Globalisation, trade and international finance

Pearson Edexcel · International A-Level · Economics

Pearson Edexcel International A Level Economics (WEC14), specification Issue 2, June 2018. This topic covers spec sections 4.3.1–4.3.3 in full: the characteristics, causes and effects of globalisation (three rows); trade and the global economy – specialisation, terms of trade, trading blocs and protectionism (five rows); and the balance of payments, exchange rates and international competitiveness (three rows). Worked examples are original or adapted from the WEC14/01 Sample Assessment Materials (labelled SAM) with arithmetic re-derived; the tariff model reuses the shared micro demand and supply curves ($Q_d = 140 - 2P$, $Q_s = 20 + 4P$).

Must-know for this topic:

Family	Relationship
terms of trade	$ToT = \frac{\text{export price index}}{\text{import price index}} \times 100$; SAM: $\frac{128.9}{117.1} \times 100 = 110.1$
comparative advantage	lowest opportunity cost, NOT most output; trade ratio between the two opportunity costs
tariff (shared model)	world price 12: imports 48; tariff 4: imports 24, revenue 96, DWL 48
depreciation	Marshall–Lerner ($

Globalisation

Globalisation shows three characteristics (4.3.1.1): trade grows as a proportion of GDP; transnational companies (**TNCs**) and foreign direct investment (**FDI**) gain importance; and migration increases. Its causes over the last 50 years (4.3.1.2a): trade liberalisation; more and larger trading blocs; political change (the Soviet system's breakdown, China opening up); reduced transport and communication costs; and the increased significance of TNCs. FDI by TNCs happens to access markets, resources, cheaper labour and tax advantages, and its impact on RECIPIENT countries runs both ways – investment, jobs, technology and tax revenue against crowding out, profit repatriation and influence over policy (4.3.1.2b). Possible benefits of globalisation (4.3.1.3a): higher growth, higher tax revenue, economies of scale, lower prices with higher consumer surplus, more choice, higher living standards. Possible costs (4.3.1.3b): displaced workers, exploitation of workers, the environment, lost revenue through TRANSFER PRICING, within-country inequality, and TNC influence on domestic policy.

Specialisation and comparative advantage

Specialisation and trade raise total output, but they concentrate economies on narrow industries whose prices can collapse – the benefits and costs of specialisation in the international context (4.3.2.1a). The theory of COMPARATIVE ADVANTAGE (4.3.2.1b): a country has comparative advantage where it produces at the LOWEST OPPORTUNITY COST – distinct from ABSOLUTE advantage (most output per input). Original example: Country A makes 4 wheat or 2 cloth per labour hour, Country B makes 1 wheat or 1 cloth. A has absolute advantage in BOTH; but one cloth costs A two wheat while one cloth costs B only one wheat – A specialises in wheat, B in cloth, and a trade ratio between the two opportunity costs (say 1.5 wheat per cloth) lets BOTH consume beyond their own frontiers: A buys cloth at 1.5 wheat instead of forgoing 2; B sells cloth at 1.5 wheat instead of 1. Assumptions: constant costs, no transport costs, full employment, perfect factor mobility. Limitations: costs are rarely constant, transport and trade barriers exist, factors are not perfectly mobile, and exchange rates and TNCs blur the story.

Comparative advantage: output per labour hour

	Wheat per hour	Cloth per hour	Opportunity cost
Country A	4	2	1 cloth = 2 wheat
Country B	1	1	1 cloth = 1 wheat

A: absolute advantage in both goods; B: comparative advantage in cloth (lower cost)

Trading at 1.5 wheat per cloth lets BOTH countries consume beyond their own PPF

Original data: output per labour hour; the trade ratio 1.5 wheat per cloth sits between the two opportunity costs.

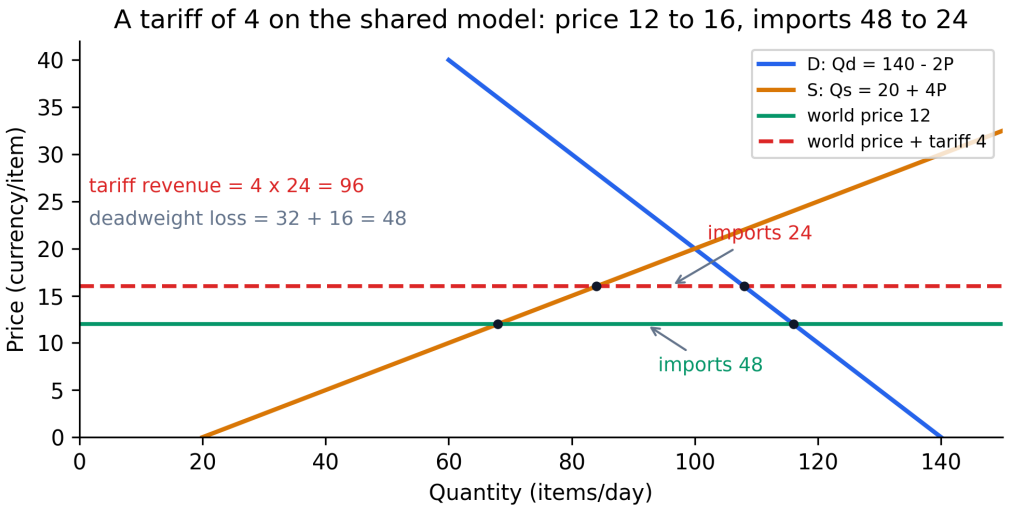
Terms of trade, trading blocs and protectionism

The **terms of trade** (4.3.2.3) measure export prices against import prices: $ToT = \frac{\text{export price index}}{\text{import price index}} \times 100$. *(SAM WEC14/01 Q3)* Tanzania's export price index rose from 100 to 128.9 while its import price index rose to 117.1, so its terms of trade $= \frac{128.9}{117.1} \times 100 = 110.1$ – a 10.1% improvement. The terms move with relative inflation, relative productivity, relative labour costs, the exchange rate and import/export prices (4.3.2.3b); a RISE improves export revenue per unit and living standards (imports cost fewer exports) but a rise driven by dearer exports can worsen the balance of trade if demand is inelastic (4.3.2.3c). Trade PATTERNS (4.3.2.2) shift with emerging economies, changing comparative advantage, trading blocs and bilateral agreements,

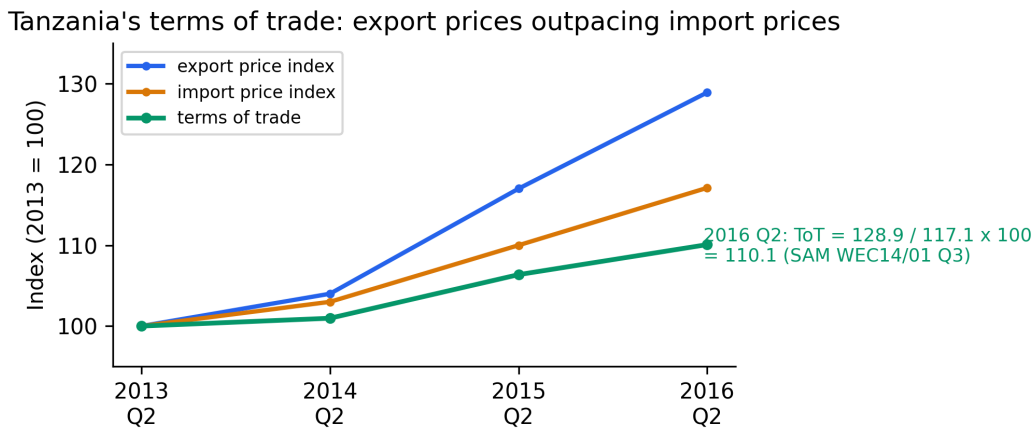
relative exchange rates and protectionism.

The WTO promotes trade liberalisation through negotiation rounds, rules and dispute settlement (4.3.2.4a). Trading blocs deepen in stages (4.3.2.4b): **free-trade areas** (no internal barriers), customs unions (plus a common external tariff), **common markets** (plus free factor movement), economic and monetary unions (plus a shared currency). Membership brings TRADE CREATION (cheap partner production replaces dear domestic) but risks TRADE DIVERSION (dear partner production replaces cheap world production once the external tariff bites), plus lower costs and prices, economies of scale, lower transaction costs and factor mobility (4.3.2.4c); blocs can conflict with the WTO's most-favoured-nation principle (4.3.2.4d).

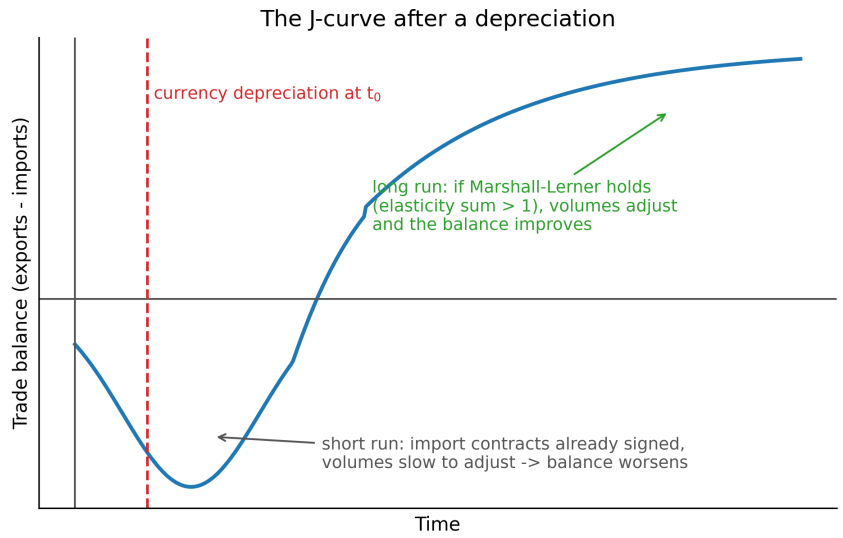
Restrictions on free trade (**protectionism**, 4.3.2.5) are justified to protect infant (and geriatric) industries, domestic employment, national security, against **dumping**, to correct a current-account deficit, or to raise revenue (4.3.2.5a); the types are **tariffs**, quotas, non-tariff barriers and subsidies to domestic producers (4.3.2.5b). On the shared model at a world price of 12: $Q_d = 116$ against $Q_s = 68$, so imports are 48. A tariff of 4 raises the domestic price to 16: imports fall to 24, government collects $4 \times 24 = 96$, producers gain, consumers lose 448 – of which 304 goes to producers and 96 to the government, leaving a deadweight loss of $32 + 16 = 48$ (4.3.2.5c: consumers lose, producers and the government gain, living standards and equality typically fall with the price rise).



Original model: world price 12 with imports 48; the tariff of 4 cuts imports to 24, raises 96 in revenue and destroys 48 of welfare.



SAM data: export prices outpaced import prices, lifting the terms of trade to 110.1.



After a depreciation the current account first worsens (the J-curve) before volumes adjust and Marshall–Lerner takes over.

Balance of payments and exchange rates

The balance of payments (4.3.3.1) has the CURRENT ACCOUNT (trade in goods and services plus primary and secondary income – topic 3) and the CAPITAL AND FINANCIAL ACCOUNTS (asset transactions, reserves). Current-account deficits follow deficient competitiveness, strong domestic demand, or commodity price collapses; surpluses mirror them (4.3.3.1b). Imbalances can be reduced by expenditure-reducing

policies (deflation), expenditure- switching policies (depreciation, tariffs) and supply-side competitiveness policies (4.3.3.1c); global imbalances matter because surplus savings finance deficit borrowing, storing up corrections (4.3.3.1d).

Exchange-rate systems (4.3.3.2a): **fixed exchange rate** (pegged, state-maintained), **managed exchange rate** (market-set within a band the state defends) and **floating exchange rate** (market-set). Government intervenes through foreign-currency transactions, interest rates and quantitative easing (4.3.3.2b). Floating rates move with relative interest rates, relative inflation (the purchasing power parity theory – currencies adjust until baskets cost the same), the current account, economic strength, capital flight, expectations and speculation, and global shocks such as commodity price falls (4.3.3.2c). A RISE under a fixed rate is a REVALUATION; under a float it is an APPRECIATION; a fall is DEVALUATION versus DEPRECIATION (4.3.3.2d–e). A **depreciation** makes exports cheaper abroad and imports dearer: the current account improves ONLY if the **Marshall–Lerner condition** - holds – the sum of export and import demand elasticities exceeds one – and even then the **J-curve** J effect sees the account WORSEN first (contract values adjust before volumes do), then improve. Depreciation also raises FDI inflows (cheaper domestic assets) but imports inflation, cutting growth and employment in import-dependent industries (4.3.3.2f); competitive depreciations invite retaliation and trade wars (4.3.3.2g).

International competitiveness

Competitiveness is measured by relative productivity rates, relative unit labour costs and relative export prices (4.3.3.3a); it is influenced by productivity, human-capital quality, the exchange rate, wage and non-wage costs, regulations, infrastructure quality and non-price factors (4.3.3.3b). Measures to raise it: education and training, investment incentives, privatisation and deregulation, reducing the currency's value, and trade liberalisation (4.3.3.3c). A competitive economy enjoys export growth, jobs and FDI; an uncompetitive one suffers persistent current- account deficits, deindustrialisation and forced deflation (4.3.3.3d).

Checklist

- Globalisation's three characteristics, five causes, FDI reasons and impacts; six benefits and six costs (4.3.1).
- Specialisation's benefits and costs; absolute versus comparative advantage with the 4/2 and 1/1 table; the trade ratio between the opportunity costs; assumptions and limitations (4.3.2.1).
- Trade patterns and their five shift factors (4.3.2.2).
- Terms of trade formula with the SAM Tanzania calculation (110.1); its five influences; effects on export revenue, living standards and the trade balance (4.3.2.3).
- WTO role; the four bloc types; trade creation versus diversion; bloc-WTO conflicts (4.3.2.4).
- Six motives and four types of restriction; the tariff arithmetic – price 12 to 16, imports 48 to 24, revenue 96, DWL 48 – with the five impact groups (4.3.2.5).
- BoP components; deficit causes; three imbalance remedies; global imbalances (4.3.3.1).
- Fixed, managed and floating systems; three intervention routes; seven floating-rate factors; revaluation vs appreciation, devaluation vs depreciation; Marshall–Lerner and the J-curve; depreciation's six impact channels; competitive depreciations (4.3.3.2).
- Competitiveness: three measures, seven influences, five measures to raise it, advantages and problems (4.3.3.3).

Boundary notes: WEC14 is 2 hours, 80 marks, drawing on Units 1–3 – expect AD/AS, market failure and business-economics material inside global questions. Data questions reward index-number work (the ToT calculation) and diagram labels (D, S, world price, tariff line, revenue box, DWL triangles). Worked examples are original or SAM-adapted as labelled.