AQA A Level Economics

Your notes

14. The International Economy

Contents

Globalisation

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The Causes of Globalisation

- **Globalisation** refers to the increasing **interdependence** of world economies as a result of the growing scale of cross-border trade of commodities and services, flow of international capital and wide and rapid spread of technologies
- In 2000, the value of global trade was approximately **$6.45 trillion**. By 2020, this figure was at $19 trillion
- Numerous factors have contributed to the **rapid increase in the pace of globalisation** but perhaps two of the most significant are the improvements in **containerised shipping** and the **innovation** in communication technology

Causes of Globalisation

Cause	Explanation
Economies of scale	▪ **Economies of scale** generated by containerisation in the shipping industry
Technology	▪ The improved ability for firms to easily **connect** and **promote** themselves internationally as a result of the internet and improvements to communications technology e.g Skype, WhatsApp, WeChat etc
The growth of the WTO	▪ The Increased effectiveness of the **World Trade Organisation (WTO)** in negotiating new trade agreements and in helping countries to open up to free trade (trade liberalisation), thus increasing international specialisation and the volume of trade
Multinational corporations	▪ A rapid growth in the number and influence of **transnational corporations**
Geopolitical changes	▪ The end of the **cold war** between Russia and the West in 1990 opened up former communist countries around the world enlarging the **global supply of labour** e.g. more than 800,000 people migrated from East Germany to West Germany between 1990 and 1991
Deregulation	▪ In the 1990's there was **deregulation** of many financial markets which resulted in the **expansion of global financial services** & provided more access to capital

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The Main Characteristics of Globalisation

- Globalisation has been increasing for thousands of years - it is not a new phenomenon
  - Improvements in **technology** and 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

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

The Consequences of Globalisation

- Both **less-developed** and **more-developed** economies have benefited from globalisation
  - As firms grow in size, they benefit from **economies of scale**, causing costs to fall and consumers benefit in the form of lower prices
- However, **tax avoidance** has become easier for global firms as they often exploit loopholes across different countries

Consequences of globalisation for less-economically developed countries

1. **Reduction in absolute poverty**: Globalisation facilitates the flow of taxes from multinational corporations (MNC's) to host countries, enabling investment in vital public services such as healthcare, education, and infrastructure. This improves economic development
2. **Employment opportunities**: Increased involvement in global markets can generate jobs and higher incomes, potentially triggering a multiplier effect that stimulates overall economic growth. However, concerns arise regarding MNCs' exploitation of low-wage labour and poor working conditions in some instances, such as sweatshops
3. **Depletion of natural resources:** Some MNC's may exploit legal loopholes like **transfer pricing** and engage in corrupt practices, leading to the depletion of natural resources in developing countries. This phenomenon has been likened to a form of 'new colonialism'
4. **Increased power of monopolies:** Large firms can dictate prices and production levels across various regions. They may manipulate governments and gain access to raw materials through bribery and corruption

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Consequences of globalisation for more-economically developed countries

1. **Increased trade:** Trade favours more economically developed countries. They export more manufactured goods at much higher prices and import cheaper raw materials from poorer countries
2. **Increased capital flow**: The profits earned by MNCs are often repatriated to their home country

The Role of Multinational Corporations in Globalisation

- **Multinational Corporation (MNCs)** is a company that has business operations in at least one country other than its home country
  - E.g. Starbucks headquarters are in Washington, USA but they have 32,000 stores in 80 countries

The Role of Multinational Corporations in Globalisation

Factor	Explanation
Cross-border trade	▪ MNCs has facilitated increased trade and a greater choice of goods on the global market ▪ They have also increased **cultural globalisation,** as western values replace local cultures and goods with global brands such as Coca-Cola, Nike, and Apple
Technology Flow	▪ MNCs often bring a **rapid spread of technologies** and **production methods** to the countries where they operate ▪ **Containerised shipping** and the **innovation** in communication technology by MNCs has enabled quick and efficient trade and spread of goods across borders
Labour Mobility	▪ Increased opportunities from large MNCs has influenced the movement of labour ▪ It also impacts the structure of employment in a country. **Deindustrialisation** has meant that entire productions have been **outsourced** to less economically developed economies due to cheaper resources and labour. This may cause **structural unemployment** in more economically developed countries
Capital Flow	▪ There is a increased flow of international capital through FDI across borders ▪ Better roads, transportation and access to electricity improve international connections, **increasing global networks**

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International Trade

The Model of Comparative Advantage

- International trade **decreases prices** and increases the **variety of goods/services** available to a nation
  - This results in a **higher standard of living**
- **Comparative advantage** is the theory developed by David Ricardo in 1817 which states that a country should **specialise** in the goods/services that it can produce at the lowest opportunity cost
  - By specialising, the **volume of production increases**
  - Excess production can be **exported**
  - Goods/services which are not produced in the country can be **imported**

The assumptions of comparative advantage

- As with any economic model, there are underlying assumptions to the theory of comparative advantage:

1. **Transport costs are zero:** it does not account for moving goods or services between countries. Depending on a nation's location, this is more or less of a problem
2. **There is perfect knowledge**: each country knows what it has a comparative advantage in and also the comparative advantages of other countries
3. **Factor substitution is easily achieved**: economies can quickly adjust to changing global market conditions by switching from capital to labour - and vice versa
4. **Constant costs of production**: the theory does not take into account the **economies of scale** that can be achieved with an increase in output

Comparative & Absolute Advantage

- **Absolute advantage** occurs when a country is able to produce a product using **fewer factors of production** than another country
  - A country may well have **absolute advantage** but still not have **comparative advantage**
    - It should produce goods/services in which it has **comparative advantage**
- **Production possibility frontiers** can be used to illustrate **comparative and absolute advantage**

Diagram: Production Possibility Frontier for T-shirts & Computers

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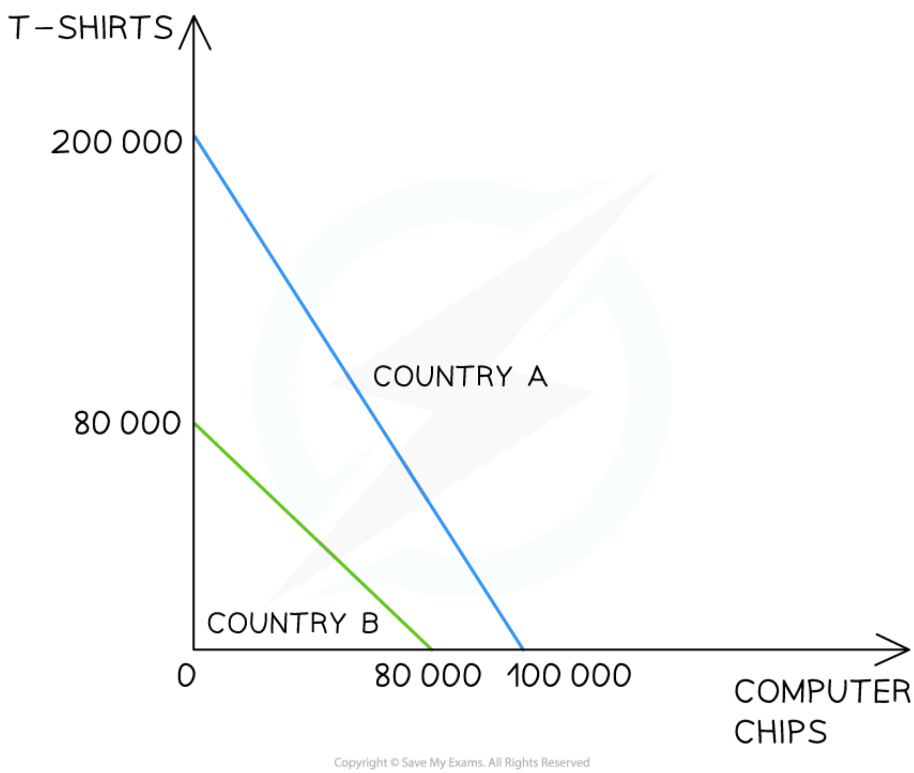

The production possibility frontiers for 2 countries that both produce two goods

Diagram analysis

- Country A has an **absolute advantage** as it can produce more of both products
- **Country A** can produce either 200,000 t-shirts or 100,000 computer chips
  - To produce 100,000 computer chips, it **gives up** production of 200,000 t-shirts
  - The **opportunity cost** of producing 1 computer chip is

$$\frac{t - shirts}{computer\ chips} = \frac{200{,}000}{100{,}000}$$ = **2 t-shirts**

  - The opportunity cost of producing 1 t-shirt is

$$\frac{computer\ chips}{t-shirts} = \frac{100{,}000}{200{,}000}$$ = **0.5 computer chip**

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- **Country B** can produce either **80,000 t-shirts** or **80,000 computer chips**
  - To produce 80,000 computer chips, it **gives up** production of 80,000 t-shirts
  - The opportunity cost of producing 1 computer chip is

$$\frac{t-shirts}{computer\ chips} = \frac{80{,}000}{80{,}000}$$ = **1 t-shirts**

  - The opportunity cost of producing 1 t-shirt is

$$\frac{computer\ chips}{t-shirts} = \frac{80{,}000}{80{,}000}$$ = **1 computer chip**

- To produce 1 computer chip **Country A gives up** 2 t-shirts and **Country B gives** up 1 t-shirt
  - **Country B has a comparative advantage in producing computer chips** as it is giving up fewer t-shirts, so it should specialise in computer chip production
- To produce 1 t-shirt Country A gives up 0.5 computer chips and Country B gives up 1 computer chip
  - **Country A has a comparative advantage in producing t-shirts** as it is giving up fewer computer chips, so it should specialise in t-shirt production

The gains from trade

- **Comparative advantage** shows that by **specialising**, the volume of **production increases**
  - Resulting in a large increase in the volume of overall **global trade**
- For example: excess production can be **exported** (Country A exports T-shirts and Country B exports computer chips)
  - Goods/services which are not produced in the country can be **imported** (Country A imports computer chips and Country B imports T-shirts)

Worked Example

Using information from the table below, explain which country should specialise in producing T-shirts and which country should specialise in producing computer chips [2]

	T-Shirts	Computer Chips
Country A	200,000	100,000
Country B	80,000	80,000

Method A

Step1: Cross Multiply and identify highest output

80,000 x 100,000 = 8,000,000

200,000 x 80,000 = 16,000,000 [1 mark]

Step 2: Using highest output, state who has comparative advantage

Country A should specialise in producing T-shirts (200,000)

Country B should specialise in producing computer chips (80,000)

Worked Example

Using information from the table below, calculate which country should specialise in producing T-shirts and which country should specialise in producing computer chips [3]

	T-Shirts	Computer Chips
Country A	200,000	100,000
Country B	80,000	80,000

Method B

Step 1: Calculate the opportunity costs for Country A

- The opportunity cost of producing 1 computer chip is $\frac{t-shirts}{computer\ chips} = \frac{200{,}000}{100{,}000}$ = **2 t-shirts**

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- The opportunity cost of producing 1 t-shirt is $\frac{computer\ chips}{t-shirts} = \frac{100{,}000}{200{,}000}$ = **0.5 computer chip**

Step 2: Calculate the opportunity costs for Country B

- The opportunity cost of producing 1 computer chip is $\frac{t-shirts}{computer\ chips} = \frac{80{,}000}{80{,}000}$ = **1 t-shirts**
- The opportunity cost of producing 1 t-shirt is $\frac{computer\ chips}{t-shirts} = \frac{80{,}000}{80{,}000}$ = **1 computer chip**

Step 3: State who has comparative advantage in each product

- **Country B has a comparative advantage in producing computer chips** as it is giving up fewer t-shirts (1 as opposed to 2) and so it should specialise in computer chip production
- **Country A has a comparative advantage in producing t-shirts** as it is giving up fewer computer chips (0.5 as opposed to 1) and so it should specialise in t-shirt production

[2 marks for any correct working and 1 mark for the correct answer]

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The Benefits & Costs of Trade

The Economic Benefits of Trade

- **Free trade** is the movement of goods and services across borders without **barriers to trade**
  - There are no or limited taxes, quotas, subsidies, regulations on the trade of goods or services

Diagram: The Economic Benefits of Free Trade

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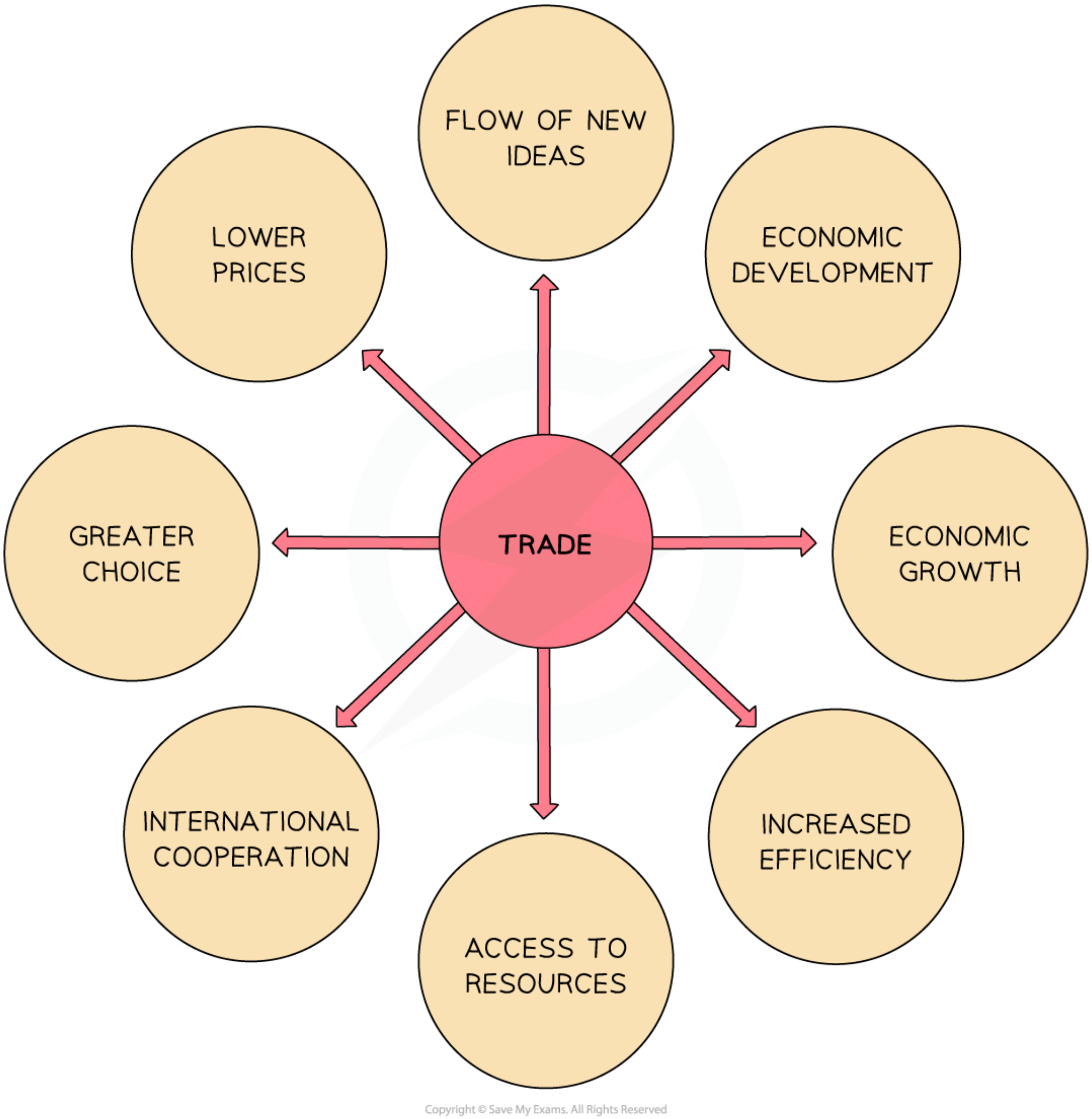

Free trade is the movement of goods and services without government restrictions

- **Greater choice:** with access to a wider variety of goods/services, the standard of living improves
- **Lower prices:** As the amount of competition increases, firms benefit from **economies of scale**, causing costs to fall and consumers benefit in the form of lower prices
- **International cooperation:** required for trade helps countries build better relationships, which leads to lower levels of hostilities

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- **Flow of new ideas**: innovative ideas and technology can be shared between countries
- **Access to resources:** output can increase and costs of production can fall with increased access to raw materials
- **Increased efficiency:** international competition allows the most efficient firms to emerge and this improves the use of global resources
- **Economic growth**: exports are a key component of the gross domestic product of many countries and an increase in exports can lead to economic growth
- **Economic development:** Increased output leads to lower levels of unemployment, which leads to higher incomes and a higher standard of living

The Costs of International Trade

- **International trade** countries increases the choice of goods and services
  - However, this trade may **favour more economically developed countries** and and **exploit less economically developed** countries
  - The following outlines the costs associated with international trade for countries

The Costs of International Trade

Disadvantage	Explanation
Deficit on the current account	▪ Some countries will **import more** than they export, resulting in a **deficit** on the current account on [popover id="vSuJtzgqI3Miukkl" label="Balance of Payments"] ▪ In developing countries, this situation is usually the result of a la**ck of global competitiveness** and involves importing necessity products
Unemployment	▪ Employment in **successful industries** will increase, and employment in **unsuccessful industries** will decrease ▪ **Structural unemployment i**s a particular concern. Government supply-side policies make a significant difference to the length and severity of structural unemployment
Over-specialisation	

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	▪ Developing countries often lack the finance to develop a diversified product base and end up **over-specialising in commodity products** ▪ This makes the country's GDP very **dependent** on commodity prices
Loss of sovereignty	▪ With an increase in trade, languages and cultures have blended, impacting on some indigenous languages and cultures ▪ Countries have also **lost some sovereignty** as they are more easily influenced by dominant trading partners
External shocks	▪ **Shocks to other economies** have a knock-on effect due to the interdependence that develops with trade ▪ E.g. the Russian war on Ukraine has created global shockwaves in the energy & grain markets

Reasons for Changes in UK Trading Patterns

- Numerous factors **influence the pattern of trade** between the UK and the rest of the world e.g. Brexit has resulted in a fundamental change to the trading relationship with the EU

- **Patterns of trade can change** significantly over time
  - Up until the 1980s, the UK mainly traded with Commonwealth Countries
  - In 2020, 46% of trade was with EU countries and 26% was with the USA

1. **Comparative advantage:** As firms seek to profit maximise they **increase production** due to natural advantages. When it makes financial sense to **outsource production** because another country does it better/cheaper. Over time, this changes what countries produce & trade

2. **Impact of emerging economies:** Emerging world economies like China, Brazil, India & Thailand have obtained a much **higher share** of the global business which means that other countries are losing out as **trading relationships**

3. **Growth of trading blocs & bilateral trading agreements**: By December of 2016, the World Trade Organisation (WTO) had helped to facilitate more than 420 regional **trading blocs** & bilateral

agreements (between 2 countries)

4. **Changes in relative exchange rates:** If a country's exchange rate appreciates, then its exports are relatively more expensive & its imports become cheaper. This means that changes to the **exchange rates** influence the patterns of trade over time as goods/services either become **cheaper** or more **expensive** in relation to the price of goods/services in other countries

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Protectionist Policies: An Introduction

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The Causes & Consequences of Protectionist Policies

- **Free trade** aims to maximise global output based on the principle of **comparative advantage**
- 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** and may take the form of **limiting imports**, **limiting exports**, **boosting exports,** or putting **administrative barriers** in place

Reasons Countries Adopt Protectionist Policies

Reason	Explanation
Protect infant firms	▪ To protect **new firms** that would be unlikely to succeed at start-ups due to the level of global competition. Once established support is removed
Sunset industry	▪ Similar to above, but at the other **end of the life cycle,** these firms are on their way out, and the government chooses to support them to help limit the economic damage that would occur if they closed abruptly ▪ There is a **welfare loss** as inefficient industries are producing at the expense of more efficient global producers
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 and low-cost production due to **poor environmental regulations** ▪ Protectionism can help apply pressure to bring about change in these countries

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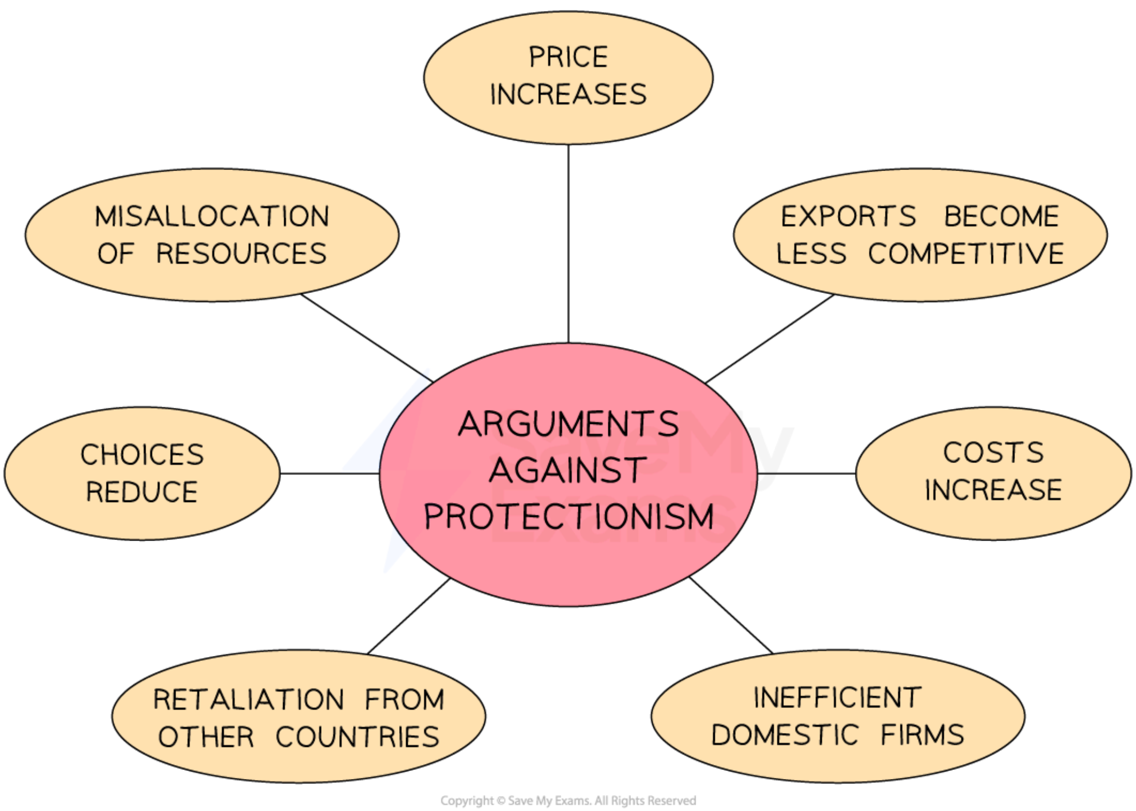
Consequences of Protectionism

- The consequences of **trade protection** are evident from the impact that each form of protection has on the stakeholders
  - These can be summarised in the diagram below

Diagram: Consequence of Protectionism



Arguments against the use of protectionism measures

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1. **Reduced choice:** Protectionism reduces both the quantity and variety of goods/services available to customers
2. **Increased prices:** Protectionism either reduces the supply of goods and services, which leads to higher prices, or in the case of tariffs, directly leads to higher prices
3. **Increased costs:** Manufacturers who rely on imported raw materials face higher production costs. If protectionism is widespread, it may generate inflation in the economy and/or lead to a loss of employment
4. **Retaliation:** Foreign producers are hurt by protectionism and it is common for their governments to retaliate with their own measures, which further harm free trade
5. **Reduction in export competitiveness:** Protectionism reduces the need to be efficient or to innovate. Over time, this leads to higher prices and worse quality products which will reduce export sales
6. **Resource misallocation:** Global welfare is reduced as protectionism shifts production away from more efficient foreign producers to less efficient domestic producers
7. **Domestic inefficiency increases:** With a reduced level of competition, domestic firms will be less **productively efficient** and will spend less on research, development and innovation

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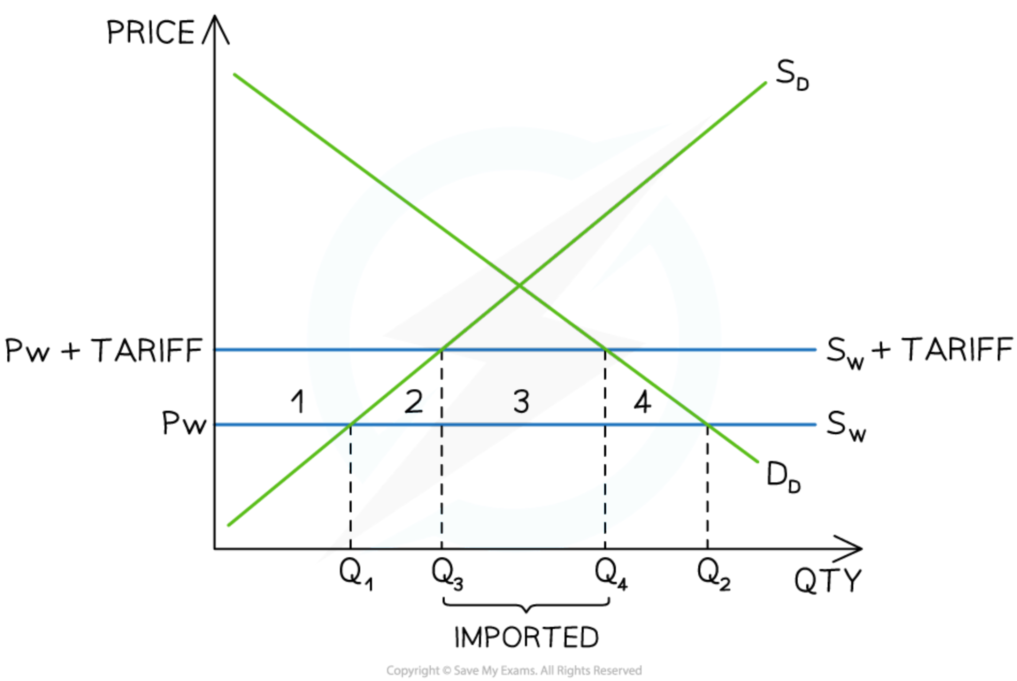
Protectionist Policies: Tariffs

How a Tariff Works

- A **tariff** is a tax on **imported** goods/services (customs duty)
- **Domestic producers/retailers** have to pay the tariff when the good/service crosses the border into the country
  - This raises the **cost of production** for domestic firms
  - Firms often pass on the increased costs to consumers in the form of **higher prices**
  - These higher prices allow some domestic firms to increase their output (law of supply)
- Due to the tariff, more **inefficient domestic firms** are now **producing more** at the expense of more efficient foreign firms, which reduce their output due to the tariff
  - With increased domestic output, **employment** may increase

Diagram: Tariff Imposed on Imports



A tariff raises the price of world supply from P_W to P_W + Tariff. This reduces the quantity of imports from Q_1Q_2 to Q_3Q_4

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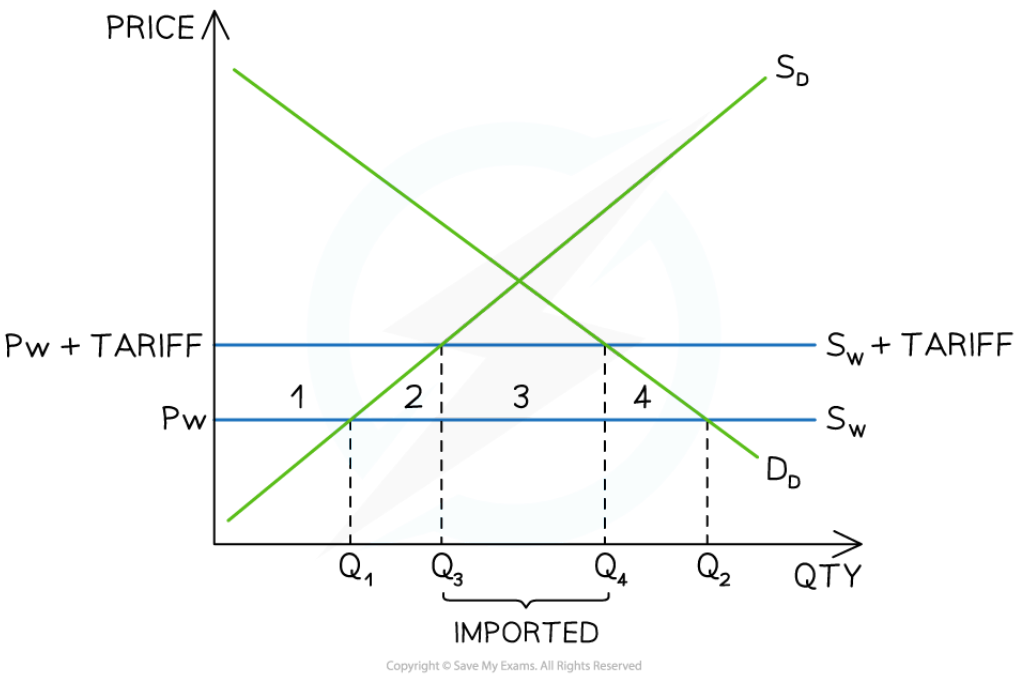
Diagram analysis

- **World supply (W_s)** is considered to be infinite, and this supply curve is added to the domestic demand (DD) and supply (SD) curves
- The **pre-tariff** market equilibrium is seen at P_wQ_2
  - Domestic firms supply up to Q_1 at a price of P_w
  - Foreign firms supply the difference equal to Q_1Q_2 (the level of imports), at a price of P_w
- **After the tariff** is imposed, the world price increases from P_w to P_w + Tariff
  - Following the law of demand, the **quantity demanded contracts** from Q_2 to Q_4
  - Following the law of supply, the **quantity supplied** by domestic firms **extends** from Q_1 to Q_3
  - The **new market equilibrium** is seen at P_w+tariff Q_4
  - The level of **imports is reduced** from Q_1Q_2 to Q_3Q_4
    - Domestic **producer surplus** has **increased** by **area 2**
    - Domestic **consumer surplus** has **decreased by areas 1, 2, 3 & 4**
    - The government receives tax revenue equal to ((P_w+tariff) - P_w) x (Q_4-Q_3)
      - This is equivalent to area 3 on the diagram

The Impact of a Tariff

- The best way to consider the **impact of a tariff** on stakeholders is to explain it using a diagram

Diagram: The Impact of Tariffs on Stakeholders



A tariff impacts domestic producers, consumers, foreign producers and the government

The Impact of Tariffs on Stakeholders

Stakeholder	Impact on Stakeholder
Domestic producers	▪ **Before the tariff** domestic producers produced output equal to $0Q_1$ and their revenue was equal to P_w x Q_1 ▪ **After the tariff** was imposed domestic producers produced $0Q_3$ and their revenue was equal to P_w+tariff x Q_3 ▪ Domestic **producer surplus** has increased by area 1
Foreign producers	▪ **Before the tariff** foreign producers sold output equal to Q_1Q_2 and their revenue was equal to P_w x (Q_2 - Q_1) ▪ **After the tariff** was imposed foreign producers sold output equal to Q_3Q_4 and their revenue was equal to P_w x (Q_4 -Q_3) ▪ Foreign **producer surplus** has decreased by the areas underneath 2 and 4

Your notes

Your notes

Domestic consumers	▪ **Before the tariff** domestic consumers consumed Q_2 products at a price of P_w ▪ **After the tariff** domestic consumers consumed **fewer products** (Q_4) at a **higher price** of P_w+tariff ▪ Domestic **consumer surplus** has decreased by areas 1,2 3 and 4 ▪ Some consumers have been priced out of the market (contraction of quantity demanded from $Q_2 \rightarrow Q_4$
The government	▪ **After the tariff** is imposed the government receives **tax revenue** equal to ((P_w+tariff) - Pw) x (Q_4-Q_3) ▪ This is equal to area 3
Downstream producers	▪ Other producers who rely on the imported product as a **raw material** in their own production process, now have to pay more for it as prices are higher ▪ This increases their **costs of production** ▪ They may have to reduce output which could impact **unemployment levels** and government tax receipts in their industry
Society (welfare loss)	▪ **Less efficient** domestic firms are now producing at the expense of more efficient foreign producers - there is a welfare loss equal to area 2 ▪ Consumers are frustrated with the higher prices and there is no longer **allocative efficiency** - there is a welfare loss equal to area 4 ▪ The net welfare loss is equal to areas 2 and 4

Impact on standards of living

- The **standards of living for consumers worsen** as the value of their income is eroded as they are paying **higher prices**
- Domestic firms that benefit from increased production may **increase employees' wages**
  - This would increase the s**tandard of living for employees**

Impact on equality

- Workers in industries that have been experiencing **structural unemploymen**t due to foreign competition will feel that the tariff results in them being treated more fairly

Protectionist Policies: Quotas & Export Subsidies

Your notes

How a Quota Works

- **A quota is a physical limit on imports** e.g. in June 2022 the UK extended its 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

How an Export Subsidy Works

- An **export subsidy** lowers the cost of production for **domestic firms**
  - They can increase output and **lower prices**
  - With lower prices, their goods and services are **more competitive** internationally
  - If firms are able to meet all of the domestic demand then the excess supply may be exported
  - The increased output may result in **increased domestic employment**
- The export subsidy can be given to the firm by the government using any of the following methods:
  - Direct subsidy payments
  - Tax relief which can be substantial
  - The provision of cheap credit or interest-free government loans
- Following the 2nd World War, the **European Union** subsidised food production and this has continued ever since
  - Once food security had been established within Europe, countries were able to start **exporting the excess supply** that subsidies generate

Diagram: Impact of Subsidies on Truffles

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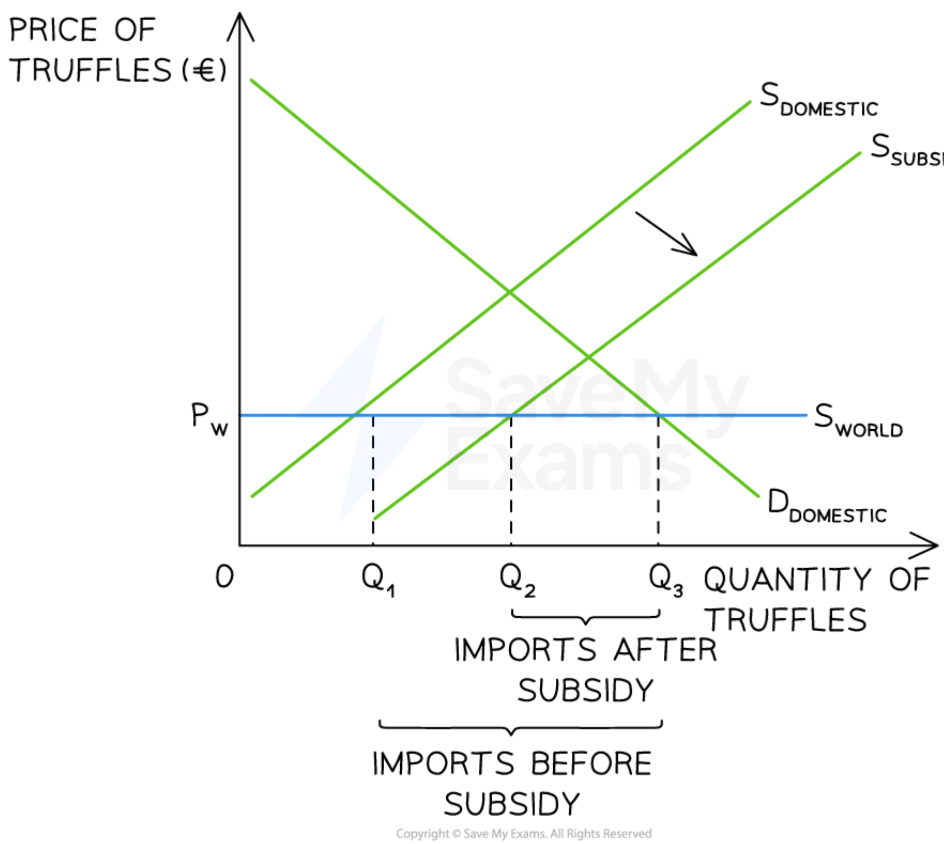

European Union subsidies for truffle producers shift the domestic supply curve to the right, which decreases the level of truffle imports required from Q_1Q_3 to Q_2Q_3

Diagram analysis

- The domestic market for truffles in the EU was initially in **equilibrium at P_wQ_3**
  - Domestic firms supplied up to Q_1, while Q_2 - Q_1 was imported into the EU

- The implementation of the subsidy **lowered firms costs of production**, shifting the domestic supply curve from Sd to Sd + subsidy
  - Domestic firms increase output and market share from $Q_1 \rightarrow Q_2$
  - Imports reduce from $Q_1Q_3 \rightarrow Q_2Q_3$

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Examiner Tips and Tricks

You do not need to be able to draw the export subsidy diagram above. However, you do need to understand how export subsidies work. Since you have studied subsidies in Micro, it is easy to apply your Micro knowledge to an export subsidy situation. For more visual learners, it helps to have the diagram above as you can then explain what you see.

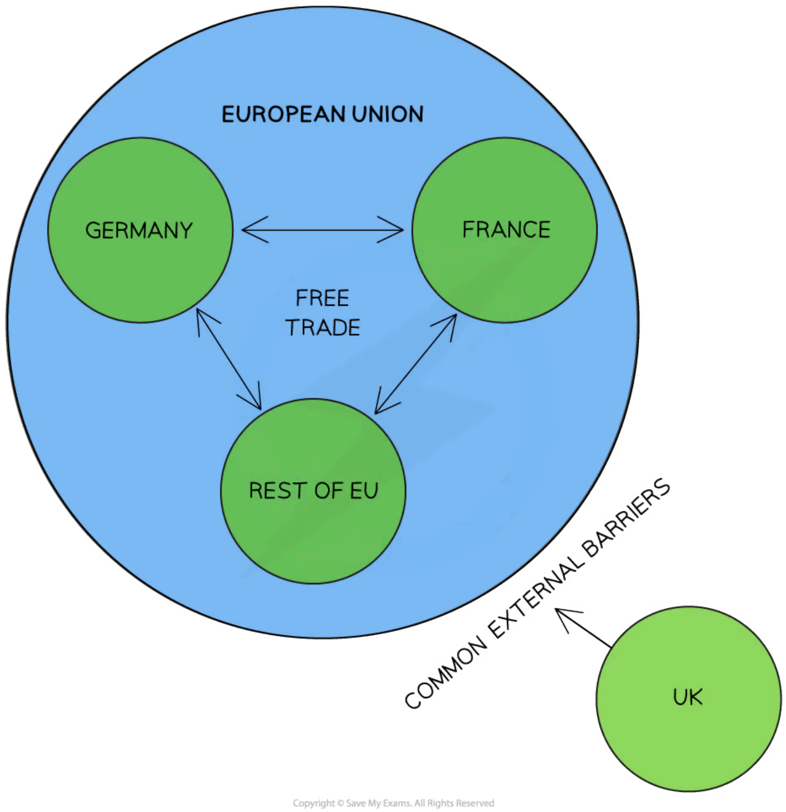
Your notes

Types of Economic Integration

- **Economic integration** occurs as countries **reduce trading barriers** between themselves and become more **interdependent**
- A **trading bloc** is a group of countries who come together and agree to reduce or eliminate any barriers to trade that exist between them
- Each subsequent type of **trading bloc** has increased levels of economic integration

Different Types of Trading Blocs

Trading Bloc	Explanation
Free Trade Area	▪ A **free trade area** is a bloc in which countries agree to abolish trade restrictions between themselves but maintain their own restrictions with other countries ▪ E.g. Canada-United States-Mexico Agreement (CUSMA)
Customs Union	▪ A **customs union** is an agreement between countries in which all goods/services produced by members are **traded tariff free** ▪ Additionally, countries agree on **common tariff rates on imports** from all external (third-party) countries **Diagram: A Customs Union**

	
	▪ In the diagram above, countries in the European Union have **eliminated all tariff barriers** between themselves but **impose common tariff barriers** on third party countries such as the UK or China
	▪ Countries inside the union also agree on common policies, such as:
	  ▪ Environmental policies
	  ▪ Safety standards
	  ▪ Competition laws

Common Market **E.g. Single European Market (SEM)**	▪ Similarly, to a **customs union**, goods/services are traded tariff-free in common markets ▪ Additionally, the four **factors of production** flow freely between member countries ▪ The goal is to improve the allocation of resources between the common market members and lower the costs of production

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	▪ Labour can move freely and people can live and work in any member country ▪ The **Single European Market (SEM) was** created in 1993 ▪ **27 Member states** have access to market size of over 500 million people ▪ The SEM is a customs union and a common market ▪ Members receive **capital Funding** throughout its years of membership which supports activities such as improvement in infrastructure; re-training grants
Monetary Union	▪ A **monetary union** takes integration a step further. Members enjoy all of the benefits of a customs union and common market, but then also establish a **common central bank** which issues a common currency and controls the monetary policy of member countries ▪ Prior to Brexit, the UK was a member of the European Customs Union and common market but never joined the Eurozone ▪ At the start of 2023, **20 of the 27 countries** in the EU are also **members of the Eurozone**

The Role of the World Trade Organisation (WTO)

- The **World Trade Organisation (WTO)** was established in 1995 to **promote free trade**
  - They believe free trade is the best way to raise living standards, create jobs and improve people's lives
- **Trade liberalisation** is the process of rolling back the barriers to free trade e.g. removing tariffs
- The WTO has two main roles in liberalising trade

1. It brings countries together at conferences and encourages them to re**duce or eliminate protectionist trade barriers** between themselves e.g. The Doha Round conferences
2. It acts as an **adjudicating body in trade disputes.** Member countries can file a complaint if they believe a trading partner has violated a trade agreement. The WTO will then run a hearing and make a judgement

The Objectives and Functions of the WTO

Objectives of the WTO	Functions of the WTO
▪ Improving people's lives	▪ Trade negotiations

▪ Promotion of fair competition ▪ Protecting the environment	▪ Implementation and monitoring of trade agreements ▪ Dispute settlement ▪ Building trade capacity between nations ▪ Outreach to governments and influential organisations on behalf of member countries

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Factors affecting the influence of the WTO

- In March 2022 there were **320 regional trade agreements** globally
- While these are **beneficial to the members** in the agreement (as they strengthen ties and create more trade between them), they also create conflicts with the stated aim of the WTO - to liberalise trade
  - Regional agreements often **shift trade** from a non-member who is more efficient in producing certain goods/services, to a member country who is less efficient
  - Regional trade members then often institute common **trade barriers** on non-members which is the opposite of trade liberalisation (protectionism)

The Balance of Payments

Your notes

The Balance of Payments (BoP)

- 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 and services, along with payments related to the transfer of income
  - The **financial and capital account**: all transactions related to savings, investment and currency stabilisation
- Money flowing into an account is recorded in the relevant account as a credit (+) and money flowing out as a debit (-)
  - If more money flows into an account than out of it, there is a **surplus** in the account
  - If more money flows out of an account than into it, there is a **deficit** in the account

The Current Account

- The **Current account** comprises trade in goods, trade in services, primary income and secondary income
- The Current Account is often considered to be the most important account in the BoP
- This account records the **net income** that an economy gains from **international transactions**

An Example of the UK Current Account Balance for 2017

Component	2017
Balance of trade in goods (exports - imports)	£-32.9bn
Balance of trade in services (exports - imports)	£27.9bn
Sub-total trade in goods/services	£-5bn
Net income (interest, profits and dividends)	£-2.1bn

Current transfers	£-3.6bn
Total Current Account Balance	£-10.7bn
Current Account as a % of GDP	3.7%

Your notes

- 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 and send remittances home
  - **Debits** are sent by foreigners working in the UK back to their countries
- **Current transfers** are typically payments at government level between countries, e.g. contributions to the World Bank

The Capital Account

- The Capital Account records small capital flows between countries and is relatively inconsequential
- The capital account is made up of two sections:

1. Capital transfers

- Smaller flows of money between countries
- E.g**. Debt forgiveness** payments by the government toward developing countries
- E.g**. Capital transfers** by migrants as they emigrate and immigrate

2. Transactions in non-produced, non-financial assets

- Small payments are usually associated with **royalties or copyright, e**.g. royalty payments by record labels to foreign artists

The Financial Account

- The Financial Account records the flow of all transactions associated with changes of ownership of the country's foreign financial assets and liabilities
- It includes the following subsections:

1. Foreign Direct Investment (FDI)

- Flows of money to purchase a controlling interest (10% or more) in a foreign firm. Money flowing in is recorded as a credit (+) and money flowing out is a debit (-)

2. Portfolio Investment

- Flows of money to purchase **foreign company shares** and **debt securities** (government and corporate bonds). Money flowing in is recorded as a credit (+) and money flowing out is a debit (-)

3. Official Borrowing

- Government borrowing from other countries or institutions outside of their own economy e.g. **loans** from the International Monetary Fund (IMF) or foreign banks
- When the money is received, it is recorded as a credit (+) and when the money (or interest payments) are repaid, it is recorded as a debit (-)

4. Reserve Assets

- These are assets controlled by the Central Bank and available for use in achieving the goals of monetary policy
- They include **gold, foreign currency** positions at the International Monetary Fund (IMF) and **foreign exchange** held by the Central Bank (USD, Euros etc.)

Deficit & Surplus on the Current account

- It is called the BoP as the current account should **balance** with the capital and financial account and be **equal to zero**
  - If the current account balance is **positive,** then the capital/financial account balance is **negative** (and vice versa)
  - In reality, it never balances perfectly and the difference is called **'net error and omissions'**
- If there is a **current account deficit,** there must be a **surplus** in the **capital and financial account**
  - The excess spending on imports **(current account deficit**) has to be financed from money flowing into the country from the sale of assets (**financial account surplus**)
- If there is a **current account surplus,** there must be a deficit in the capital and financial account
  - The excess income from exports (**current account surplus**) is financing the purchase of assets (**financial account deficit**) in other countries

The Factors that Influence a Country's Current Account

Your notes

- **Productivity**, **inflation** and **exchange rates** can influence a country's current account:

Productivity

- **Supply-side policies**, such as tax incentives or education can improve **labour productivity**
  - There is an increase in **output per worker** as a result of **price and quality competitiveness**
  - Which may result in an **increase in export volumes** in international markets

Inflation

- **High rates of inflation** relative to trading partners, can make exports more expensive for foreign markets and imports cheaper for domestic consumers
  - This can result in a worsening of current account or a trade deficit
- Low **inflation** or deflation relative to trading partners, can make exports cheaper in foreign markets and imports more expensive for domestic consumers
  - This can result in an improvement in the current account balance (or a **trade surplus**)

Exchange rates

- A **stronger exchange rate** makes **imports cheaper** and **exports more expensive**
  - When a country's currency **appreciates,** its exports become relatively more expensive for foreign buyers, potentially leading to a decrease in export volumes
  - Imports become relatively cheaper for domestic consumers, which may lead to an **increase** in **import volumes**
- A **weaker exchange rate** makes **imports more expensive** and **exports cheaper**
  - When a country's currency **depreciates,** its exports become relatively cheaper for foreign buyers, potentially leading to an increase in export volumes.
  - At the same time, imports become relatively more expensive for domestic consumers, which may result in a **decrease in import volumes**

The Consequences of Investment Flows Between Countries

- The **financial account** measures the inflows and outflows of financial assets, including **foreign direct investment and portfolio investment**
- Changes in the financial account can impact the **exchange rate**

Your notes

Your notes

  - When there is an **inflow** of foreign investment into a country, it **increases the demand** for the country's **currency,** potentially leading to an **appreciation** of the exchange rate
  - When there is an **outflow** of domestic investment to other countries, it **increases the supply** of the country's **currency i**n the foreign exchange market, potentially leading to a **depreciation** of the exchange rate
- The exchange rate influences the attractiveness of a country for **foreign investment**
  - A **stronger exchange rate** makes foreign investments more expensive in terms of the investor's home currency, potentially **reducing the appeal** of investing in that country.
  - A **weaker exchange rate** can make a country's assets more affordable for foreign investors, potentially **increasing the attractiveness** of investing in that country

Correcting Balance of Payment Deficits & Surpluses

Your notes

Significance of Persistent Current Account Deficits

- A **persistent current account deficit** refers to a situation where a country consistently spends more on imports than it earns from exports

The Impact of a Persistent Current Account Deficits on the Economy

Impact	Explanation
Depreciating exchange rate	▪ A persistent current account deficit can put **downward pressure (depreciate)** on a country's currency as the economy is constantly supplying its currency onto world markets
Interest rates	▪ With falling demand for a country's currency, the Central Bank may **raise interest rates** in order to attract foreign investment ▪ The raised rates will encourage demand for the currency which will help it to stop [popover id="R_K9APg0X~Rh783K" label="depreciating"]
Domestic assets	▪ A persistent current account deficit may result in **increased foreign ownership of domestic assets** ▪ It can be driven by the need to finance the deficit through foreign **capital inflows,** leading to a larger share of ownership from abroad
National debt	▪ Government needs to **borrow** to finance a current account deficit, which can create a large national debt, especially if deficit is persistent

Your notes

Credit ratings	▪ If the deficit is persistent, international credit rating agencies may downgrade the country's creditworthiness, potentially raising borrowing costs ▪ Investors can **lose confidence** in a country's ability to repay any future borrowing
Conflict with macroeconomic objectives	▪ The government may have to **trade off** with other macroeconomic policies objectives ▪ They may have to use monetary or fiscal policy to stimulate **domestic consumption** or stimulate exports to reduce the deficit and rebalance the economy
Economic growth	▪ A large current account deficit can have implications for economic growth ▪ It may signal an imbalance in the economy, relying on **external financing** rather than domestic productivity and competitiveness

Significance of a Persistent Current Account Surplus

- A persistent current account surplus occurs when a country consistently **exports more goods and services than it imports**
- The implications of this occurring can be summed up as follows:

1. Rising consumption and investment

- **Investment increases** as exporting firms are making excellent profits
- With a higher level of profits in the economy, domestic income rises leading to **an increase in consumption**

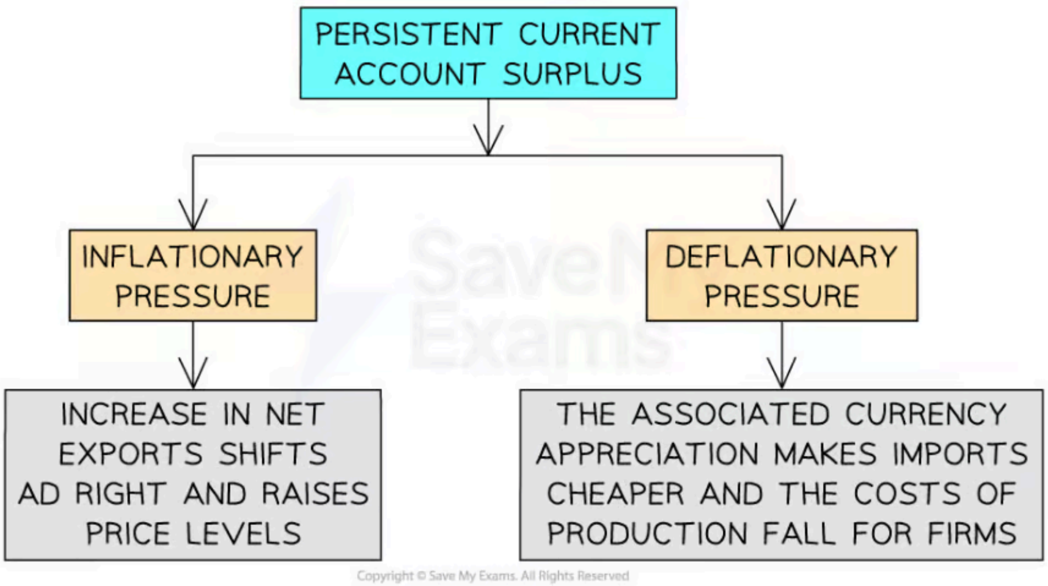
2. Appreciating exchange rates

- With higher exports, foreigners demand more of the local currency to pay for their goods/services **leading to currency appreciation**

- Appreciating exchange rates make the economy less desirable as a destination for **foreign direct investment**

3. Both an inflationary and deflationary effect on price levels

Diagram: Persistent Current Account Surplus



A surplus may cause price levels to rise or fall in an economy

- The **net effect on inflation** will depend on the extent to which domestic firms rely on imported raw materials used in their production process

4. Employment

- With rising demand for exports, unemployment usually falls as **exporting industries require more workers**
- Rising profits usually result in **increased investment** which may mean that even more workers are required
- Decreasing unemployment creates a **higher average domestic income** and much of this income is spent domestically
  - Non exporting domestic industries **may also require more workers** to help meet the rising domestic demand

5. Export competitiveness

Your notes

- Appreciating exchange rates associated with a persistent surplus, will gradually erode the nation's export competitiveness over time
- The **extent to which this is eroded** will depend on the price elasticity of demand for the country's exports
    - if PED for their exports in [popover id="Bv1knULMbp3AEkrb" label="**inelastic**"], then currency appreciation will not impact the competitiveness as much as it does when the PED for exports is [popover id=Uz-HDkXw9P75ze9K" label="**elastic**"]

Policies to Correct Deficits & Surpluses

- The Government has several options available to them in order to tackle persistent current account imbalances
    - They could do nothing, leaving it to market forces in the foreign exchange market to self-correct the deficit
    - They could use **expenditure-switching policies**
        - These aim to switch consumption from foreign goods to domestic goods and involve the use of protectionism (tariffs, quotas), or a devaluation of the currency under a fixed exchange rate mechanism
    - They could use **expenditure-reducing policies**
        - These aim to reduce aggregate demand in an economy and include policies such as contractionary fiscal or monetary policy
    - They could use **supply-side policies**
- The choice of any policy, or any combination of policies, generates both costs and benefits

Costs & Benefits of Policies used to Tackle Current Account Deficits or Surpluses

Policy Option	Benefits	Costs
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) and exports to increase (they are now cheaper)	▪ There may be other **external factors** that prevent the currency from depreciating ▪ It may take **a long time** for self-correction to happen and many domestic industries may go out of business in the interim

Your notes

	▪ This improves the deficit	▪ 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 ▪ The retaliation 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	▪ Deflationary fiscal policy invariably reduces **discretionary income,** which leads to a **fall in demand for imported goods** and improves a deficit	▪ **Deflationary fiscal** policy also dampens domestic demand, which can cause output to fall. When output falls, GDP growth slows and unemployment may increase
Supply-side policies	▪ Improves the quality of products and 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, so the benefits may not be seen for some time ▪ They usually involve government spending in the form of subsidies and this always carries an **opportunity cost**

The Implications for the Global Economy of Correcting Imbalances

- If a **small economy** experiences a deficit or surplus on the current account, it is unlikely to have a major impact on another economy. However, if the **economy is large**, it will likely to have a large effect on other economies
  - E.g. **USA** runs a large current account **deficit**, while **China** runs a a large current account **surplus**
- Correcting these **persistent deficits** can be problematic as it means that **finance from abroad** (in the form of **loans or foreign direct investment**) is required in order to fund continued imports
  - This may mean that a country is gradually **selling its assets**

- Owing money to a foreign entity creates **vulnerabilities**
  - The **2008 Global Financial Crisis** demonstrated the impact of fast changing conditions in which creditors were insisting on being repaid quickly e.g. Greece owed creditors (including Germany) significant sums & was required to pay these back creating numerous problems in their economy

Your notes

Your notes

Floating Exchange Rate Systems

Foreign Exchange Rates

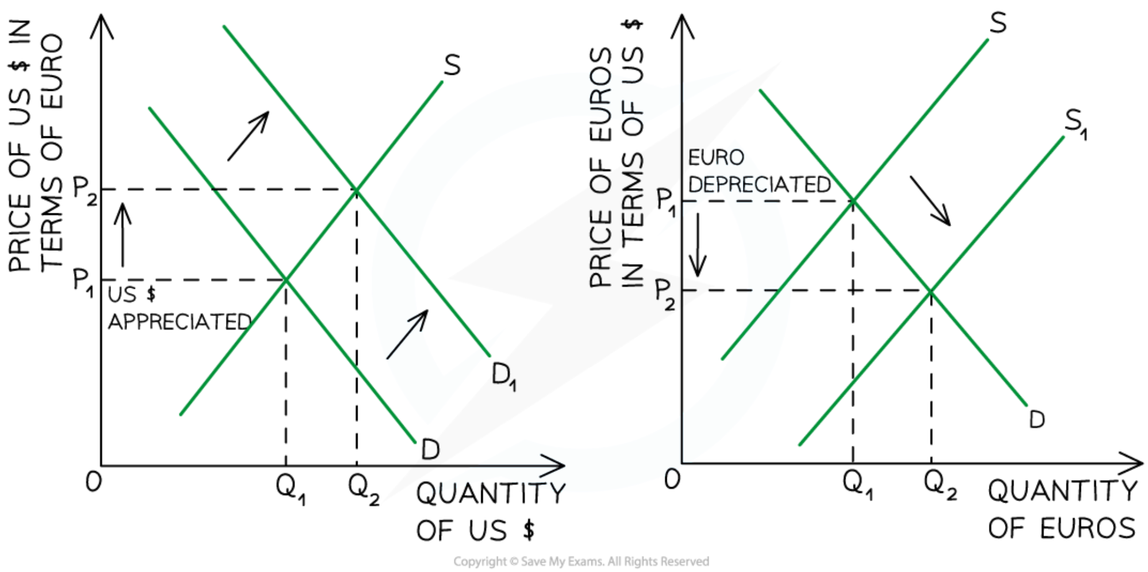
- An **exchange rate** is the price of one currency in terms of another e.g. £1 = €1.18
  - International currencies are essentially **products** that can be bought & sold on the **foreign exchange market** (forex)
- The Central Bank of a country controls the **exchange rate system** that is used in determining the value of a nation's currency
- Two of the main **exchange rate systems** used are:
  - A **floating exchange rate**
  - A **fixed exchange rate**

1. A Floating Exchange Rate System

- The forces of **demand and supply** determine the rate at which one currency exchanges for another and there is no government intervention in the currency market
- Different currencies can be bought and sold, just like any other product
- 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**)

Diagram: Floating Exchange Rates

Your notes



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

Diagram analysis

- The Euro/US$ market is shown by **two market diagrams** - one for the USD market on the left and 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$ and 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 and 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 $P_1 \rightarrow P_2$ and a new market equilibrium forms at P_2Q_2

Floating exchange rate calculations

- As the value of a currency appreciates or depreciates, the value of any international transaction changes
- These changes can be significant for firms during times of exchange rate volatility

Your notes

Worked Example

Marsha is a currency trader who buys and sells currency in order to make a profit. Currently, she is holding €200,000 and expects that the Pound will appreciate against the € in the next few months.

At present £1 = €1.10

1. Marsha exchanges her Euros for Pounds. Calculate the quantity of Pounds she will receive for €200,000 [1]
2. The Pound depreciates against the Euro by 10%. Fearing further depreciation, Marsha changes her Pounds back to Euros. Calculate the loss she has made.

Step 1: Calculate the quantity of Pounds received for €200,000

$$\frac{200,000}{1.1} = £\,181,818.18$$

Step 2: Calculate the new exchange rate

£1= (€1.10 x 0.9) = €0.99

Step 3: Use the above value to calculate the new amount of Euros

£181,818.18 x 0.99 = £179,999,9982

Step 4: Round to two decimal places

£180,000

Step 5: Calculate the loss

£200,000 - £180,000 = £20,000 loss

Evaluating Exchange Rate Systems

- Each exchange rate system has advantages and disadvantages attached

An Evaluation of A Floating Exchange Rate Mechanism

Advantages	Disadvantages

▪ **Natural fluctuations** in the exchange rate based on demand and supply help to **maintain stable current account balances** ▪ If a currency appreciates, the country's exports fall and imports rise ▪ If a currency depreciates, the country's exports rise and 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 r**educe/slow down economic growth** as export sales decrease
▪ Government does not need to **monitor and maintain** a fixed exchange rate	

Your notes

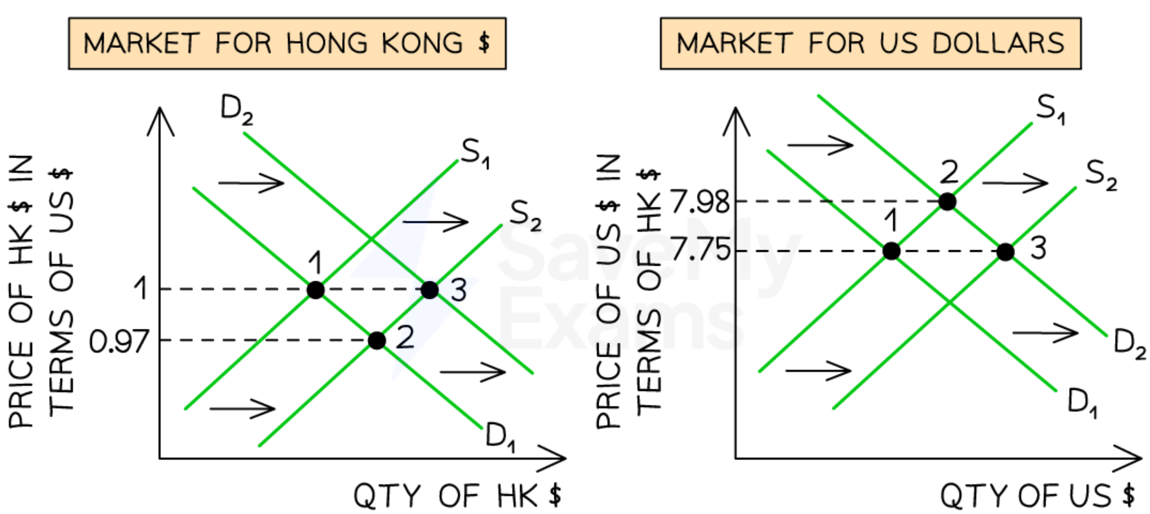
Your notes

Fixed Exchange Rate Systems

Introduction to Fixed Exchange Rates

- 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 and increase the strength of its currency
- A **devaluation** occurs if the Central Bank decides to change the peg and decrease the strength of its currency

Diagram: Market for Hong Kong Dollar and Market for US Dollar



The Hong Kong Monetary Authority intervenes to maintain the exchange rate of HK$ 7.75 = US$ 1

Your notes

Diagram analysis

- The HK$/US$ market is shown by **two market diagrams:** one for the HK$ market on the left and one for the US$ market on the right
- The **initial exchange rate equilibrium** is found at ***HK$ 7.75 = US$ 1,*** *represented by point 1*
- When Hong Kong firms import goods from the USA, they demand US$ to pay for them and supply HK$
- This impacts the market for each currency: the US$ appreciates and the HK$ depreciates
- To maintain the fixed exchange rate at ***HK$ 7.75 = US$ 1,*** the Hong Kong Monetary Authority intervenes in the forex market **by using US$ from its foreign reserves to buy HK$**

Left diagram – HK$

- The **increased supply of the HK$** shifts the supply curve to the right, which results in the value of the HK$ depreciating from (HK$7.75 = $1) → (HK$7.75 = $0.97) and a new market equilibrium forms at point 2
- The Monetary Authority intervenes by buying HK$, which shifts the demand curve right from $D_1 \rightarrow D_2$
- The HK$ has now been moved **back to its target value** of K$ 7.75 = US$ 1 - point 3

Right diagram – US$

- The **increased demand for the US$** shifts the demand curve to the right, which results in the value of the US$ **appreciating** from ($1 = HK$7.75) → ($1 = HK$7.98) and a **new market equilibrium** forms at point 2
- The Monetary Authority intervenes by buying HK$ using UD$, which increases their supply shifting the supply curve right from $S_1 \rightarrow S_2$
- The HK$ has now been **moved back to its target value** of K$ 7.75 = US$ 1 - point

Evaluating Fixed Exchange Rate Systems

- A fixed exchange rate system offers **stability,** reduces **speculative activities,** but **limits monetary policy** autonomy

The Advantages & Disadvantages of a Fixed Exchange Rate System

Advantages	Disadvantages

▪ Provides **stability and predictability** for international trade and investment ▪ Businesses can plan for **future costs**	▪ The central bank actively intervenes to maintain the fixed rate ▪ This limits a country's ability to independently conduct **monetary policy** as the focus is on exchange rate and not the interest rate
▪ In theory, a fixed exchange rate should **lower speculative trading** and **currency volatility**	▪ A country needs to hold a large amount of **foreign reserves** in order to be able to buy and sell currencies
▪ If exchange rates are fixed, firms may be forced to be **more competitive** to keep inflation as low as possible ▪ They need to keep costs **costs down** and **increase productivity** to remain competitive	▪ Fixed exchange rates are **difficult to maintain** ▪ It is a complex process that needs to take into account **many variables**

Your notes

Currency Unions

Your notes

The Implications of Joining a Currency Union

- A **currency union,** also known as a **monetary union,** is established when the members of a **customs union** and common market establish a common **central bank** which issues a **common currency** and controls the **monetary policy of member countries**
  - Prior to Brexit, the UK was a member of the European Customs Union and common market but never joined the Eurozone
  - At the start of 2023, 20 of the 27 countries in the EU were members of the **Eurozone**

Evaluating Currency Unions

Advantages	Disadvantages
▪ **Price stability** ▪ The common currency eliminates exchange rate fluctuations, reducing transaction costs and increasing price stability within the union	▪ **Limited monetary policy flexibility** ▪ Member countries relinquish control over their monetary policy decisions to a regional authority, such as the European Central Bank in the case of the Eurozone ▪ This **restricts a country's ability** to independently adjust interest rates or implement policies tailored to its specific economic conditions, potentially hindering its ability to address domestic economic challenges
▪ **Increased trade and market access** ▪ A single currency makes it easier for businesses to engage in cross-border trade within the union, leading to increased trade and economic growth	▪ **Loss of exchange rate control** ▪ Countries in a monetary union lose the ability to adjust their exchange rates to maintain competitiveness ▪ They cannot rely on currency devaluation or revaluation to restore competitiveness or rebalance their economies
▪ **Enhanced monetary policy credibility**	

▪ Having a credible and independent central bank that follows a transparent monetary policy promotes investor confidence in all countries within the union (even weaker ones)	▪ **Fiscal constraints and policy coordination** ▪ Countries must adhere to strict budgetary rules, deficit and debt limits, and **coordinated fiscal policies** ▪ This constraint limits a country's fiscal policy autonomy and can create challenges during economic downturns (recession)

Your notes

Your notes

The Difference Between Growth and Development

- **Economic development** is the sustainable increase in **living standards** for a country, typically characterised by increases in life span, education levels, and income
- **Economic growth** is defined as an increase in output and does not involve a change in structure in society. Measured using GDP, GNP, etc

The Main Characteristics of Less-developed Economies

- Less developed economies have many similar characteristics which slow down the rate of economic development

Characteristics of Less-developed Economies

Characteristic	Explanation
High rate of population growth	▪ High rates of **population growth** as a result of high birth rates ▪ There is also a very low life expectancy
High foreign debts	▪ High levels of debt uses government revenue ▪ The repayments have **opportunity cost** of spending ▪ That could have been used for investment into public services
Uneven distribution of wealth	▪ There is a low income per capita ▪ A minority of the population may control a large part of the country's wealth resulting in **widespread poverty**

Over-dependence on one product	▪ May be over-dependent on **one crop** ▪ The country may be subject to crop failure and/or a wide variation in export prices
Large primary sector	▪ High percentage of the population engaged in **extractive/primary industries** ▪ This results in not enough workers in secondary & tertiary sectors, resulting in l**ow standards of living.**
Poor levels of education	▪ **Low** levels of **education and literacy** ▪ This limits economic development, resulting in high unemployment
Poor living conditions	▪ A large percentage of the population live in **poor living conditions** with no water and poor sanitation

The Human Development Index (HDI)

- There are many measures of **economic development**
  - **Single indicators** e.g. number of doctors/1000 people; infant mortality rate; % of the population with access to clean drinking water
  - **Composite indicators** include indicators such as the Human Development Index (HDI), the Gender Inequality Index (GII), Inequality Adjusted Human Development Index (IHDI), and the Happy Planet index (HPI)

The Human Development Index (HDI)

- Developed by the United Nations, it is a combination of 3 indicators

Diagram: The Human Development Index

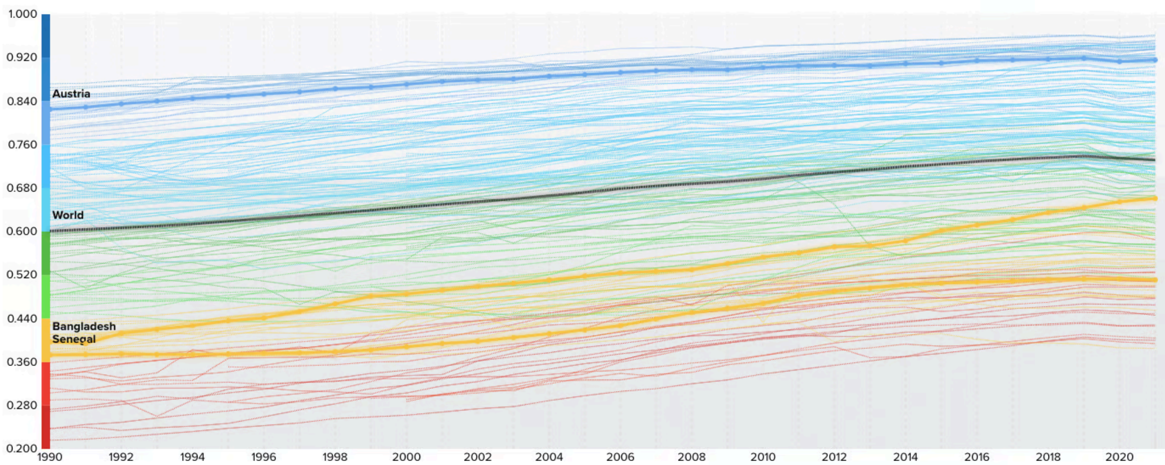
The components of the Human Development Index

1. **Health**, as measured by the life expectancy at birth e.g. in 2019 it was 81.2 years in the UK

Your notes

2. **Education**, as measured by a combination of the **mean** years of schooling that 25 year old's have received, together with the **expected years** of schooling for a pre-school child
3. **Income**, as measured by the real **gross national income** per capita at **purchasing power parity (PPP)**

- Each indicator is given **equal weighting** in the index
- The index ranks countries on a score between 0 & 1
  - The closer to 1, the **higher the level of economic development** and the better the **standard of living**



The Human Development Index scores from 1990 to 2021 (Source: UNDP Data Centre)

- A value of < 0.550 is considered **low development,** e.g. Senegal was at 0.514 in 2021
- A value of 0.550–0.699 is considered **medium development,** e.g.Bangladesh was at 0.667 in 2021
- A value of 0.700–0.799 is considered **high development;** e.g Thailand was at 0.777 in 2021
- A value ≥ 0.800 is considered **very high development,** e.g. Austria was at 0.918 in 2021

Evaluating the Different Approaches used to Measure Development

- All **development indicators** have limitations
- Due to the **multi-dimensional nature** of economic development, it is necessary to use a **range of indicators** in order to gain insights into the many dimensions of quality of life, well-being, human development and happiness

Your notes

- **Composite indicators** provide better insight than single indicators
- Single indicators can be useful in targeting just one aspect - or in **prioritising different aspects** of development
- **Qualitative data** is used to measure many aspects of economic development and this can be subject to bias and errors in data interpretation
- It requires **time** to gather qualitative data and this means that the data often lags reality by several years
- **Data collection and statistical reporting** is subject to political agendas and often the data presented has to be questioned in light of these e.g. many Middle East countries moved from the bottom third to the top third in the Gender Inequality index (GII) in 2017, a very unlikely transition in such a short time period

The Advantages and Disadvantages of Using the HDI

Advantages	Disadvantages
▪ It is a composite indicator which provides a **more useful** comparison metric than single indicators do ▪ It incorporates three of the **most important metrics** for households i.e. health, education and income ▪ It is widely used all over the world which provides an opportunity for **meaningful comparisons** ▪ It provides a goal for governments to use when developing their policies e.g. it may help identify that the education levels are holding back improvements to the HDI and **government policy** can target that ▪ It provides citizens with an understanding of how their **quality of life** compares to other countries	▪ It does not measure the **inequality** that exists as it uses the mean GNI/capita ▪ It does not measure or compare the levels of absolute and relative poverty that exist ▪ For many countries it does not provide useful **short-term information** as gathering the data required for the calculation is difficult. This means the **data often lags reality** by several years

Factors that Affect Growth & Development

Your notes

Factors that Improve Growth & Development

- Data shows that **economic growth** has a very positive impact on **economic development**
- In most cases **growth precedes development**, but this is not always true, e.g. Bangladesh used a range of strategies (including micro-finance) to transform the quality of life for many households
- In some cases (usually in developing countries), economic growth is tied to **one industry** and generates so many **negative externalities of production** that the standard of living **decreases** for many **even as growth increases**

Economic Factors that Affect Growth & Development

Factor	Explanation

Investment	▪ Higher savings result in **higher investment & economic growth**. It is believed that as economies develop, savings increase
	  ▪ Increased savings → increased investment → higher capital stock → higher economic growth → increased savings
	  ▪ If the **dependency ratio** is high, it means there is less money available for savings & investment

Education and training	▪ High levels of education and training increases **productivity** ▪ Investing in **supply-side policy** to improve health and education increases the potential output of the country (shifts the **production possibility frontier outwards**)
Healthcare	▪ The level of health directly impacts **productivity of labour** ▪ Productivity influences output & income ▪ **Developed economies** tend to have healthy workforces ▪ The less developed the economy, the **more sickness & disease** there is

Barriers to Economic Growth & Development

- There are numerous factors that act as a barrier economic growth and economic development

Your notes

Barriers to Economic Growth & Development

Barrier	**Explanation**
Corruption	▪ Aid or revenue intended for investment can be used by **corrupt politicians,** resulting in a **lower level of investment** ▪ Corruption diverts funds to certain groups that have bribed or lobbied officials (e.g. multinational firms) resulting in projects that deliver a low level of growth and development

Institutional factors	▪ If government institutions are not functioning, it can be a barrier to growth and development. This includes:
	  ▪ The certainty of a strong **legal system** attracts investment and builds confidence in an economy
	  ▪ A lack of **property rights** prevent household assets being used to secure loans or generate income in developing countries
	  ▪ A **progressive tax** system redistributes from those with higher income to those with lower income and reduces income inequality
	  ▪ Sometimes the benefits of a good progressive tax system are eradicated by weak tax collection and tax enforcement

Lack of infrastructure	▪ Good **infrastructure** reduces business costs and attracts **foreign direct investment**
	  ▪ This is one reason why China has invested so heavily in infrastructure projects in Asia and Africa as it unlocks economic potential
	  ▪ Some developing countries have such poor infrastructure which makes it difficult to generate economic activity

Human capital	▪ Low levels of education and healthcare reduce [popover id="DTxVl4QEb1cQKxdb" label="productivity"] ▪ Investing in **supply-side policy** to improve health and education increases the potential output of the country (shifts the **production possibility frontier outwards**)
Governance	▪ Poor governance leads to **inefficient use of resources** and poor decision-making

Your notes

	▪ Eg. In **Venezuela,** the economic crisis, combined with poor governance and corruption caused skilled labour to migrate abroad ▪ If governments keep changing, it results in constantly changing policies & priorities ▪ E.g **political instability** and conflict in **Afghanistan** has reduced confidence in the economy & international investors are slower to invest as they are fearful of losing their investment
Geography	▪ It is harder for landlocked countries to generate economic growth ▪ Often **transportation and administration** costs are higher than those with access to ports, which increases the costs of production & decreases international competitiveness ▪ Natural terrain can also be a limiting factor e.g the arid, **mountainous terrain of Pakistan**
Primary commodities	▪ A barrier to growth occurs if country is too dependent on a narrow range of primary commodities ▪ In 2020, 25% of Bolivia's GDP was generated by exports. Commodities accounted for 60% of its exports ▪ When commodity prices rise, **GDP rises** - and vice versa ▪ A more **diversified** range of exports prevents this

Policies to Promote Growth & Development

Your notes

Market-Based Policies

- **Market-based strategies** create the conditions for private individuals and firms to pursue an economic activity with the aim of **maximising output and profit**
- These strategies are able to generate a better standard of living, leading to an improvement in economic development

Market-based Strategies to Generate Economic Growth & Development

Strategy	Explanation	Advantages	Disadvantages
Trade liberalisation	▪ Removing the barriers to international trade such as tariffs, quotas etc.	▪ More trade increases output, employment & incomes ▪ Lowers **costs of production** for firms ▪ May result in lower prices for consumers ▪ More efficient global allocation of resources	▪ Global competition intensifies and some firms may fail ▪ There may be an element of **structural unemployment** as inefficient industries die out
Privatisation	▪ Government firms are usually so big that private enterprise refrain from trying to compete with them ▪ **Privatisation** encourages new firms to enter the market and compete, thus increasing the **total supply** in the economy	▪ May increase **competition** leading to an increase in output, employment and incomes ▪ Private firms may be **more efficient** than government firms ▪ Competition may result in **cheaper prices** for consumers	▪ Government assets are often sold off cheaply at prices below **fair market value** ▪ The quality of services may deteriorate as private firms focus on profit maximisation ▪ **Unemployment** may increase as private firms seek to cut their wages

Your notes

		▪ The money from the sale of assets can be used to provide more **merit** and **public goods**	in order to maximise profits ▪ Prices may actually **rise** as firms provide a **monopoly service** e.g. rail travel
Deregulation	▪ This is the process of removing **government controls/laws** from markets in order to increase competition	▪ Any regulation increases costs of production for firms and **deregulation decreases costs** which may result in greater supply ▪ Less regulation may result in **innovation and more enterprise** in an economy	▪ Deregulation may create an environment of **corruption** leading to inefficiency ▪ Deregulation may increase the quantity of **negative externalities** ▪ Deregulation may allow foreign firms to monopolise industry within the nation, leading to **higher prices and less output**

Interventionist Policies

- **Interventionist strategies** are put in place by governments to correct the **failings** of the free market and promote the **welfare/development** of its citizens
- Interventionist strategies aim to increase human capital, productivity and output
- These can lead to an improvement in the standard of living

Interventionist Strategies to Generate Economic Growth & Development

Strategy	Explanation	Advantages	Disadvantages
Tax policies	▪ A **progressive tax system** redistributes from those with higher income to those with lower income & reduces **income inequality**	▪ Redistribution often starts with the provision of **free education & healthcare** paid for from tax revenue	▪ Sometimes, the benefits of a good progressive tax system are eradicated by the penalties imposed through multiple **regressive** (indirect) taxes

Your notes

		▪ Tax revenue provides the means of supporting **poorer households** and the unemployed	▪ If the tax burden is too high it may become a **disincentive** to work
Transfer payments	▪ **Transfer payments** are usually given to the **poorest & most vulnerable** people in society and include **unemployment & disability payments**, pension payments, heating discounts, public transport subsidies etc.	▪ The poorest households are supported ▪ Money received from transfer payments generates **consumption** in the economy and increases aggregate demand	▪ Poorer countries have less money available to support the poor ▪ There is an **opportunity cost** for the government associated with each transfer payment ▪ Supporting the poor makes **good economic sense** but is sometimes politically unpopular
Minimum wages	▪ **Minimum wages** are set above the free market rate and firms are not allowed to pay anyone less than the **legal rate**	▪ Workers receive higher wages and have more **disposable income** ▪ Consumption increases leading to increased aggregate demand ▪ **Standard of living** increases with higher income	▪ **Costs of production** for firms increase, possibly leading to less international competitiveness ▪ With higher costs of production, output may fall leading to **increased unemployment**

The Role of Aid & Trade in Promoting Growth & Development

- It can be argued that **liberalisng trade** by removing **protectionist barriers** is a more effective method of promoting growth and development, than aid

Your notes

- **Aid** is often offered to developing nations in several different forms to promote growth and development:
  - **Humanitarian/development aid**
  - **Debt relief**
  - **Official Development Assistance (ODA)**

1. Humanitarian/development aid

- Two of the most common forms are **grants** & **soft loans**
- Critics argue that aid **breeds dependency**, corruption & disincentivises individual responsibility
  - E.g. The Central African Republic receives **ongoing food aid**

2. Debt relief

- Many developing nations have borrowed significant sums of money in the past which have to be **repaid (with interest)** over a long period of time
- The **opportunity cost** of these repayments is significant & often includes
  - Loss of infrastructure development
  - Inability to create a welfare system
  - Investment in human capital/education
- Countries began to default on their loans in 1982 (Mexico was the first) & this has led to the **restructuring** of these loans to make it more affordable
- More recently there has been significant progress in **writing off** the entire debt of the most **heavily indebted poor countries (HIPC)** so that they can focus on building their economies
- The country may have a lot more funds available than ever before and this can breed corruption as individuals in government seek to get their hands on it
- Once the debt is forgiven, many **developing nations** borrow more money and the cycle starts again

3. Official development assistance (ODA)

- **ODA** can be **bilateral** (from donor government to recipient government) or provided through a **multilateral**
  development agency, such as the United Nations
- Two of the most common forms of ODA are **grants** & **soft loans**

- Bilateral ODA can help to develop the relationship between the two countries, possibly **facilitating the exchange** of resources, ideas and technology
- **Corruption** may mean funds are diverted from their true purpose
- ODA in the form of loans has to be repaid and these repayments carry an opportunity cost