

6. International Economic Issues

6.1 The Reasons for International Trade

Syllabus 6.1 ▾

- Distinction between absolute and comparative advantage
- Benefits of specialization and free trade (trade liberalization), including the trading possibility curve
- Export, imports and terms of trade: measurement, causes, and impact
- Limitations of the theories of absolute and comparative advantage

Absolute and Comparative Advantage

- Different countries have different **factor endowments**, so they have different quantities, qualities, and costs of production; it is usually easier to move goods and services between countries instead of factors, and therefore trade occurs
- **Absolute Advantage:** a country can produce a good more efficiently compared to another country
 - it can produce the same quantity with a lower cost and fewer inputs
- **Comparative Advantage:** a country can produce a good at a lower opportunity cost compared to another country
 - it sacrifices less of other goods to produce it

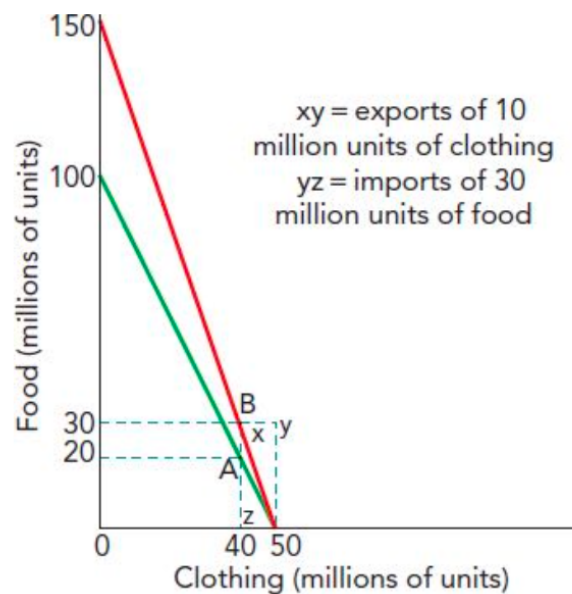
Benefits of Specialization and Free Trade

- **Specialization:** countries focus on producing a limited range of goods or services to gain greater degrees of productive efficiency
- **Free Trade:** the exchange of goods and services across national borders without any government restrictions

Benefits

- Comparative advantage, Factor endowment → Increased efficiency & productivity → Economic growth & Employment opportunities
- Encourages competition & Open access → Lower prices & More choices
- Buffer against potential domestic market shocks

Trading Possibility Curve (TPC)



- Let the green represents country M and the red represents country N. If country M initially produces at point A, it can produce 40 units of clothing and 20 units of food. However, if country M starts producing only 50 pieces of clothing due to comparative advantage and exports 10 pieces of clothing, it can earn 30 units of food by trade. Therefore, although the country cannot produce outside of its trade possibility curve, it can consume outside of its trade possibility curve

Exports, Imports and Prices

Terms Of Trade (TOT)

- Terms of Trade:** the measure of the ratio of export prices and import prices

$$\text{Terms of Trade} = \frac{\text{Index of Export Prices}}{\text{Index of Import Prices}} \times 100$$

- if TOT increases, it means that fewer exports have to be sold to buy any given quantity of imports, which is **favorable**
- if TOT decreases, it means that more exports have to be exchanged to gain the same quantity of imports, which is **unfavorable**
- Causes of movement**
 - the supply and demand of the good, the price level, and the exchange rate
- Impacts of movement**
 - whether the movement is positive depends on the cause of the movement

Limitations

- countries may want to avoid overspecialization
- countries may impose trade restrictions
- countries do not always adapt to changes in comparative advantage
- hard to determine the comparative advantage with many countries and a vast number of products
- high transport costs may offset the comparative advantage
- the exchange rate may not lie between the opportunity cost ratios
- the assumption that resources are mobile and there are constant returns
 - if production is switched suddenly, structural unemployment will increase

6.2 Protectionism

- Meaning of protectionism in the context of international trade
- Different tools of protection and their impact: tariffs, import quotas, export subsidies, embargoes, excessive administrative burdens ('red tape')
- Arguments for and against protectionism

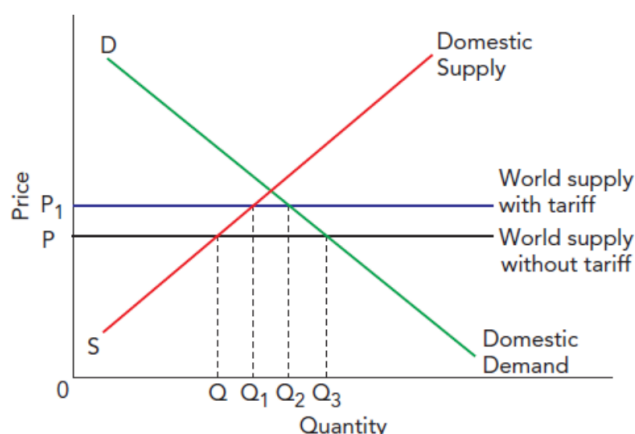
Protectionism

- When governments seek to protect domestic industries from foreign competition
 - involves the restriction of free trade & increasing the price/competitiveness of domestic industries

Tools of protection and their impact

Tariffs

- taxes on imports or exports
- can be *specific* (a fixed sum per unit) or *ad valorem* (a percentage of the price)
- **Import Tariffs:** discourage consumption & raise tax revenue
 - without tariffs, the local supply is at Q and demand is at Q_3 ; with tariffs, the local supply is at Q_1 and the demand is at Q_2
 - elastic demand → better trade protections; inelastic demand → more government revenue



- **Export Tariffs:** discourage exports & raise revenue
 - ensures an adequate supply of the product on the home market, reducing the risk of *absolute poverty*
 - if imposed on raw materials, it protects domestic industry by increasing its international competitiveness

Import Quotas

- **Quotas:** limits on imports
- disadvantage for consumers as they have fewer choices and higher prices
 - the government does not receive tax revenue

Export Subsidies

- can be given both to **exporters** and **domestic firms competing with imports**
 - reduce the costs for domestic firms, enabling them to capture more of the markets at home and abroad

- consumers might lose in the long run if the efficient foreign producers are driven out of the market

Embargoes

- a **complete** ban either on the imports of a particular product or on trade with a particular country
 - product: harmful ones like drugs or weapons
 - country: political disputes

Excessive Administrative Burdens ('Red Tape')

- requiring importers to **fill out lengthy forms that are time-consuming to complete**, which are called "red tape"
 - or setting **artificially high product standards** to restrict foreign competition

Arguments for Protectionism

- to protect **infant industries**
 - new industries don't have customer bases, economies of scale, or reputation
 - justified if the industry has the **potential to develop** into an efficient industry with a comparative advantage
 - however, it is **hard to identify** which industries will develop and gain a comparative advantage; also, **over-dependency** on protection might occur
- to protect **declining industries**
 - if declining industries have lost their comparative advantage and go out of business quickly, there may be a sudden and large **unemployment**
 - however, if an industry is given protection and the protection is gradually removed, unemployment might be avoided
 - however, other industries might assist as the tariffs increase their **cost of production**, e.g., when steel is a protected declining industry for car
- to protect **strategic industries**
 - industries such as weapons, fuel and food, as countries don't want to be **overdependent** on foreign supply of these products
 - they might protect even if the industries are not efficient
- to prevent **dumping**
 - **Dumping**: selling products at below their cost price to gain market share
 - foreign firms may use dumping to maliciously fire all domestic firms and control the market
- to improve the **terms of trade**
- to improve the **balance of payments**
- to provide **protection from cheap labor**

Arguments against Protectionism

- preventing countries from specializing in the products in which they have comparative advantage → **lowering global output and living standards**
- reducing **international competition**, so increasing prices, lowering quality and number of choices
- lowering the **size of the market**, and hence destroying **economies of scale**
- reducing firms' choice & price of raw materials → increasing **cost of production**
- resulting in **trade wars and retaliation**
- firms might be **overdependent** on protectionism, decreasing competitiveness

6.3 Current Account of the Balance of Payments

Definition

- Components of the current account of the balance of payments
 - current account: trade in goods, trade in services, primary income and secondary income
 - definition of balance and imbalances
- Calculation of balance of trade in goods, services, goods and services, and current account balance (CAB)
- Causes and components of imbalances

Current Account of BOP

- **Balance of payment:** a record of all the economic transactions between residents of that country and residents in other countries
 - the BOP account consists of the **capital account** and the **financial account**
- **Current Account Balance:** the overall balance of the trade in goods, trade in services, primary income, and secondary income
 - **inflow** of money: **credit** the account; **outflow** of money: **debit** the account
 - **Current Account Deficit:** debit > credit
 - the *value* of imports (price × quantity) is greater than the *value* of exports
 - **Current Account Surplus:** credit > debit
 - the *value* of exports (price × quantity) is greater than the *value* of imports
- **Imbalances:** the total value of current account deficits is matched by current account surpluses; the total credit items of the world's current account are always equal to the total debit items

Components

1. **Trade in Goods:** the exports and imports of goods, the "visible balance"
 - imports: **debit** (because money is lost and purchase is made), exports: **credit**
 - *trade in good balance:* the money revenue from net exports
2. **Trade in services:** the exports and imports of services, the "invisible balance"
3. **Primary Income:** earnings from foreign investments minus payments made to foreign investors
 - earnings include profits, interests, and dividends
4. **Secondary Income:** transfer payments, such as foreign aid and remittances
 - includes payments made and receipts received from which there is no corresponding exchange of an actual good or service

Causes of Imbalance

Causes of current account deficit

1. *A growing domestic economy:* firms increase output, so they may buy more raw materials from abroad; people also have more income to buy imports
 - it is **self-correcting**, as when firms buy more raw materials/capital goods for production, they are likely to sell more products abroad
2. *Declining economic activity in a country's trading partners:* less demand for exports by the trading partner
 - this is short-term and self-correcting as well
3. *Structural problems:* domestic firms are not internationally competitive, and the country may have to borrow to finance the surplus spending

- causes might include an overvalued exchange rate, high inflation rate, low productivity, or lack of resources
- these are always **long-run** (e.g., you need training & education to increase labor productivity)

Causes of current account surplus

1. *A declining domestic economy*: demand for exports decline
2. *Increasing economic activity in a country's trading partners*: more demand for exports by the trading partner
3. *Structural advantages*: good education and training, a high level of investment and innovation, etc, can make the country competitive for international trade

Consequences of Imbalance

- the significance of the consequences is determined by the value of the imbalance as a percentage of GDP

Current Account Surplus → basically having more reserves

- **Benefits**: increased foreign reserves, improved credit rating, more investment opportunities, more economic stability (less reliance on foreign debt)
 - increased foreign reserves: buffer against economic shocks like a sudden outflow of capital & supporting the national currency by manipulating the demand in the foreign exchange market
- **Drawbacks**: currency appreciation (less export competitiveness), economic dependence on exports, trade tensions, inflationary pressures

Current Account Deficit → basically spending more money

- **Benefits**: export competitiveness, access to foreign goods and services...
- **Drawbacks**: increased debt levels (not sustainable), dependence on foreign capital to finance its deficit (FDI is recorded in the financial account), great currency depreciation

6.4 Exchange Rates

Definition ▾

- Definition of exchange rate
- Determination of a floating exchange rate
- Depreciation and appreciation of a floating exchange rate
- Causes of floating exchange rate changes: demand and supply of currency
- AD/AS analysis of the impact of exchange rate changes

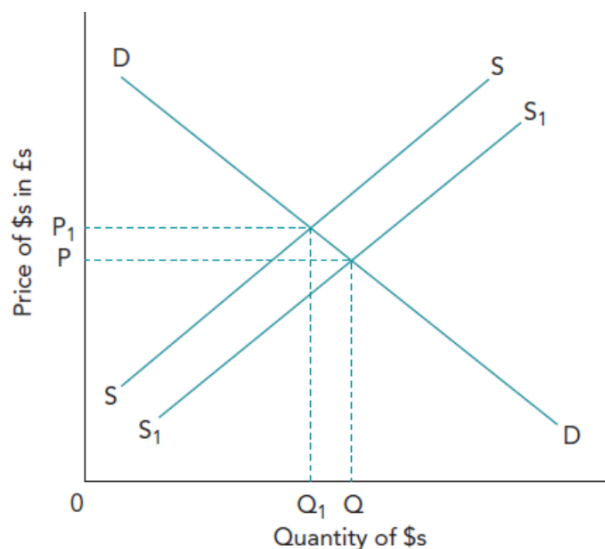
Exchange Rate

- **Foreign exchange rate**: the price of one currency in terms of another currency
 - the exchange rate shows **external** value, and the price level shows the **internal** value

Floating Exchange Rate

- **Flowing exchange rate**: the exchange rate determined by market forces in the global foreign exchange market

- **Reasons for purchasing a currency:** 1. purchase goods and services from the country; 2. invest in the country; and 3. speculate on making a profit if the value of the currency should rise in the future
- **Depreciation:** a fall in the value of a currency caused by market forces
 - causing export prices to fall and import prices to rise



- good for consumers & producers purchasing things from abroad
- **Appreciation:** a rise in the value of the currency caused by market forces
 - causing export prices to rise and import prices to fall

Causes of Exchange Rate Changes

- changes in the demand for and supply of a currency will cause a change in the price of the currency in a floating exchange rate
- **Changes in Demand** → basically want to do things in the country
 - Trade balances
 - Interest rates → higher IR can attract foreign capital
 - Economic growth, Political stability, High productivity → attract investment from abroad
 - Anticipation of appreciation → attract **hot-money**
- **Changes in Supply** → basically it is not worth to do things in the country
 - Trade balances
 - Government debts → lack of confidence & people sell the currency
 - Inflation rates → high inflation rate decreases the currency's value
 - Decreased interest rates
 - Anticipation of depreciation

Impact of Exchange Rate Changes

- **Depreciation**
 - more net exports, shifting AD to the right → inflation, more employment, higher price level, higher real GDP
 - export-favored firms might earn more money and invest more, shifting AS to the right
 - higher import prices → increase in cost of production, shifting AS to the left
- **Appreciation**
 - less net exports, shifting AD to the left → less inflation, less employment, lower price level, lower real GDP
 - lower import prices → decrease in cost of production, shifting AS to the right

- also, domestic firms will feel the pressure to compete, which might increase productivity and shift AS to the right even more

6.4 Policies to Correct Current Account Imbalances

Definition ▾

- Government policy objective of stability of the current account
- Effect of fiscal, monetary, supply-side, and protectionist policies

The Stability Objective

- most governments do seek to achieve a **balance of payment stability**
- a balanced account provides
 - *balanced trade* (no debt problems & over-saving of reserves)
 - *economic stability* (large fluctuations can lead to volatile exchange rates)
 - *sustainable growth* (great international credit, no debt problems)
- however, in the **short run**, governments might welcome account imbalances

The Policies → change the demand, the market, the exchange rate, and the inflation rate

- **Fiscal Policy**
 - **Contractionary fiscal policy**: less demand for imports & push domestic firms to increase their exports for survival
 - **Expansionary fiscal policy**: more demand for imports & products diverted to the domestic market
 - **Tax**: attract the MNCs if the taxes are low
 - **short-run**, but not long-run; it has **adverse side effects**
- **Monetary Policy**
 - **Interest rate & Money supply**
 - affect the inflation rate → affect the competitiveness of exports
 - affect the exchange rate → affect the price of exports/imports
 - affect the consumer expenditure & firm investment → affect the demand for imports
 - **short-run**, but not long-run; it has **adverse side effects**
 - it does not tackle the structural issues of the economy
- **Supply-side Policy**
 1. Make the domestic market more **attractive to invest**
 - e.g., deregulation, privatization
 2. Make the domestic firms **more productive**
 - e.g., education & training, trade union reforms
 - however, it takes a **long time** to be effective; it cannot solve the **current account surplus**
- **Protectionist Policy**
 - encouraging domestic consumers and firms to switch to buying domestic products → increasing local demand
 - However, it might provoke **retaliation and over-dependency on protection**