International economic issues (A Level)

Policies to correct balance of payments disequilibrium, exchange rate systems and their effects, economic development and its measurement, the characteristics of countries at different levels of development, relationships between countries and globalisation.

11.1 Policies to correct disequilibrium in the balance of payments

The balance of payments

The **balance of payments** has the **current account**, **capital account** (capital transfers) and **financial account** (**foreign direct investment, portfolio investment, loans, reserves**). **By definition, the balance of payments balances** (the **current account deficit** is financed by a **financial account surplus** or a fall in **reserves**).

Causes of disequilibrium

Current account deficit: high AD (imports), **low competitiveness**, **strong currency**, **low productivity**, **recession abroad**, **structural** weaknesses. **Surplus: export strength**, **weak currency**, **low consumption**.

Policies

Policy	Mechanism	Evaluation
Expenditure-reducing	**contractionary fiscal and monetary**: cuts income and imports	**reduces growth**, jobs
Expenditure-switching	**depreciation/devaluation** or **tariffs**: shifts spending to home goods	works if **elastic** (**Marshall–Lerner**), **J-curve**, **inflation**, **retaliation**
Supply-side	raise **productivity** and **competitiveness**	long term, **costly**
Protectionism	restricts imports	**retaliation**, **distortion**

Persistent deficits may be **sustainable** if financed by **FDI** and the **country is growing**; **persistent surpluses** affect others (**global imbalances**).

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11.2 Exchange rates

Determination

In a **floating** system, the exchange rate is set by the **demand and supply** of the currency. **Factors affecting it: relative interest rates** (**hot money**), **relative inflation** (**purchasing power parity**), **current account**, **speculation**, **investment flows**, **government intervention** and **confidence**.

Fixed systems use **reserves** and **interest rates** to **maintain** the rate; **devaluation** and **revaluation** are deliberate changes. **Currency union** (a common currency) removes **exchange-rate risk** but removes **independent monetary policy**.

	Floating	Fixed
Advantages	**automatic adjustment**, **independent monetary policy**, **no need for reserves**	**certainty** for trade, **discipline** on inflation
Disadvantages	**volatility**, **uncertainty**	**needs reserves**, **loss of monetary independence**, **misaligned rates**, **speculative attacks**

Effects of exchange rate changes

> **Depreciation: exports cheaper, imports dearer; AD rises, inflation rises (import prices) and the current account improves if demand is elastic. Appreciation: the opposite: lower inflation but loss of competitiveness.**

Exchange rate changes affect **competitiveness**, **inflation**, **growth**, **employment**, **terms of trade**, **foreign debt** and **tourism**. **Real exchange rate** adjusts for inflation differences.

Nominal exchange rates are the **actual market rates**; **real** exchange rates **adjust for inflation differences**, showing **true competitiveness**. A country whose inflation is higher than its partners' can see its **real** rate **rise** even if the nominal rate is unchanged, **harming exports**. The **effect on the external economy:** by **Marshall–Lerner** a depreciation improves the current account when **PED(exports) + PED(imports) > 1**, and by the **J-curve** the balance **worsens first** (prices change before quantities adjust) **then improves**.

11.3 Economic development

Economic development is an **improvement in people's standard of living and wellbeing**, broader than **growth** (it includes **health, education, poverty reduction, freedoms**).

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Measuring development

Measure	Content
Real GDP per head (PPP)	average income
Human Development Index (HDI)	**income (GNI per head)**, **education**, **life expectancy**
Other indicators	**poverty rates**, **inequality (Gini)**, **literacy**, **infant mortality**, **access to water**, **multidimensional poverty**

Limitations: averages **hide inequality**, **informal** activity, **environment** and **freedom**.

Factors influencing growth and development

Physical capital, **human capital**, **technology**, **institutions** and **governance**, **natural resources**, **trade and openness**, **savings**, **political stability**, **geography** and **conflict**. **Barriers: poverty traps**, **low savings**, **debt**, **corruption**, **poor infrastructure**, **disease**, **dependence on primary products**, **population pressures**.

Strategies for development

Strategy	Description	Evaluation
Industrialisation	**import substitution** or **export-led** growth	protection can be **inefficient**; exports need **competitiveness**
Trade and openness	free trade, **FDI**	exposure to **volatility**, **dependence**
Investment in human capital	**education**, **health**	slow payoff, **brain drain**
Infrastructure	transport, energy	costly; **public** funding
Aid and debt relief	**grants and loans**	**dependency**, **corruption**
Microfinance and rural development	credit for the poor	limited scale
Institutional reform	**property rights**, **good governance**	political resistance

Primary product dependence: volatile prices, **low income elasticity** of demand for **primary** goods, **declining terms of trade** (the **Prebisch–Singer** hypothesis).

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Monetary indicators: real GDP per head (and **GNI per head**), compared using **purchasing power parity (PPP)** to adjust for different price levels. **Issues in comparing: informal and subsistence** output, **exchange-rate distortions**, **inequality hidden by averages**, **quality** and **pollution**. **Non-monetary indicators: life expectancy, literacy, infant mortality, school enrolment, access to clean water**, and composite measures such as the **Human Development Index**. The **Kuznets curve** suggests that **inequality first rises then falls** as an economy develops (an **inverted U**), because early growth benefits those in the new sectors, and later gains spread through **education and redistribution**. **Growth rates and living standards** differ widely between countries, so comparisons use **growth rates**, **PPP** and **non-monetary** data together.

11.4 Characteristics of countries at different levels of development

	Low-income countries	High-income countries
Income	**low GDP per head**	high
Sectors	large **primary (agriculture)** share	large **services** share
Population	**high growth**, **young** structure	**slow growth**, **ageing**
Health and education	poorer	better
Inequality and poverty	high **absolute poverty**	lower
Infrastructure	weaker	strong
Trade	**primary exports**, **imports of manufactures**	**manufactures and services**

Emerging economies (for example China, India) have **rapid growth**, **industrialisation** and **urbanisation** but **inequality** and **environmental** pressure. **Demographic transition**: **birth and death rates** fall as countries develop.

> **TRY IT**
>
> Name two reasons why GDP per head overstates a developing country's living standards.
>
> It ignores **inequality** (the average hides poverty) and **environmental damage**; it also misses **informal** and **subsistence** activity, which may either **understate** or **overstate** welfare.

Population: the **birth rate** and **death rate** (per 1,000 people), **infant mortality** and **migration** determine **growth and structure**; falls in birth rate with development lead to an **ageing population** and a **higher dependency ratio**. **Optimum population** is the size that gives the **highest output per head**; below it there is **under-population**, above it **over-population** (diminishing returns). **Income distribution:** the **Gini coefficient** (0 to 1) and the **Lorenz curve** show inequality; **Lorenz curve analysis** compares **how far**

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a curve bows from the line of equality. **Economic structure:** developing countries have **most employment in the primary sector**, middle-income countries in the **secondary**, and developed economies in the **tertiary** sector.

11.5 Relationship between countries at different levels of development

Trade and the terms of trade

Developing countries often **export primary goods** whose **prices are volatile** and whose **terms of trade may decline**. **Trade barriers** in rich countries (agricultural subsidies, tariffs) may **limit** exports. **Fair trade** and **trade agreements** try to help.

Aid, debt and investment

- **Aid: bilateral** (country to country) or **multilateral** (through institutions like the **World Bank, IMF**); **grants** or **loans**; can **fund infrastructure and health**, but may be **tied to purchases**, create **dependency** or be **lost to corruption**.
- **Debt: high debt servicing** diverts funds; **debt relief** and **restructuring** are used.
- **Foreign direct investment (FDI)** by **multinational companies**: **capital, technology, jobs, exports**; but **profit outflows**, **tax avoidance**, **environmental and labour** concerns, **dependency**.
- **Remittances** from workers abroad support **incomes**.

Institutions

The **IMF** (stability and **loans**), the **World Bank** (**development finance**) and the **WTO** (**trade rules**) shape the **international economy**; **conditions** attached to loans (**structural adjustment**) can be **controversial**.

International aid takes the forms of **grants**, **concessional (cheap) loans**, **technical assistance**, **emergency (humanitarian) aid** and **food aid**. **Reasons for giving aid: poverty relief and humanitarian need**, **political influence**, **trade interests** and **global stability**. **Multinational companies (MNCs)** are firms that **operate in more than one country**; their **activities** include **production, sales, R&D and investment** across borders; **consequences: jobs, technology transfer, exports and tax revenue**, but also **profit repatriation**, **tax avoidance**, **pressure on local firms** and **environmental and labour concerns**. **Foreign direct investment (FDI)** is **investment by a firm in physical assets abroad** (factories, shops), with **consequences** of **capital, technology and jobs** but **dependence and profit outflows**.

External debt arises from **borrowing abroad** to fund **deficits, investment or consumption**; **causes** include **persistent current account deficits**, **falling commodity prices**, **high interest rates** and **corruption**; **consequences: debt servicing** takes up **export earnings and government spending**, **currency weakness** and **loss of investor confidence**, sometimes leading to **debt relief** or **austerity**. The

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IMF promotes **monetary and exchange rate stability**, **lends to countries with balance of payments problems** (with **conditions**) and gives **policy advice**.

11.6 Globalisation

Globalisation is the **increasing integration** of **economies** through **trade, capital flows, migration and technology**.

Causes: technology (communications, transport), **trade liberalisation**, **growth of multinationals**, **capital market** freedom, **falling costs**.

Benefits	Costs
larger markets, **specialisation**, **lower prices**, **more choice**, **efficiency** and **economies of scale**, **FDI**, **technology transfer**, **growth**	**structural unemployment** in some regions, **inequality**, **environmental damage**, **exploitation of labour**, **loss of national control**, **vulnerability to external shocks** and **contagion**, **tax avoidance**

Multinational companies shift production for **low costs**, **spread** technology, but wield **market power** and may harm **host economies**.

Impact on different countries: newly industrialised economies gain through **exports and FDI**; some **poor countries** are **marginalised**; **developed** economies see **deindustrialisation**.

> **Globalisation raises efficiency and growth overall, but the gains are unevenly shared, so policy responses (training, redistribution, regulation) matter.**

Trading blocs differ in depth: a **free trade area** removes **tariffs between members**, each keeping its own external tariffs; a **customs union** adds a **common external tariff**; a **monetary union** adds a **common currency**; **full economic union** adds **common economic policies**. **Trade creation** is where **trade shifts from a high-cost domestic producer to a lower-cost partner** (a gain); **trade diversion** is where trade shifts from a **lower-cost non-member** to a **higher-cost member** because of the tariff (a loss). A bloc is **beneficial overall** if **trade creation exceeds trade diversion**.

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