International economic issues (AS)

Why countries trade (absolute and comparative advantage), protectionism, the current account of the balance of payments, exchange rates and policies to correct current-account imbalances.

6.1 The reasons for international trade

International trade is the **exchange of goods and services between countries**. It allows **specialisation**, **larger markets**, **lower prices**, **greater choice** and **economies of scale**.

Absolute and comparative advantage

- **Absolute advantage:** a country can produce a good with **fewer resources** than another.
- **Comparative advantage:** a country can produce a good at a **lower opportunity cost** than another.

> **Comparative advantage decides who should specialise. Country A makes 20 cars or 40 tonnes of wheat; Country B makes 10 cars or 10 tonnes of wheat. A's opportunity cost of one car is 2 wheat (B's is 1 wheat), so B has the comparative advantage in cars; A's cost of one tonne of wheat is 0.5 car (B's is 1 car), so A has the comparative advantage in wheat. Both gain by specialising and trading.**

Benefits: higher world output, **lower prices**, **more choice**, **economies of scale**, more **competition** and **efficiency**. **Assumptions and limits: no transport costs**, **constant opportunity cost**, **no trade barriers**, **mobile factors**. In practice, **over-specialisation** (**risk**), **structural unemployment**, **dependence on imports**, **dumping** and **environmental costs** can arise.

Terms of trade = **export price index ÷ import price index × 100**. A rise (more imports per unit of exports) is an **improvement**.

> **TRY IT**
>
> The price of a country's exports falls and import prices stay the same. What happens to its terms of trade?
>
> They **deteriorate** (the index falls): it must **export more** to buy the same imports.

The **trading possibility curve** shows the combinations of two goods a country can **consume after specialising and trading**, lying **outside its PPC** when trade takes place at a favourable **terms of trade**. **Trade liberalisation** (cutting trade barriers) allows more specialisation and free trade, **raising output and consumption**.

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6.2 Protectionism

Protectionism is **government action to restrict imports** to protect domestic industries.

Method	Effect
Tariff (tax on imports)	raises **price**, cuts imports, **raises revenue**
Quota (limit on quantity)	restricts supply, raises **price**; **no revenue** for the government
Subsidies to domestic producers	lower costs; **distort** trade
Embargo (ban)	stops trade
Administrative barriers	**regulations**, **standards**, delays

Arguments for: protect **infant industries**, **protect jobs** and **strategic industries**, prevent **dumping**, **improve the balance of payments**, **raise revenue**, diversify. **Arguments against: higher prices** for consumers, **less choice**, **inefficiency** (less competition), **retaliation** (**trade wars**), **losses** to exporters and **reduced world output**.

> **A tariff reduces imports and consumer surplus; the government gains revenue, domestic producers gain producer surplus, and there is a net welfare loss (deadweight loss).**

6.3 Current account of the balance of payments

The **balance of payments** records **all transactions between a country and the rest of the world**. The **current account** has:

Component	Content
Trade in goods	**visible** exports minus imports (the **balance of trade in goods**)
Trade in services	**invisibles**: tourism, banking, shipping
Primary income	**profits, interest, wages** from abroad
Secondary income	**transfers**: remittances, foreign aid

> **Current account balance = (X − M of goods) + (X − M of services) + net primary income + net secondary income. A deficit means more money flowing out than in.**

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Causes of a deficit: high consumer demand for imports, **strong currency**, **lack of competitiveness**, **low productivity**, **inflation higher than trading partners**, **recession abroad** (falling exports). **Causes of a surplus:** the reverse; **export-led** growth.

Consequences of a persistent deficit: borrowing or selling assets to fund it, **a falling currency**, **debt**, **loss of confidence**, **lower AD** in the long run. A **surplus** may bring **currency appreciation** and **inflation**, and **political tension**.

Consequences of current account imbalances: a **persistent deficit** means **net borrowing or sales of assets**, **pressure on the exchange rate**, a higher **external debt** and lower confidence, and (through the injections–leakages model) a **leakage** that depresses **AD**; a **surplus** means **net lending abroad**, **upward pressure on the currency** and possible **inflation**, but also lower consumption at home. The domestic effect depends on **size, duration and how the deficit is financed**.

6.4 Exchange rates

An **exchange rate** is the **price of one currency in terms of another**.

- **Floating:** determined by **demand and supply** of the currency in the foreign exchange market.
- **Fixed:** the central bank **sets and defends** a rate (it buys or sells currency or changes interest rates).
- **Managed float:** floats but **with intervention**.

Demand for a currency comes from **exports** (foreigners buy the currency to pay), **foreign investment** in the country, **speculation** and **higher interest rates**. **Supply** comes from **imports** and **investment abroad**.

A rise in value (appreciation) makes **exports dearer** and **imports cheaper**; a **fall (depreciation)** does the reverse. **Appreciation** reduces **inflationary pressure** but harms **exporters**.

> **If the currency depreciates, exports become cheaper abroad and imports dearer. The effect on the current account depends on elasticities: the Marshall–Lerner condition says a depreciation improves the balance if the sum of PED for exports and imports exceeds 1; the J-curve shows the balance may worsen first.**

Competitiveness depends on **price** (relative costs and exchange rate) and **non-price** factors (quality, innovation, delivery).

Exchange rate: the **price of one currency in terms of another** (for example $1.25 per pound). Using **AD/AS**, a **depreciation** raises **net exports**, so **AD shifts right**, increasing **real output and employment** but also the **price level** (dearer imports raise costs, **SRAS shifts left**); an **appreciation** does the reverse.

6.5 Policies to correct imbalances in the current account of the

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balance of payments

Policy	How it works	Limits
Expenditure-reducing (**contractionary fiscal or monetary**)	cuts **AD** and so **imports**	**lower growth**, **higher unemployment**
Expenditure-switching (**devaluation or depreciation, tariffs**)	makes **domestic goods relatively cheaper**	**elasticities**, **retaliation**, **inflation**
Supply-side (productivity, innovation)	raises **competitiveness** long term	slow, **costly**
Protection	cuts imports	**retaliation**, **less efficiency**

Policies are chosen according to the **cause** and **size** of the problem. **Trade-offs** with **growth, inflation and unemployment** must be weighed.

Stability of the current account is a government policy objective because **large persistent deficits** are costly to finance and can weaken the currency; governments aim for a **sustainable** balance rather than exactly zero.

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