Globalisation, trade and international finance

Edexcel IAL Economics WEC14 sections 4.3.1-4.3.3 full package

Globalisation, trade and international finance

- describe the characteristics and causes of globalisation and weigh its costs and benefits;
- use **opportunity cost** to explain **comparative advantage** and the gains from trade;
- calculate the **terms of trade** and analyse trading blocs and the WTO;

Globalisation, trade and international finance (2)

- use a diagram to analyse the effects of a **tariff**;
- explain the **balance of payments**, exchange-rate systems, **depreciation** and the J-curve;
- measure international competitiveness and evaluate policies to raise it.

Globalisation

- **trade grows as a share of GDP**: world exports and imports were about a quarter of world GDP in 1970 and about 60% by 2008;
- **transnational companies** (TNCs) and **foreign direct investment** (FDI) become more important: a TNC owns production in more than one country;
- **migration** of workers between countries increases.

Globalisation (2)

- **trade liberalisation** : average **tariffs** fell through rounds of talks, and China joined the **World Trade Organization** on 11 December 2001;
- more and larger trading blocs, such as the European single market and ASEAN;
- political change: the end of the Soviet system and China's opening up from 1978 brought more than a billion workers into world trade;

Globalisation (3)

- lower transport and communication costs: containers, cheaper air freight, the internet;
- the growth of TNCs, which spread their production across many countries.

Specialisation and comparative advantage

- When countries **specialise** , each produces the goods it makes best and trades for the rest.
- World output rises.
- But a country that specialises in a few products depends on their prices: when world copper prices fell by more than half in late 2008, Zambia's export earnings fell sharply.
- A country has an **absolute advantage** when it can produce more of a good from the same resources.

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Terms of trade, trading blocs and protectionism

- **Terms of trade** $= \frac{128.9}{117.1} \times 100 = 110.1$.
- The terms of trade improved by 10.1%: each unit of exports now buys 10.1% more imports.
- to protect an **infant industry** until it grows large enough to compete, or an old (sunset) industry while it shrinks;

$$\text{terms of trade} = \frac{\text{index of average export prices}}{\text{index of average import prices}} \times 100$$

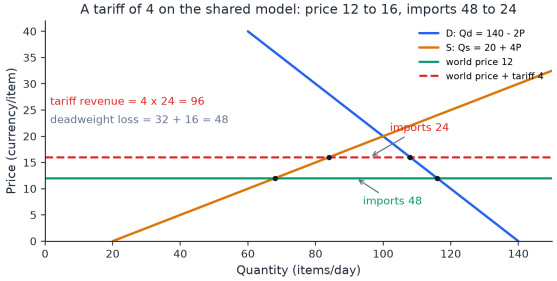
Terms of trade, trading blocs and protectionism (2)

- to save domestic jobs;
- national security: food, energy, defence and computer chips;
- to stop **dumping** : selling exports below their cost of production;

Terms of trade, trading blocs and protectionism (3)

- to reduce a current-account deficit;
- to raise tax revenue.

Figure: Terms of trade, trading blocs and protectionism



- The **tariff** raises the price from 12 to 16, halves imports from 48 to 24, raises 96 for the government and leaves a **deadweight loss** of $32 + 16 = 48$.
- Match each part of the diagram to the text.

Balance of payments and exchange rates

- the **current account** : trade in goods, trade in services, primary income (wages, profits and interest earned abroad) and secondary income (transfers such as remittances and aid);
- the **capital account** : small flows such as debt forgiveness and the transfer of patents;
- the **financial account** : FDI, purchases of shares and bonds (portfolio investment), bank lending and changes in reserves.

Balance of payments and exchange rates (2)

- **expenditure-reducing policies** : higher taxes or interest rates cut spending, including on imports, but also cut growth and jobs;
- **expenditure-switching policies** : a lower **exchange rate** or **tariffs** make imports dearer and domestic goods relatively cheaper;
- supply-side policies that raise productivity and competitiveness over time.

Balance of payments and exchange rates (3)

- **relative interest rates**: in 2022–2024 US interest rates rose above 5% while Japan's stayed near zero, and the yen fell to about 160 per dollar in April 2024;
- **relative inflation**: by **purchasing power parity** theory, the currency of a high-inflation country falls until a basket of goods costs the same in both countries;
- the current-account balance and the economy's strength;

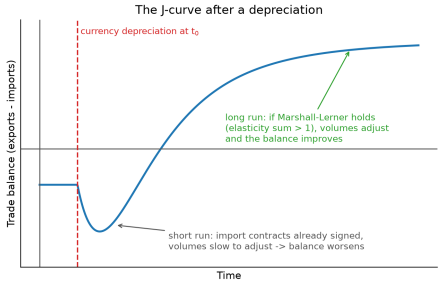
Balance of payments and exchange rates (4)

- **speculation** and expectations, and **capital flight** in a crisis;
- global shocks, such as a fall in world commodity prices for a commodity exporter.
- A £20 British jacket cost an American buyer $20 \times 1.50 = 30$ dollars before and $20 \times 1.32 = 26.40$ dollars after: 12% cheaper.

Balance of payments and exchange rates (5)

- A 600-dollar phone cost a British buyer $600 \div 1.50 = £400$ before and $600 \div 1.32 \approx £455$ after: about 14% dearer.
- **economic growth and jobs**: more exports and fewer imports raise aggregate demand;
- **inflation**: dearer imported food, fuel and parts raise costs;
- **FDI**: domestic assets become cheaper for foreign investors, but an unstable currency deters investment.

Figure: Balance of payments and exchange rates



- The **J-curve**: after a **depreciation** the trade balance first worsens, then improves as export and import volumes respond.
- Read the axes and units first.

International competitiveness

- relative **unit labour costs** : labour cost per unit of output;
- relative productivity: output per worker or per hour;
- relative export prices.

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Data-response practice (Section B style)

- (a) Calculate the percentage fall in the value of the Egyptian pound against the US dollar. [2]
- (b) Explain **two** reasons why Egypt allowed its currency to fall. [4]
- (c) With the help of a **J-curve** diagram, explain how Egypt's trade balance might change after the **depreciation**. [6]

Data-response practice (Section B style) (2)

- (d) Examine the likely effect of the **depreciation** on inflation in Egypt. [8]
- (e) Evaluate whether the depreciation is likely to improve Egypt's **current account**. [12]

Sources for this lesson

- M. Levinson, *The Box: How the Shipping Container Made the World Smaller and the World Economy Bigger* (2006).
- World Bank, World Development Indicators: trade (% of GDP); IMF, World Economic Outlook database (current-account balances).
- Shanghai International Port Group, 2023 annual container throughput.

Sources for this lesson (2)

- A. Flaaen, A. Hortaçsu and F. Tintelnot, "The Production Relocation and Price Effects of US Trade Policy: The Case of Washing Machines", *American Economic Review* 110 (2020).
- People's Bank of China announcements of 21 July 2005 and 11 August 2015; Court of Justice of the European Union, *Commission v Ireland and Apple* (10 September 2024).
- Pearson Edexcel International A Level Economics specification (WEC14), Issue 2, sections 4.3.1–4.3.3, and the WEC14/01 Sample Assessment Materials.

Common errors

- Saying a country should make the good it is "best at". Compare opportunity costs, not output.
- Calling any rise in the **terms of trade** "good". Ask why export prices rose and what happened to export volumes.
- Confusing **trade creation** (cheaper partner replaces dearer home production) with **trade diversion** (dearer partner replaces cheaper outside producer).

Common errors (2)

- On a **tariff** diagram, counting the revenue box as a loss to society. Only the two triangles are **deadweight loss**.
- Working out a currency's fall from the change in units per dollar. 30.9 to 49.5 pounds per dollar is a 38% fall in the pound, not 60%.
- Saying a **depreciation** always improves the current account. It depends on the Marshall–Lerner condition, the time period and inflation.
- Using "devaluation" for a floating currency. Floating currencies depreciate; fixed ones are devalued.

Key terms

- **Globalisation**: the growing integration of national economies through trade, investment, **migration** and technology.
- **Comparative advantage**: producing a good at a lower **opportunity cost** than another country.
- **Terms of trade**: export price index $\div$ import price index $\times$ 100.

Key terms (2)

- **Trade creation / trade diversion**: a bloc moves production to a cheaper partner / from a cheaper outsider to a dearer partner.
- **Tariff / quota**: a tax on imports / a limit on the quantity imported.
- **Current account**: trade in goods and services plus primary and secondary income.

Key terms (3)

- **Depreciation / devaluation**: a fall in a floating / **fixed exchange rate**.
- **Marshall–Lerner condition**: a **depreciation** improves the trade balance if the export and import price elasticities sum to more than 1.
- **J-curve**: the trade balance worsens after a depreciation before it improves.
- **Unit labour cost**: labour cost per unit of output.

Check yourself

- 1.
- One hour of labour makes 6 phones or 3 bikes in country P and 2 phones or 2 bikes in country Q.
- Which country has the **comparative advantage** in bikes? 2.
- A country's export price index falls to 95 and its import price index rises to 105.