# 6.1 The global economy

Name: _____ Class: _____ Date: _____ **Total: 24 marks**

**KEY WORDS** comparative advantage • terms of trade

## The global economy

## Objective

Apply comparative advantage, the protection arithmetic, exchange-rate determination with Marshall–Lerner, the terms of trade, and the development barriers and strategies (syllabus 4.1–4.10).

## 1 Key knowledge and worked examples

**Global toolkit.** Comparative advantage = lowest opportunity cost (A: 4 wheat or 2 cloth; B: 1 or 1; trade between 1 and 2 wheat per cloth). Tariff on the shared model: world price 12 → imports 48; tariff 4 → price 16, imports 24, revenue 96, DWL 48. Exchange model: D meets S at 5; import-demand growth → 6.5 = depreciation (Marshall–Lerner for the current account). ToT = export ÷ import index × 100: 128.9/117.1 = 110.1. Development: HDI's three components; savings gap, poverty trap; liberalisation, FDI, aid, microfinance, human capital.

## 2 Practice

**2.1** Define comparative advantage and distinguish it from absolute advantage using A (4 wheat or 2 cloth/hour) and B (1 or 1). [3]

**2.2** Name any three types of trade protection. [2]

**2.3** Name the four stages of economic integration in increasing depth. [2]

**2.4** State the Marshall–Lerner condition. [2]

**2.5** Export prices rise from 100 to 128.9 while import prices rise to 117.1. Calculate the terms of trade index. [3]

## 3 Exam-style questions

**3.1** *(Original.)* With $Q_d = 140 - 2P$ and $Q_s = 20 + 4P$ and a world price of 12, the government imposes a tariff of 4. Calculate the imports before and after, the government revenue, and the total deadweight loss. [5]

**3.2** *(Original.)* In the exchange model demand meets supply at 5 domestic per foreign currency. Import demand grows. Explain, with the diagram, the effect on the exchange rate and on the current account. [4]

**3.3** *(Original, development.)* A low-income country's savings are too small to fund the investment its growth needs. Name the barrier, and evaluate one strategy that addresses it. [3]

## Solutions

**2.1** Comparative advantage is the ability to produce at the LOWEST OPPORTUNITY COST (1). A is absolutely better at both goods ($4 > 1$ and $2 > 1$) (1); but one cloth costs A two wheat and B only one, so B has the comparative advantage in cloth and A in wheat (1).

**2.2** Any three of: tariffs; quotas; subsidies to domestic producers; administrative/technical barriers.

**2.3** Free-trade area; customs union; common market; economic and monetary union.

**2.4** A depreciation improves the current account only if the sum of the price elasticities of demand for exports and imports exceeds one.

**2.5** $ToT = \frac{128.9}{117.1} \times 100 = 110.1$ – a 10.1% improvement on the base 100.

**3.1** Before: $Q_d(12) = 116$, $Q_s(12) = 68$, imports 48. After: price 16, $Q_d = 108$, $Q_s = 84$, imports 24. Revenue $= 4 \times 24 = 96$. Deadweight loss $= \frac{1}{2} \times 16 \times 4 + \frac{1}{2} \times 8 \times 4 = 32 + 16 = 48$.

**3.2** Import demand shifts the demand curve for foreign currency RIGHT, so the domestic price of it rises from 5 to 6.5: a depreciation. Import prices rise in domestic currency and export prices fall abroad, so import demand falls and export demand rises – the current account improves IF Marshall–Lerner holds; the J-curve records the short-run worsening while contract values adjust before volumes do.

**3.3** The savings gap (Harrod–Domar): savings too small to fund the investment the growth rate needs. Strategy (any one, evaluated): aid or FDI fills the gap directly but may create dependency; microfinance raises household investment from tiny loans with high repayment but reaches only small-scale activity; raising domestic savings through income growth or financial deepening is sustainable but slow.

Local review guidance: both equilibria before revenue or DWL; the answer runs through OPPORTUNITY COST, not output; (R1 3.3) the strategy named with the barrier it targets AND one limit. This is authored classroom guidance.