International trade and globalisation

Specialisation and free trade, globalisation and multinational companies, tariffs, quotas, subsidies and embargoes and why they are used, foreign exchange rates and what changes them, and the current account of the balance of payments.

No country produces everything it needs. This chapter covers **why countries trade**, the **barriers** they put in the way, the **exchange rates** that link currencies, and the **balance of payments**.

6.1 International specialisation

Specialisation by country

> **Specialisation by country is when a country concentrates on producing the goods and services it produces best or at lowest cost, and trades them for the rest.**

Basis: **best use of resources** (a country with fertile land specialises in farming; one with oil in oil) and **low-cost production** (cheap labour, skilled workers, technology). It then **exports** its specialist goods and **imports** others.

Advantages	Disadvantages
higher output and efficiency (resources used where they are most productive)	**overdependence** on a few products: a fall in world prices or demand harms the economy
lower prices and **more choice** for consumers	**decline of other industries** and job losses (structural unemployment)
economies of scale	**vulnerable** to changes in other countries or **disruption** of trade
more trade and income	risk of **depleting** natural resources

Free trade

> **Free trade is trade between countries without barriers such as tariffs and quotas.**

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Advantages	Disadvantages
lower prices and **greater choice** for consumers	**domestic firms** may be driven out by **foreign competition**, causing job losses
competition pushes firms to be efficient and innovate	**new (infant) industries** cannot grow against established foreign firms
firms access **bigger markets** and economies of scale	risk of **dumping** and dependence on imports
encourages **specialisation** and growth	**less control** over strategic industries; harms the environment through more transport

6.2 Globalisation, free trade and protection

Globalisation

> **Globalisation is the growing integration and interdependence of the world's economies: trade, finance, people and ideas moving across borders.**

Causes of changes in globalisation:

- **fewer trade restrictions** (tariffs lowered, trade agreements and trading blocs)
- **falling transport costs** (container ships, air freight)
- **falling communication costs** (the internet, mobile phones)
- the **movement of multinational companies (MNCs)** to new countries.

Effects of globalisation on:

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Area	Effect
International trade	grows (more imports and exports)
Competition	rises (foreign firms enter markets), forcing efficiency but harming weaker firms
The environment	more transport, pollution and resource use; but also spread of **green technology** and agreements
Migration	more people move for work
Income distribution	can **widen** inequality (skilled workers gain; low-skilled workers in rich countries lose jobs; wages low in poor countries) or **narrow** the gap between countries
Economic development	**more trade, investment, technology and jobs** may speed development; but poorer countries may become dependent

Multinational companies (MNCs)

An **MNC** is a firm that **operates in more than one country**.

	Host country (where the MNC operates)	**Home country** (where it started)
Advantages	**jobs**, **investment**, **new technology and skills**, **exports**, **tax revenue**, more **choice**	**profits are sent back** (repatriated), may **create jobs** in head office, access to **cheaper goods**
Disadvantages	**local firms may close**, **profits repatriated**, **exploitation** of workers or resources, **pollution**, the MNC may **leave**	**jobs lost** if production moves abroad, **lower tax revenue** from moved activity

Trade restrictions (methods of protection)

Method	Meaning
Tariff	a **tax on imports**, raising their price
Import quota	a **limit on the quantity** of a good that may be imported
Subsidy	**government payment** to domestic producers, lowering their costs and so their prices compared with imports
Embargo	a **complete ban** on trade with a country or in a product (often for political reasons)

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Reasons for trade restrictions

- **Protect infant (sunrise) industries**: new industries need time to grow before they can compete.
- **Protect declining (sunset) industries**: to slow job losses while workers retrain.
- **Protect strategic industries**: defence, food, energy, for national security.
- **Avoid dumping**: selling goods abroad **below cost** to drive out competition.
- **Reduce a current account deficit**: imports fall.
- **Raise tax revenue** (tariffs).
- **Restrict imports of demerit goods** (drugs).
- **Promote environmental sustainability** (restricting imports of products that harm the environment).

Consequences of trade restrictions

Home country	**protects jobs** and industries; **higher prices** and **less choice** for consumers; **less efficient** firms; may raise revenue (tariffs)
Trading partners	**lower exports** and income; risk of **retaliation** (a trade war)

Overall: restrictions protect certain groups at the cost of **consumers** and **efficiency**, and risk retaliation, while helping home firms to survive or grow.

6.3 Foreign exchange rates

> **A foreign exchange rate is the price of one currency in terms of another (for example $1 = 280 rupees).**

Why currencies are bought and sold

- **Trade in goods and services**: importers need foreign currency; foreign buyers of exports need the exporter's currency.
- **Speculation**: buying a currency in the hope it will rise in value and selling for profit.
- **Government intervention**: central banks buy or sell currency to influence the rate.
- **Payment of profit, interest and dividends** between countries (for example an MNC sending profits home).
- **Workers' remittances**: money sent home by people working abroad.
- **Investment in capital goods** between countries (buying foreign companies and property).

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Determination of the exchange rate

A **floating exchange rate** is **determined by the demand for and supply of the currency** in the foreign exchange market, without government fixing.

- **Demand for a currency** comes from foreigners buying that country's exports, investing there or speculating on it. The **demand curve slopes downwards**.
- **Supply of a currency** comes from residents buying imports and investing abroad. The **supply curve slopes upwards**.
- The **equilibrium exchange rate** is where **demand = supply**.

Appreciation: the currency **rises in value** (it buys more foreign currency). **Depreciation**: the currency **falls in value**.

Causes of fluctuations:

Change	Effect
Increase in demand for exports	more demand for the currency, so **appreciation**
Increase in demand for imports	more supply of the currency (to buy foreign money), so **depreciation**
Higher interest rate	foreign savers want to deposit money there, so demand for the currency rises and it **appreciates**
Speculation	if people expect a currency to fall, they sell it, so it **depreciates**

Consequences of changes

	Currency appreciates	**Currency depreciates**
Export prices (to foreigners)	**rise**, so **demand for exports falls**	**fall**, so **demand for exports rises**
Import prices (in the home market)	**fall**, so **demand for imports rises**	**rise**, so **demand for imports falls**
Overall	exporters and tourism lose; importers and consumers gain	exporters gain; imports (and inflation) become dearer

TRY IT

The exchange rate falls from $1 = 280 rupees to $1 = 300 rupees. What has happened to the rupee, and what is the effect on Pakistani exports? The rupee has **depreciated** (it takes more

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rupees to buy $1). Pakistani goods are **cheaper in dollars**, so foreign demand for exports tends to **rise**; imports become **more expensive in rupees**.

6.4 Current account of the balance of payments

The **balance of payments** records **all money flowing into and out of a country** in a year. The **current account** records trade and income flows.

Components

Component	What it includes
Trade in goods	**exports and imports of physical goods** (the "visible" balance)
Trade in services	exports and imports of **services** (tourism, banking, shipping)
Primary income	**income from abroad**: profits, interest and dividends, and wages of workers abroad
Secondary income	**transfers** with no payment in return: **remittances**, foreign aid, gifts

Current account balance = trade in goods + trade in services + primary income + secondary income (each balance is inflows minus outflows). A surplus means more money coming in than going out; a deficit means more going out.

TRY IT

Exports of goods $50bn, imports of goods $70bn; exports of services $20bn, imports of services $12bn; primary income +$3bn; secondary income +$9bn. **Goods: 50 – 70 = –20. Services: 20 – 12 = +8. Total = –20 + 8 + 3 + 9 = $0bn**: the current account is **in balance**, despite a goods deficit.

Causes of a deficit and surplus

- **Deficit**: **imports greater than exports**: high consumer demand for imports, **uncompetitive** exports (high prices, poor quality), an **overvalued exchange rate**, a rise in **oil import prices**, falling demand abroad.
- **Surplus**: **strong exports**, a **low (competitive) exchange rate**, high savings and low spending on imports, large **remittances**.

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Consequences

	Deficit	Surplus
GDP and employment	exports less than imports **lowers total demand**, so slower growth and **lower employment**; but cheaper imports help consumers	more demand for exports, so **higher GDP and employment**
Inflation	a falling currency makes imports dearer, causing **inflation**	rising currency lowers import prices; strong demand may cause **inflation**
Exchange rate	pressure for the currency to **depreciate**	pressure to **appreciate**
Other	must **borrow or use reserves** to pay for the deficit; a large persistent deficit is **unsustainable**	may mean **low consumption** at home and tension with trading partners

Policies for balance of payments stability

Policy	How it helps
Higher interest rates / contractionary fiscal policy	reduce demand for imports (but also slow growth)
Lower exchange rate	makes exports cheaper and imports dearer
Supply-side policies	raise productivity and quality, making exports **more competitive** (slow, but long-term)
Trade restrictions (tariffs and quotas)	cut imports (but may cause **retaliation**)
Promoting exports	export grants, trade missions, tourism

Effectiveness: demand-side policies work quickly but reduce growth and employment; a lower exchange rate may raise import prices and inflation; supply-side policies are long-term; trade restrictions risk retaliation. **Combining** them is usually best.

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