods	40
Value of imported services	45

Calculate the current account balance of this country?

Step 1: Recall the formula for calculating the current account balance
Net trade in goods + net trade in services + net income + net current transfers

Step 2: Substitute the appropriate values

Net trade in goods = (100–40) = 60

Net trade in services = (75–45) = 30

Net income transfers = 150

Net current transfers = -50

Step 3: Complete the calculation

60 + 30 + 150 -50 = 190

Step 4: Check the units and ensure your answer uses the correct units

€190,000m

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Reasons for Deficits & Surpluses

- If there is a **current account deficit**, the value of imports must be greater than the value of exports
- If there is a **current account surplus**, the value of exports must be greater than the value of imports

Causes Of Current Account Deficits

Relatively low productivity	**Relatively high value of the country's currency**	**Relatively high rate of inflation**
• Low productivity raises **costs** • Exporting firms with low productivity may find themselves at a **price & cost disadvantage** in overseas markets which will decrease competitiveness & the level of exports	• Currency **appreciation** makes a country's exports more expensive relative to other nations • Foreign buyers look for **substitute products** which are priced lower • Exports fall & the balance on the current account worsens • Similarly, currency appreciation makes **imports cheaper** • Domestic consumers may switch demand to foreign goods & as imports rise, the **balance on the current account worsens**	• A relatively high rate of inflation makes a country's exports more expensive than other nations • Foreign buyers look for substitute products which are **priced lower** • Exports fall & the balance on the current account worsens • Similarly, **high inflation** may mean that goods/services are cheaper in other countries • **Domestic consumers** may switch demand to foreign goods & as imports rise, the balance on the current account worsens
Rapid economic growth resulting in increased imports	**Non-price factors such as poor quality & design**	

YOUR NOTES
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• Rapid economic growth raises **household income** • Households respond by purchasing goods/services from abroad & the balance on the current account worsens	• When a country develops a reputation for poor quality & design, its exports fall as foreign buyers look for **better substitutes** elsewhere • Domestic buyers who are able to shop abroad also choose to **buy better quality products elsewhere** & the level of imports rise	

Causes Of Current Account Surpluses

Relatively high productivity	Relatively low value of the country's currency	Relatively low rate of inflation
• High productivity decreases **costs** • Exporting firms with high productivity may find themselves at a **price & cost advantage** in overseas markets which will increase competitiveness & the level of exports	• **Currency depreciation** makes a country's exports less expensive relative to other nations • Foreign buyers increase their purchases & the level of exports rises • Similarly, **currency depreciation** makes **imports ,ore expensive** • Domestic consumers may switch demand to locally produced products & the **level of imports falls**	• A relatively **low rate of inflation** makes a country's exports **less expensive** than other nations • Foreign buyers increase their purchases & the level of exports rises, improving the balance on the current account

Consequences of Deficits & Surpluses

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- As global trade is a net sum game where the value of global exports = global imports, it follows that if one country is running a **current account surplus** then another country is running a **deficit**

- **Consequences of current account deficits include**

1. **Increasing unemployment:** with falling demand for locally produced goods/services, fewer workers will be required & unemployment will rise
2. **Slow down in economic growth or a recession:** exports are a key component of the **real GDP** of many countries & a fall in exports may significantly reduce the level of economic growth
3. **Lower standards of living:** a fall in economic growth usually leads to a reduction in wages which leads to a decrease in the standards of living
4. **Increased levels of borrowing:** if the deficit is caused by continually increasing levels of imports, then it is likely that these imports are being paid for through higher levels of borrowing
5. **Depreciating exchange rate:** while this may ultimately help to increase exports again, it makes the cost of imported goods/raw materials more expensive and may cause cost push inflation

- **Consequences of current account surpluses include**

1. **Increasing employment:** with increasing demand for locally produced goods/services, more workers will be required & unemployment will fall
2. **Economic growth:** exports are a key component of the real GDP of many countries & a rise in exports may significantly increase the level of economic growth
3. **Higher standards of living:** a rise in economic growth usually leads to a rise in wages which leads to an increase in the standards of living
4. **Demand pull inflation:** economic growth caused by a rise in exports will lead to **demand pull inflation**
5. **Appreciating exchange rate:** rising exports will appreciate the exchange rate which leads to imports now being cheaper which causes the demand for imports to rise

Exam Tip

When answering questions on deficits, be absolutely clear if the question refers to a **budget deficit** or a **current account deficit**. Students often confuse these two!

A **budget deficit** refers to the government budget & occurs when the **government spending > government tax revenue**

A **current account deficit** occurs when the **value of a nation's exports < value of a nation's imports**

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Policies Which Stabilise the Current Account Balance

- The Government has several policies (fiscal, monetary & supply-side policy) available to them in order to address a **current account deficit** or to stabilise the current account balance. Overall, their choices are:

1. **They could do nothing**, leaving it to market forces in the foreign exchange market to self-correct the deficit

2. **They could use expenditure switching policies**. These include:
   ● **Protectionist policies** which raise the price of imports, so consumers switch to buying domestic goods
   ● **Currency devaluation** which makes the price of imports more expensive & so consumers switch to buying domestic products

3. **They could use expenditure reducing policies**. These include:
   ● **Raising taxes** which cause consumers to have lower disposable income & so they spend less on imports
   ● **Raising interest rates** which reduces the level of borrowing resulting in a fall in the level of imports

4. **They could use supply-side policies**. These include
   ● **Investment in education** which raises productivity making exports cheaper & more attractive
   ● **Investment in infrastructure** which lowers costs for firms making exports cheaper & more attractive

- The use of any policy - or any **combination of policies** generates both advantages & disadvantages

Advantages & Disadvantages of Policies Used to Tackle Current Account Deficits

Policy Option	Advantage	Disadvantage
Do nothing	Floating exchange rates act as a **self-correcting mechanism.** Over time a higher level of imports will end up **depreciating the currency** causing imports to decrease (they are now more expensive) & exports to increase (they are now cheaper). **This improves the deficit**	There may be other **external factors** that prevent the currency from depreciating. It may take **a long time** for self-correction to happen & many domestic industries may go out of business in the interim. The longer it takes to **self-correct**, the more firms will delay investment in the economy

Expenditure Switching	This is often successful in changing the **buying habits** of consumers, switching consumption on imports to consumption on domestically produced goods/services. **This helps improve a deficit**	Any **protectionist policy** often leads to **retaliation** by trading partners. This may consist of **reverse tariffs/quotas** which will decrease the level of exports. This may offset any improvement to the deficit caused by the policy
Expenditure Reducing	Contractionary fiscal policy invariably reduces **discretionary income** which leads to a fall in the demand for imported goods & **improves a deficit**	**Contractionary fiscal policy** also dampens domestic demand which can cause output to fall. When output falls, GDP growth slows & unemployment may increase
Supply-side	Improves the **quality of products & lowers the costs of production.** Both of these factors help the level of exports to increase thus reducing the deficit	These policies tend to be **long term policies** so the benefits may not be seen for some time. They usually involve government spending in the form of subsidies & this always carries an **opportunity cost**

YOUR NOTES
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Exam Tip

The terms **expenditure switching & expenditure reducing** are **not in your syllabus**. They have been included as they clearly explain **the intention** of any fiscal, monetary or supply-side policy used to address imbalances in the current account. The policies **aim to switch expenditure away from imports** or to **reduce expenditure on imports** - both of which will help to lower any current account deficit.