

Unit 4

21 Characteristics and causes of globalisation

Activity 1

1 Globalisation is the increasing economic interdependence between countries. It is characterised by an increase in trade as a proportion of GDP, an increase in importance of transnational companies and foreign direct investment, and an increase in migration.

The extract gives reasons why exports and imports as a percentage of GDP have increased for the USA over recent decades.

Since the 1980s the USA has 'gradually opened up to cheap imports'. Trade liberalisation, promoted by the WTO, has meant countries like China, who often have a competitive advantage, can increasingly sell their goods to the USA. Consumers in the USA would demand these goods because they are cheap.

When China joined the WTO there was more certainty for firms in China that protectionist measures would remain the same or lower between China and the USA and other WTO members. This would have increased FDI into China and further promoted exports from China to the USA – hence imports for the USA.

In 1993 the USA joined NAFTA – a trading bloc – which would have promoted trade between the countries within this bloc. By 2018, the USA had 14 regional trade agreements. This means the USA has agreements with many countries to reduce or eliminate protectionist measures between them. This again would explain an increase in trade, both exports and imports, as a percentage of GDP for the USA.

Activity 2

1 Reasons include:

- The Vietnamese government has been very open to international trade and investment – this gives confidence to foreign firms to invest.
- Vietnam is a member of the CPTPP trading bloc – so trade barriers should be minimised for trade between member countries. This attracts FDI from TNCs who want to export within the bloc.
- Vietnam also has free trade agreements with the EU and South Korea – again this makes Vietnam a good base for a TNC who wants to export to these countries/blocs.
- Vietnam is close to China so firms in Vietnam can source goods/materials from China and maintain links with China's supply chains.
- Labour is cheap in Vietnam, even compared to China.
- Relatively young but skilled workforce – public spending on education is about 6.3 per cent of GDP.

2 The passage states that foreign investors are responsible for a quarter of annual capital spending. Capital spending is investment and will be an important source of actual and potential growth. This investment increases aggregate demand in the Vietnamese economy, so real GDP will rise. As a result, jobs will be created. Investment also promotes supply side growth. So real GDP rises without putting upward pressure on inflation. FDI is also likely to lead to technology and knowledge transfer skills to its workers. For example,

the passage states that at Saitex, a high-end denim manufacturer, workers must handle complex machinery. It is likely that TNCs provide good training for their workers. This helps to build up the quality of human capital in the Vietnamese economy.

3 The FDIs which are likely to have the most positive impact will be the ones which have the highest productivity gains and the ones which create the most links with local suppliers. However, this is not necessarily happening. The passage states that for Samsung, 'domestic suppliers provide it with little except plastic wrappings'. Supply chains have not been built up and more government support is needed to maximise this. This limits the benefits of FDI for Vietnam. Other factors not mentioned which limit the benefits might include TNCs involved in aggressive tax avoidance schemes, local firms finding it hard to compete, environmental concerns of TNC activity or the problems if a TNC suddenly relocates to another country.

Exam practice

1 (d)

2

(a) Exports = $12 \div 100 \times \$18,624 \text{ billion}$ = \$2234.88 billion

Imports = $15 \div 100 \times \$18,624 \text{ billion}$ = \$2793.6 billion

Net trade balance = exports – imports = \$2234.88 billion – \$2793.6 billion
= \$–558.72 billion

(b) Globalisation is the ever-increasing integration of the world's local, regional and national economies into a single international market. It is the increasing interdependence between countries. It is characterised by an increase in trade as a proportion of GDP, an increase in importance of transnational companies (TNCs) and foreign direct investment (FDI), and the increase in migration. Extract A suggests globalisation is slowing down in terms of FDI flows from developed countries towards developing countries.

However, Figure 1 in the Students' book shows a steady rise in exports for the USA, as a percentage of GDP, from approximately 5 per cent in 1970 to approximately 15 per cent in 2016. China has experienced a sharper increase in exports, as a percentage of GDP, over this period. This data therefore illustrates globalisation.

(c) The fall in FDI to developing countries is likely to have a negative impact. FDI often helps to import technology, production skills and better management. Technology and know-how transfer skills, through FDI, bringing supply-side gains to an economy. A fall in FDI inflows into developing countries will therefore slow down potential growth and poverty reduction. 'FDI inflows were well below the level needed to achieve the poverty reduction and other sustainable development goals agreed by the UN in 2015'. This is because a slowdown in real GDP per capita means living standards rise at a slower rate.

With fewer injections from FDI inflows, aggregate demand will increase at a slower rate so actual growth rates will fall.

A fall in FDI might also reduce tax revenue for the government. Again, government spending on essential areas such as health and education might fall because governments generally want to avoid high fiscal deficits. A fall in government spending on items such as health and education slows down poverty reduction and reduces potential growth.

The impact on developing countries will depend on whether the fall in FDI is sustained. FDI inflows fell in 2016, compared to 2015, but this may not be a long-term trend. However, there might be some concern about the size of the fall – FDI into emerging economies fell by 14 per cent over this period. It is also true that not all FDI brings a positive impact. The FDIs which have the most positive impact are the ones which have the highest productivity gains and the ones which create the links with local suppliers. This means the fall in some FDI inflows might only have a small negative impact. Some critics might also argue a fall in FDI can be beneficial. For example, fewer local firms destroyed by having to compete with TNCs.

(d)

Introduction

- Further globalisation means over time there would be an increase in trade as a proportion of GDP, an increase in importance of TNCs and FDI and an increase in migration.
- The factors which are likely to lead to this could be further trade liberalisation, further increases in the number and size of trading blocs, further increases in the number/size of TNCs, political change and further reductions in the cost of transport and communication.

First point

- The growth in the size and number of trading blocs might increase trade flows between member countries as protectionist measures between them fall. A regional trading bloc, particularly a large one, will be in a good position to negotiate with other trading blocs to reduce protectionist barriers and get good trade deals – all this increases trade flows between countries throughout the world. Since 2012 China has been negotiating a RCEP trade agreement. This is likely to increase trade flows between these countries – so their exports and imports would rise as a percentage of their GDP.

Evaluation

- The RCEP would be a very large bloc, including the world's two most populated countries. Its members could generate 31 per cent of world exports. This could be a significant factor. However, this agreement may not go ahead. It might be the case that further trading agreements slow down, so further globalisation might slow down.

Second point

- A further reduction in transport and communication costs would speed up globalisation. Transport costs have significantly fallen over the last 50 years due to containerisation. Transport costs might also fall with better infrastructure investment.

- Extract B mentions China's 'One Belt, One Road' initiative. This would 'speed up economic integration, both by land and sea'. The further growth of technology, such as the internet, also makes it possible for economic agents to communicate with each other. This may further increase trade between countries.

Evaluation

- The 'One Belt, One Road' initiative may be limited in its effect – Extract B says, 'if successful'. However, since China is such a large economy, the resources it invests into this infrastructure may significantly reduce transport costs across Eurasia, increasing trade in this region.

Third point

- Trade liberalisation over the last 50 years is a factor explaining globalisation in the past. The role of the WTO has helped this, and average tariff levels have fallen as well as non-tariff barriers. Extract B states that President Xi Jinping, president of China, wants to further promote trade by reducing protectionism. This would increase trade between countries if this is successful.

Evaluation

- If China is successful, at least in reducing trade between itself and some countries, then this might have a significant impact on speeding up globalisation, since China has a large impact on the global economy.
- However, the USA is currently keen to erect trade barriers. A trade war between the USA and China would significantly slow down globalisation as they are significantly large economies in the world.

Conclusion

- The extracts provide some convincing reasons why exports and imports, as a proportion of GDP, might further increase.
- However, the increase in protectionism between the USA and China might significantly undermine any other factors which would further increase globalisation. In this case, globalisation might slow down. If the trend continues with the fall in FDI flows, mentioned in Extract A, this would also slow down globalisation rather than speeding it up. However, if the RCEP is successful, then this would explain an increase in globalisation, at least in Asia and the western Pacific.

3

Introduction

- Globalisation: increased interdependence between countries; for example, increased trade as a percentage of GDP.

First point – Economies of scale

- Technical economies of scale have been achieved through containerisation in freight ships and lorries. This has reduced average transport costs. Standardisation of containers has made it quicker to load ships and lorries.

Evaluation

- This might explain globalisation in early part of the period, but not continued globalisation in recent decades.

Second point – Better transport infrastructure across the world

- As countries have invested in infrastructure, this improves efficiency of transport systems. Economic growth has been particularly high in some emerging countries. This allows governments to raise more tax revenue to fund infrastructure spending. Governments have also had an incentive to invest in infrastructure to attract FDI, which further helps their development and growth.

Evaluation

- This shows reduced transport costs might be an effect of globalisation and not just a cause; in other words, the increased significance of TNCs leads to a reduction of transport costs. This means other factors might be equally or more significant in explaining increased globalisation.

Third point – Other factors; for example, political changes

- The breakdown of the Soviet Union opened up countries to trade with the 'West'. These economies opened up to global international trade. Russia and China joined the WTO in recent decades. China in particular has sharply increased the amount of goods it exports as a percentage of GDP, as it is a low-cost producer.

Evaluation

- Likely to be a significant factor from the 1980s onwards. However, this effect will have now stabilised so globalisation may not increase further. In fact, it might slow down as the USA and China have been increasingly using restrictions on trade between themselves from 2016 onwards.

Fourth point – Trading blocs

- A significant factor is likely to be the growth and size of trading blocs. Over the last 50 years there have been trading blocs formed where a significant amount of trade occurs between member countries; for example, the EU. The free movement of goods and services creates trade between these members.

Evaluation

- This may explain globalisation within certain regions of the world, but it might not explain the growth of trade between countries outside the blocs. In this case trade liberalisation, promoted by organisations such as the WTO, might be more significant.

Conclusion

- There are many factors which explain the rise in globalisation – trade liberalisation, increased number and size of trading blocs, political change, reduced cost of transport and communication, and increased significance of TNCs. Some of these might be more significant over certain decades than others. It is also likely that the causes are interlinked, so no one factor is more significant than another.

22 The effects of globalisation

Activity 1

1 Possible benefits include:

- Improvement in global living standards
 - Globalisation can help to promote economic growth. There are a few reasons for this. One reason is export-led growth. Exports are an injection into the circular flow of income, so aggregate demand rises. Highly competitive global markets also promote efficiency – this leads to potential growth.
 - Inflows of FDI also promote both actual growth and potential growth. For example, the transfer of technology and skills promotes supply-side growth. The injection of investment also causes aggregate demand to rise in the case of greenfield FDI. There is a multiplier effect which results from this.
 - Immigration, particularly skilled labour, will also increase real GDP. Economic growth, when it leads to a rise in real GDP per capita, will help to increase living standards. Some workers' living standards might also rise for those industries where wages are pushed up as a result of globalisation.
 - 'In the decades after 1945, world trade increased rapidly, bringing with it a vast improvement in global living standards. Exports of goods rose from 8 per cent of world GDP in 1950 to almost 20 per cent a half century later. Export-led growth and foreign investment has dragged hundreds and millions out of poverty in China'.
 - 'Half of America's exports go to countries with which it has a free trade deal.'
- Increase in productivity
 - Increase in productivity and efficiency arises from efficiency gains as markets become more competitive. 'Exporting firms are more productive.' Productive, allocative and dynamic efficiency should rise.
 - FDI inflows can also result in productivity gains for an economy. For example, the transfer of technology and skills promotes supply-side growth.
 - Immigration of skilled labour should also help to transfer knowledge and skills – this may have a positive impact on increasing the quality of the stock of human capital.
- More tax revenue
 - A rise in real GDP should increase tax revenue. A rise in immigration can also add to government revenues. This helps government finances – helping a government to keep fiscal deficits low or enabling them to increase government spending on essential components such as health and education.

- 'Increased migration also brings benefits. For example, European immigrants who arrived in Britain since 2000 have been net contributors to government revenue, adding more than £20 billion (\$34 billion) to public finances between 2001 and 2011'.
- Lower prices
 - Trade liberalisation keeps prices low. This is because protectionist barriers are removed or kept low and also because more intense competition between countries keeps prices low. Consumers gain from this – their purchasing power increases. The passage states that this is particularly true for those on lower incomes.
 - 'Protectionism, by contrast, hurts consumers and does little for workers. The worst-off benefit far more from trade than the rich. A study of 40 countries found that the richest consumers would lose 28 per cent of their purchasing power if international trade ended; but those in the bottom tenth would lose 63 per cent. The annual cost to American consumers of switching to non-Chinese tyres after Barack Obama imposed anti-dumping tariffs in 2009 was around \$1.1 billion, according to the Peterson Institute for International Economics. That amounts to over \$900,000 for each of the 1,200 jobs that were 'saved'.'

Activity 2

1 As wage costs are so low in China, this gives Chinese firms a competitive advantage. Chinese firms will be price competitive in global markets. This means China was able to benefit from export-led growth. Rapid economic growth has lifted millions out of absolute poverty.

2 Many factories are relocating to cheaper countries in Asia as wage costs rise in China. China is beginning to lose its cost competitive advantage. This is causing structural unemployment in labour intensive manufacturing industries. These workers are finding it hard to find other jobs in higher tech industries and services because they are likely to be both occupationally ('more than two-thirds of workers laid off in recent years were poorly educated') and geographically immobile.

3 Other problems of globalisation for China mentioned in the passage:

- Rising inequality – there are many causes of rising inequality. Globalisation might have had some impact in widening inequality in China. For example, FDI inflows into China has created employment in TNCs. These companies are likely to pay a relatively high wage rate compared to local firms in China. This may increase inequality.
- Mass migration from the countryside to the cities – if a developing country attracts FDI, then these companies are likely to locate in areas where infrastructure links are more established. For example, they want to locate where transport links are good and also close to supporting local supplier firms. Cities and surrounding areas are therefore more likely to establish FDI, boosting the local economy. There are also likely to be fewer employment opportunities in the countryside, so workers will be attracted to the cities.

- Housing bubbles – globalisation has increased aggregate demand in China through export-led growth. As people in China become wealthier, they will start to invest in property for speculative reasons. This can fuel a housing bubble. Investors abroad will also start to invest in property in China, making housing bubbles more extreme.
- Environmental destruction – globalisation has helped China achieve rapid economic growth. The increasing demand for Chinese goods means production has increased. This is likely to lead to an increase in pollution and an overuse of natural resources. Economic growth can be environmentally sustainable but a developing country, such as China, is less likely to prioritise this in its early stages of development.

Activity 3

1 As countries develop, governments in emerging economies are likely to increase labour regulation to prevent worker exploitation. Their governments start prioritising this issue as poverty levels fall. TNCs who set up plants in developing countries are also under increasing pressure from stakeholders in developed economies to provide ethical working conditions in their plants abroad. At the same time, 'technology has also made it easier to monitor where and under what conditions things are made'.

2 Countries such as Bangladesh and the Democratic Republic of Congo are at lower levels of development so labour regulation laws which minimise worker exploitation will be non-existent or weak. Government resources might also be too low to monitor any laws which do exist. Child labour, such as child labourers being used to mine cobalt, might also be considered 'acceptable' by society and a vital source of income for many families.

Activity 4

1 Tax avoidance is when a firm is deliberately manipulating the tax system to pay less than their 'fair' amount. In the UK, the amount 'underpaid' in the year to March 2017 was estimated to be £24.8 billion.

Multinationals, compared to other firms, are more likely to pay less tax than the tax rules originally intended due to the opportunities they have to use transfer pricing, setting up offices in low tax countries and moving production facilities to a low tax country.

Transfer pricing is a way of reducing profits in one country and increasing profits recorded in another. The objective is to have the highest profits recorded in the country which has the lower tax rates. This arises when a multinational company makes a product X in country A and then transports it to country B to make into product Y, which it then sells. The notional price product X recorded on the transfer between countries will affect profits recorded on both countries.

Although multinationals have more opportunities to pay lower tax than they 'should', governments, such as those in the UK and Italy, are increasingly aiming to reduce tax avoidance. These governments are using more resources to help combat tax avoidance and to take firms to court.

Exam practice

1 (b)

2

(a) Index number for car and parts sales to Mexico in 1993

$$= \text{Car and part sales 1993} \div \text{Car and part sales in 2013} \times 100$$

$$= 10 \div 70 \times 100$$

$$= 14.3 \text{ (rounded to one decimal place)}$$

(b) Globalisation is the increasing economic interdependence between countries. It is the ever-increasing integration of the world's local, regional and national economies into a single international market. It is characterised by an increase in trade as a proportion of GDP, increase in importance of TNCs and foreign direct investment, and an increase in migration. Extract A says that 'many American firms have become tightly integrated across the southern border'. This illustrates interdependence and integration across countries. Exports to China have also grown by almost 200 per cent between 2005 and 2014. This illustrates one characteristic of globalisation.

(c) Globalisation leads to a fall in the prices of some goods and services because production is switched from high cost locations to low cost locations. Globalisation, via lower tariffs on imported finished goods, also contributes towards lower prices. Prices are also minimised for consumers as firms, who now have to compete on global markets, will need to be price competitive. To do this, firms are incentivised to be productive, allocative and dynamically efficient. As a result of lower prices, consumers will gain consumer surplus and their purchasing power will increase – it is estimated that 'trade with China alone put \$250 a year into the pocket of every American in 2008'. The increase in consumer surplus is a welfare gain. Lower income households may gain more proportionately because they spend a higher fraction of their income on food and drinks, and these sectors are characterised by more trade compared to some services. The rise in trade, with countries such as China, also creates more choice for the American consumer.

(d) Extract A talks about exports to China rising by 200 per cent between 2005 and 2014. This leads to export-led growth, since exports are an injection into the circular flow of income, so real GDP will rise. The overall impact will depend on the value of the multiplier. The extract states that trade has created new markets for American firms.

As emerging economies gain from rapid economic growth, as a result of globalisation, these countries' real GDP per capita increases rapidly. This increase in income will create a growing demand for goods and services produced in the USA; particularly for those goods whose demand is income elastic. China's urban middle class is set to double over the next decade, so the USA is likely to increase its exports substantially, which means the impact on the USA's economic growth should be significant.

The extract also states that America can compete to provide goods and services which China's growing middle class might demand. Globalisation, by increasing competition, helps to promote efficiency as firms strive to remain price competitive in global markets. A rise in efficiency will promote potential growth for the US economy. Extract A states that further trade liberalisation, created by removing non-tariff barriers across the Atlantic which would lead to further globalisation, would increase GDP in the US by up to 3 per cent. This is likely to be due to both efficiency gains and export-led gains.

Figure 1 in the Students' book shows that economic growth, although generally positive between 1990 and 2018, has been consistently lower than China. This might suggest China has gained more from globalisation than the USA. This is not surprising since China has gained significantly from export-led growth, as a result of globalisation, due to its lower wage costs.

However, the impact of globalisation may have some negative impact on economic growth in the USA. Cheap imports from China increases consumers' purchasing power but can cause structural unemployment in some US industries. If some US industries cannot compete, then this might lead to unemployment, particularly when workers are occupationally and geographically immobile. So actual growth may be constrained by globalisation, at least in the short run. If government policies are in place to retrain workers, the impact on reducing economic growth can be minimised.

(e)

Introduction

- Costs of globalisation often include displacement of workers, exploitation of workers, environmental impact of increased trade, loss of tax revenue from transfer pricing, increased income inequality and the influence of TNCs on domestic policy.

First point

- Extract B states that about 1 million out of 5.5 million manufacturing jobs were lost in the USA between 1999 and 2011 to Chinese competition. In some industries, Chinese firms can produce almost identical products, but at a lower cost. In this case, US firms would be forced to close. The transfer of many manufacturing production activities to low-cost countries has caused structural unemployment in traditional manufacturing industries in the USA.

Evaluation

- Critics argue that many of these job losses are caused by technological advances in production, rather than globalisation.
- This might only be a short run cost. The US government should have resources available to retrain workers and provide an education system which helps people have a range of skills.

Second point – An increase in inequality

- Extract A states that more complex tasks are done in the USA. This increases the demand for skilled labour and pushes up wages for skilled workers. At the same time, if unskilled workers in the USA are effectively having to compete with workers in

- low cost countries such as China, this will depress the wages of unskilled workers in the USA. This is supported by the data 'unskilled workers' wages were depressed by 10 per cent in 2011'. At the same time the college premium has increased.

Evaluation

- Although globalisation has contributed to the increase in wage differentials, other factors might be more significant in explaining this. The effect of trade on the college premium is only responsible for one-third of the rise in the college premium.
- The impact will depend on how governments respond. If the quality of education is improved, then the supply of skilled labour will increase, so wage differences will not be as large.

Third point – Exploitation of workers

- Trade with poor countries has depressed unskilled workers' wages. It might be the case that firms have exploited the argument that job losses might result, as a result of globalisation, if workers push for higher wages.

Evaluation

- This is less likely if trade union membership is strong in the USA. However, this is unlikely. The extent to which unskilled wages fall will depend on whether the USA has minimum wages and where these are set.

Conclusion

- The costs are likely to hit particular groups. Communities most affected have been called the distressed communities. The US economy is likely to have experienced both costs and benefits. It is also hard to say to what extent globalisation alone has created these.

3

Introduction

- Globalisation: increased interdependence between countries (for example, increased trade as a percentage of GDP). Most countries have experienced an increase in trade as a proportion of GDP, increase in importance of TNCs and FDI and an increase in migration.

First point – Higher economic growth

- Developed countries have to some extent gained from export-led growth. Exports are an injection into the circular flow of income. Aggregate demand rises. Real GDP increases.
- Potential growth also rises due to productivity gains, due to increasing competitive pressures.
- Lower import costs, which arise from opportunities to import from lowest cost countries in the world, also increase economic growth. SRAS shifts to the right, so real GDP increases.
- Immigration of skilled labour helps to raise productivity and fills labour shortages in important sectors, such as health care. Both potential and actual growth can result from immigration.

Evaluation

- However, rising imports reduces aggregate demand. Low cost imports will be substituted for domestic goods, resulting in falling real GDP. Firms in some industries in developed countries close down. Developed countries gain less from export-led growth compared to emerging economies because they have higher costs, partly due to labour market regulations such as minimum wages. Immigration may in some cases just displace domestic workers in developed countries – this limits any positive impact of immigration on economic growth.

Second point – Benefits to consumers

- Consumers in developed countries are likely to gain from lower prices. Lower prices are due to production switching from high cost locations to low cost locations, the increase in competition, as well as firms benefitting from economies of scale – both internal and external. Consumers gain from consumer surplus which increases their purchasing power.
- More choice for consumers. Some evidence that poorer groups have particularly benefited from lower prices, as they spend a higher fraction of their income and spending patterns show that more is spent on goods, such as food, which are traded more than some services.

Evaluation

- Globalisation is pushing up some prices, such as commodity prices.
- If globalisation depresses wage costs for some workers, particularly unskilled workers in developed countries, then this counteracts the fall in prices – so consumers may not end up being better off.
- Although choice would be expected to increase, globalisation has reinforced the power of multinationals, so these brands are increasingly dominating consumer markets.

Third point – Increased tax revenue

- If globalisation increases economic growth then this should raise tax revenue from income tax receipts, goods and sales tax receipts. More trade will also generate more tariff revenue.

Evaluation

- For developed countries, the extra tax revenue raised will depend on tax rates set. Likely to be more significant for developed countries because tax evasion is relatively low due to the efficiency of the tax system.

Fourth point – Higher living standards

- If globalisation leads to economic growth and rising GDP per capita, then living standards might rise. A rise in tax revenue, if it leads to higher government spending, could also raise living standards. For example, it gives government more scope to raise spending on welfare or health spending. Both of these improve quality of life.

Evaluation

- Only some groups may benefit. Evidence suggests wage differentials between skilled and unskilled labour has risen due to globalisation. Unskilled workers are also likely to be less occupationally mobile. This, combined with the higher probability of their jobs being displaced, means this group is vulnerable. If globalisation leads to an increase in inequality, then this also reduces happiness of those on lower incomes, but raises happiness of those with high relative income – psychological impact of income status, and so on.

Conclusion

- Although developed countries can gain from globalisation, there are likely to be high short-term costs. Structural unemployment has been caused in some industries, such as textiles, as developed countries cannot compete with low cost countries in these sectors. In the long run, developed countries can gain if labour is mobile and can be re-allocated into sectors where the country has a comparative advantage.
- If governments invest in education and training, the short-term costs can be minimised.

23 Specialisation and comparative advantage

Activity 1

- 1 Country Y has an absolute advantage in the production of phones.
- 2 Country Y has an absolute advantage in the production of computers.
- 3 For country X, the opportunity cost of producing two phones is four computers. Therefore, the opportunity cost of producing one phone is two computers.
- 4 For country Y, the opportunity cost of producing three phones is nine computers. Therefore, the opportunity cost of producing one phone is three computers.
- 5 Country X has a comparative advantage in the production of phones, because it only has to sacrifice the production of two computers to produce one phone; whereas country Y has to sacrifice the production of three computers to produce one phone.
- 6 Country Y has a comparative advantage in the production of computers. For country Y, the opportunity cost of producing one computer is one-third of a phone; whereas for country X, the opportunity cost of producing one computer is half a phone. So country Y sacrifices fewer phones to produce one computer.

Activity 2

- 1 In the UK, the cost ratio of meat to bread is 2:4, while in France it is 3:4. Therefore:
 - (a) England has a comparative advantage in the production of meat.
 - (b) France has a comparative advantage in the production of bread.

2 Before trade took place, total meat production in the two countries was 58 units while total bread production was 46 units. If the UK uses all its resources to produce meat, it can produce 60 units of meat (total man hours available $300 \div$ cost per unit in man hours 5),

while France can produce 50 units of bread ($200 \div 4$). Therefore, the two countries could produce two more units of meat and four more units of bread if both specialised fully and then traded.

3 The answer is set out in Table 1. The cost ratios in the first two columns have been multiplied up in order to make the comparison between the UK and France easier to see at a glance.

	UK	France	UK	France
(a)	5;10	10;10	Meat	Bread
(b)	35;70	30;70	Bread	Meat
(c)	5;10	5;10	Neither country has a comparative advantage	Neither country has a comparative advantage
(d)	5;10	5;10	Neither country has a comparative advantage	Neither country has a comparative advantage
(e)	5;10	4;10	Bread	Meat
(f)	15;30	10;30	Bread	Meat

Table 1

Activity 3

1

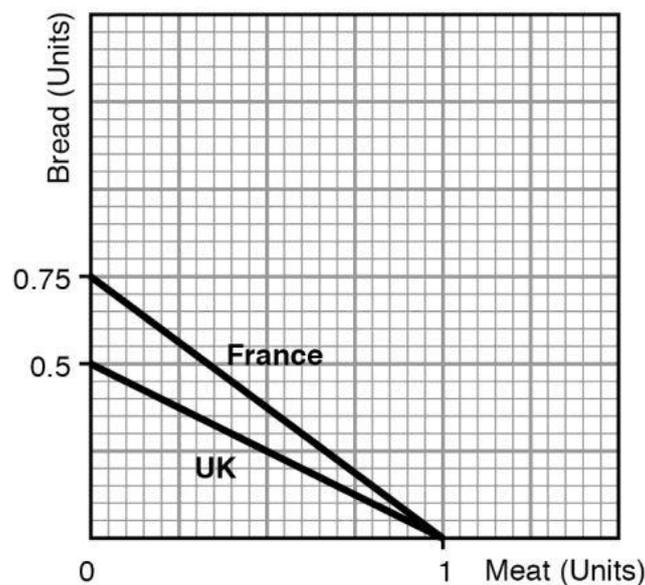


Figure 1

Note: Meat and bread can be shown on either axis. Also, any graph showing the ratios accurately would be correct. For example:

- both lines might start at the same point on the horizontal meat axis at 2 units for meat and go on the vertical bread axis to 1.5 units of bread for France and 1 unit of bread for the UK;
- both lines might start at the same point on the vertical bread axis at 20 units of bread and go on the horizontal meat axis to 15 units of meat for France and 10 unit of meat for England.

The graph given here in Figure 1 is the one that is easiest to use to answer Question 2.

2 Both countries will find it advantageous to trade if the price ratio lies between the two lines, which is between price ratios of 1 unit of meat to $\frac{1}{2}$ unit of bread and 1 unit of meat to $\frac{3}{4}$ unit of bread. This means that neither country would simultaneously find it advantageous to trade at any of the price ratios in questions (a) to (g). At best, if the price of meat to bread were $1:\frac{1}{2}$, the UK would be indifferent about whether to trade (it can produce meat and bread at this price ratio domestically anyway), whereas France would find it advantageous to produce bread and exchange it for meat from the UK.

Activity 4

1 Vietnam already had a comparative advantage in the production of those goods which used abundant and therefore relatively unskilled labour. However, producing parts in a supply network injected know-how transfer skills. It is now possible to create a specialism which slots into global supply chains. For example, Vietnamese firms learned management skills and technical skills from Honda's parent company. This, combined with abundant and cheap labour, created a new product specialism of motorcycle parts that could be slotted into this global supply chain.

2 If countries specialise in those goods in which they have a comparative advantage, then all countries can potentially gain from higher economic growth. Specialisation also increases productivity in an economy. This increases SRAS and LRAS, so increases actual and potential growth. Specialisation also implies countries need to trade if they are to obtain a wide variety of goods for consumption. Opening markets increases competition – this will further increase efficiency and so promote economic growth.

Exam practice

1 (c)

2

(a) A country has a comparative advantage in the production of a particular product or service if it can produce it at a lower opportunity cost compared to another country: it is relatively more efficient at producing it. If countries specialise in producing those goods in which they have a comparative advantage and then trade, world output can increase. As Extract A states, 'trade boosts productivity by promoting reallocation of resources, with production shifting towards sectors and firms with comparative advantage'.

- (b)** Extract A talks about the impact of trade on productivity. The opportunities for firms to trade in global markets and the need to remain competitive incentivises firms to maximise their productivity. This will reduce unit cost so they are able to price compete in global markets. The drive to increase productivity means firms will invest in process innovation – they will continuously want to find new methods of production which help them lower their average costs. When Brazil reduced its tariff barriers, this opening up of markets provided Argentinian firms the incentive to invest in new technology to take advantage of a potentially large export market available to them. This investment would increase productivity.

Trade also promotes specialisation as countries potentially benefit if they specialise in those goods in which they have a comparative advantage. Shifting production into those sectors where a country has a relative efficiency advantage, means productivity increases in the economy.

- (c)**
- Some countries have an absolute advantage in the production of a good because they can produce it using less factor inputs than other countries. However, even if a country has an absolute advantage in the production of all goods and services, the law of comparative advantage states that if countries specialise in the production of those goods and services in which they have a comparative advantage, then world output can increase. A country has a comparative advantage in the production of a good or service if it can produce it at a lower opportunity cost compared to another country. Provided the terms of trade lie between the two opportunity cost ratios, then both countries can gain. Their real GDP will be higher after specialisation and trade than if they had remained self-sufficient. In Extract A, the World Bank, IMF and WTO are making the case for trade as 'an engine of growth for all' If real GDP is higher, then real GDP per capita will be higher after specialisation and trade. This should increase living standards.
 - However, not all will gain – 'trade is leaving too many individuals and communities behind'. The increase in competition means industries that cannot compete with low cost imports from abroad will be forced to close down. Often these are located in particular regions, so whole communities feel the negative impact. For these individuals and communities, living standards will fall unless individuals are occupationally or geographically mobile or governments can provide adequate financial support.

(d)

Introduction

- Explanation of specialisation – Extract A mentions specialisation according to the law of comparative advantage. If countries specialise, then trade will be necessary.

First point

- Specialisation and trade can cause some structural unemployment – demand for labour lower than supply of labour in an individual labour market.
- Traditional manufacturing sector in America declined due to 'the impact of Chinese imports'.

- Structural unemployment often related to regional unemployment ‘America’s Midwest region hit hard’ – between 1990 and 2007 Chinese imports explained 44 per cent of the decline in employment in manufacturing in the USA. The number of people employed in manufacturing fell from approximately 20 million in 1990 to 15 million in 2007.

Evaluation

- Costs will be higher in the short run. It will take time for retraining – in the long run labour should be more occupationally mobile.
- Costs will be minimised if the education system in a country such as the USA prepares workers for the changing demand of the labour market and job search assistance is provided.

Second point – External shock to the economy

- Rising imports from China would cause a fall in aggregate demand.
- Real GDP falls.

Evaluation

- Overall impact on economic growth in the USA will depend on to what extent exports increase as a result of specialisation and trade. Falls in manufacturing activity should mean ‘production shifts towards sectors and firms with comparative advantage and higher efficiency’. This may promote export-led growth.

Third point – Inequality

- ‘Trade is leaving too many individuals and communities behind’. It is likely that competition from China hits sectors in the USA that employ more unskilled workers than skilled. This is because China has an abundant amount of unskilled labour employed in factories which are now directly competing with some US manufacturing firms. Inequality will rise in the USA between skilled and unskilled workers as job losses hit more of the latter group.

Evaluation

- This can be minimised if welfare payments adequately protect those who have lost their jobs and these workers quickly find new employment.

Conclusion

- If comparative advantage changes over time, then specialisation and trade can result in short-run costs to an economy. In the long run, resources reallocate. Governments can minimise short-run costs if policies improve occupational and geographical mobility.

3

Introduction

- Understanding of specialisation.

First point

- If specialisation is according to comparative advantage, countries can be better off after trade – world output increases. Living standards should rise. Explanation of law of comparative advantage. A country will gain provided terms of trade lie between opportunity cost ratios.

Evaluation

- A country may not be better off if terms of trade do not lie between opportunity cost ratios. The law also makes other assumptions which may be unrealistic.

Second point

- Specialisation means there are benefits of economies of scale. Lower LRAC – so this helps a country remain price competitive in global markets. Consumers will also benefit if these lower costs are passed on to consumers. Higher consumer surplus.

Evaluation

- Possibility of diseconomies of scale.

Third point

- Specialisation leads to productivity gains – labour and capital productivity likely to rise. SRAS and LRAS increase. Actual and potential growth. More competition also increases efficiency, promoting growth.

Evaluation

- Countries might become too dependent on a few types of export. If demand suddenly falls, this leads to a demand-side shock. Real GDP will fall. This would result in large-scale structural unemployment.

Fourth point

- Specialisation and trade might create export-led growth for some economies. This generates economic growth and employment. Extent depends on the multiplier effect.

Evaluation

- Some countries might end up importing far more than they export. Imports withdraw from circular flow of income. Increased vulnerability to external shocks – developing countries that specialise in primary products experience a demand-side shock when commodity prices fall.

Conclusion

- Although potential for gains, there are weaknesses in the comparative advantage model. It is also unclear to what extent countries can specialise as many factors of production are immobile in practice. Whether an individual economy gains is likely to depend on what it specialises in and how demand for that changes over time. Some countries may also become overdependent on crucial imports.

Note: Aim to bring some real-world examples into your discussion; for example, costs to America, gains to China.

24 Patterns and volume of world trade

Activity 1

1 Trade flows between Mexico and the EU are likely to increase – both exports from the EU to Mexico as well as exports from Mexico to the EU. The extra flows will be in agricultural goods, which had previously been excluded from any trade agreement. However, a bilateral trade agreement between the EU and Mexico has recently been agreed for agriculture. In the past, liberalisation of trade between the two applied mostly to industrial products.

The removal or reduction of non-tariff barriers and tariff barriers, applied to EU agricultural products, will mean more EU agricultural goods will be imported into Mexico. Similarly, Mexico will be able to export more orange juice, fruit and vegetables to the EU since trade barriers applied to these by the EU have been reduced or eliminated.

Activity 2

1 Changes to the patterns of trade include:

- Exports to China from the USA have become a bigger proportion of its exports since the early 2000s.
- In contrast, China's exports to the USA have become a smaller proportion. This is probably because many emerging economies have experienced rapid economic growth over this period. As a result, import spending in emerging economies will rise proportionately faster than import spending in the USA, over this period.

2

- In 2017, China bought about 10 per cent of all goods exported by the USA. By comparison, the USA bought about 20 per cent of all goods exported by China. However, since 2000, the proportion of exports to China from the USA had been on an upward trend, whereas the proportion of exports to the USA from China had been on a downward trend.
- A trade war between China and the USA would be likely to reduce trade flows between these countries, particularly in certain goods where tariffs have been targeted. For example, hi-tech and industrial sectors in China will export less to the USA. The USA would see exports of soya beans and other agricultural products reduce if tariffs are imposed by China. As a result, these two countries would likely

- target the sale of these goods to other international markets. World trading patterns would be likely to change but the extent to which this happens would depend on how large other markets become for China and the USA. For example, if India experiences rapid economic growth, then the effects might be more significant.

Activity 3

1

- If an economy is recovering from a recession, then it is moving from negative economic growth to positive economic growth. This increase in income will lead to more imports (the marginal propensity to import links a change in national income to a change in imports). If countries across Asia, Latin America and central and eastern Europe experience positive growth, then the rising demand for imports for one country is a rise in exports for another. Pulling out of a recession also implies business confidence is rising, so firms in emerging economies will be more confident to invest in new plant capacity and invest in innovation. Both of these will promote exports as production capacity increases and the goods from these firms become more price and non-price competitive.
- The trade elasticity is forecast to rise to 1 in 2017, from 0.6 in 2016, so the increase in economic growth in emerging economies will have more impact on volumes of world trade.

2

- The extract states that emerging markets have increased their exports of merchandise trade (commodity and manufacturing goods) in volume terms by 29.1 per cent since January 2008. This compares with only an 8.3 per cent increase by developed countries. This shows that export flows of merchandise goods from developed countries are growing at a slower rate than emerging economies. This is not surprising as emerging economies are likely to have cost advantages and comparative advantage in the production of these goods.
- Emerging economies are increasing their share of the world trade in goods. It is likely that developed economies are exporting more services and hi-tech goods.

Exam practice

1

- (a) 'Patterns of trade' refers to what types of goods and services countries or groups of countries export and import, who they trade with and how their trade volumes compare. For example, of total UK exports, two-fifths are services. Figure 8 in the Students' book shows that since 1999, UK exports to China have grown at a faster rate than to India and Malaysia. This is likely to reflect the different economic growth rates of these countries. China has achieved rapid economic growth so this will cause demand for imports into China to rise quickly.
- (b) During 2016, the value of the pound fell by 17 per cent against the US dollar and was down 14 per cent against the euro. A fall in the value of the pound makes UK goods and services more price competitive in the USA and in the Eurozone. This should increase UK exports to these countries; particularly to the USA where the fall in the value of the pound was greater. At the same time, imports from the USA and the

Eurozone countries become more expensive. So, demand for these imports should fall. So, export volumes are likely to rise and import volumes are likely to fall for the UK for trade between the UK and the USA/Eurozone. In this way, the UK's trading patterns will change.

(c)

Introduction

- The impact of rapid economic growth of emerging economies on the UK's trading patterns refers to how the UK's export and import patterns change as a result. For example, will UK exports increase or decrease? Will the composition of the types of goods exported and imported change? Will the destination of UK exports change? Will the UK import more goods from emerging economies?

First point – Increase of UK exports to emerging economies

- By 2016 China was already the UK's sixth biggest export market for goods and the seventeenth biggest export market for services (Figure 4 in the Students' book). The UK's exports of goods and services to China has increased at a much faster rate than India, during the period 1999 to 2016, largely because China's real GDP per capita growth was higher than India's. This suggests that rapid economic growth in an emerging economy will cause the proportion of the UK's exports to these markets to increase over time. It is likely that the UK will see the demand for its services rise more quickly, because the UK has a comparative advantage in the production of services and the YED (income elasticity of demand) tends to be elastic.

Evaluation

- How quickly the UK increases the proportion of goods and services it exports to emerging markets will depend on how long and to what extent economic growth in emerging markets remains higher than developed economies. It will also depend on the income elasticity of demand in emerging economies for the types of goods and services the UK produces.
- High economic growth in countries with large population growth too, such as India and Pakistan, will have a larger impact on UK export growth.

Second point – Geographical distance

- From Extract A, analysis by PwC states that 'halving the geographical distance to a market roughly doubles the volume of exports sold'. This suggests that rapid economic growth for emerging economies which are far from the UK, in terms of distance, will have limited impact on the UK's trading patterns.

Evaluation

- However, over time, transport and communications methods may improve with technological advances, so this constraint will be less significant.

Third point – Rapid economic growth

- Rapid economic growth in emerging economies is likely to change the types of goods and services these economies produce and may change their comparative advantage. For example, China is beginning to lose some of its cost advantages

compared to other emerging economies as wage costs are rising faster. This may therefore change the composition of the types of goods and services the UK exports and the types of goods and services it imports from these countries.

Evaluation

- Rapid economic growth might have more impact on UK trading patterns if the UK establishes trading deals with these economies too. When the UK leaves the EU, there will be more opportunities for bilateral trade deals between the UK and some emerging economies – so both UK exports and UK imports should increase.

Conclusion

- The long-run impact is likely to be more significant, as by then new trade deals might also have been established between the UK and some emerging economies.
- The impact might depend on to what extent geographical closeness remains important.
- Those emerging economies with fewer language constraints and similar legal systems might be expected to have more impact on UK trading patterns.

2

Introduction

- Understanding of patterns of trade.

First point – Exchange rate

- A fall in the value of a currency will increase the price competitiveness of exports but make imports more expensive. This is likely to increase export volumes and reduce import volumes.

Evaluation

- Depends to what extent the exchange rate changes and, more crucially, whether the change is over a sustained period. A short-run change is unlikely to affect patterns of trade.
- Depends on price elasticity of demand. In the short run PED is more likely to be inelastic, so import volumes may not fall significantly until substitute firms in the domestic market are found.

Second point – Trading blocs and bilateral trading agreements/leaving a trading bloc

- For example, once the UK leaves the EU, there is likely to be some higher trade barriers between the UK and EU countries. This would be expected to reduce UK trade flows – both exports and imports – between the UK and other EU countries. Leaving the EU provides opportunities for new trade agreements between the UK and countries outside the EU. Potential for UK to join a new trading bloc. So, destination of UK exports might change significantly as well as which countries the UK imports from.

Evaluation

- Impact will depend on how much tariff and non-tariff barriers change between different countries. This may be offset by geographical considerations – some countries located far away may be more difficult to trade with.

Third point – Changes in comparative advantage

- Comparative advantage can change over time. A country has a comparative advantage in the production of a good or service if it can produce it at a lower opportunity cost compared to another country. This can change over time – for example, education and training programmes might help to shift a country's comparative advantage towards a new specialism. FDI transfers new skills, such as management and technology skills to workers and the economy; this can change a comparative advantage for a country. This will then change a country's pattern of trade.

Evaluation

- But the law of comparative advantage is based on unrealistic assumptions such as perfect mobility of resources, so changes in patterns of trade may not be explained by this.

Fourth point – Impact of emerging economies

- Rise in emerging economies has often explained the loss of manufacturing in developed economies. Hence, exports of goods can become a smaller proportion of exports for these countries.

Evaluation

- But technological advances mean TNCs are increasingly bringing manufacturing back to developed economies as production can be largely capital intensive. Some emerging economies are also losing their cost advantages, so TNCs starting to leave.

Conclusion

- Many factors cause changes in the pattern of trade for a country over time. Different impacts more or less important for different economies. For example, a dramatic event, such as the UK leaving the EU, may create a fairly significant change.

3

Introduction

- The volume of world trade increased significantly between 1945 and the Global Financial Crisis of 2007–08. The volume of trade grew on average 1.5 times faster than world GDP. During the financial crisis the volume of world exports fell. After the crisis, the volume of trade picked up but at a slower rate.

First point – Low growth in world GDP

- Low growth in world GDP would be expected to slow down the growth in the volume of world trade. The relationship between growth in world GDP and volume of trade is positive. This means if growth in world GDP increases, then volume of world trade

increases. After the Global Financial Crisis, recovery was slow for many economies. For example, weak growth in the Eurozone. China's economic growth also slowed down, which had a big impact on world growth. This would reduce consumption and therefore reduce imports. As a result, the growth in the volume of world trade would be low.

Evaluation

- However, since the Global Financial Crisis the ratio of trade growth to world GDP growth has been lower than before the crisis. This suggests that factors other than world real GDP growth influence the growth in the volume of world trade. So although world GDP growth is an important factor, it is not sufficient on its own.

Second point – Protectionism

- Slow growth in world trade might also be caused by rising protectionism. If countries such as the USA and China were to be involved in a trade war, then this would significantly reduce trade flows between these countries. Because these are large economies, the impact on the volume of world trade will be significant.

Evaluation

- Protectionism might be a more important factor in the short run. The WTO will try to promote trade liberalisation and resolve trade disputes.

Third point – TNCs

- In the past, TNCs considered developing countries a good location for foreign direct investment. Producing goods in these countries enabled TNCs to take advantage of lower production costs abroad. The volume of trade has partly slowed down because many are now moving production back to developed countries. This is because advances in technology enable capital-intensive methods to take place in developed economies without losing price competitiveness. Wage costs are also rising in some emerging economies, so imports of some goods are falling.

Evaluation

- As some developing countries grow, such as Bangladesh, then development in these countries might start attracting more FDI. For example, these countries might increasingly offer skilled labour but still at low cost. Once infrastructure is better developed, some economies will start to attract FDI. This would then increase the volume of trade as production moves to low cost countries and is then exported to developed ones.

Fourth point – Trading bloc, bilateral trading agreements

- The slow growth in the volume of world trade might also be caused by the slowing down in the growth of new trading blocs or trade agreements between countries breaking up. For example, the UK is leaving the EU, so the volume of trade between the UK and EU countries might fall.

Evaluation

- However, a country is likely to find new trade agreements with other countries to compensate.

Conclusion

- The slow growth in world real GDP is likely to be a significant factor to explain the slow growth in the volume of trade. This is largely because a slow-down in income for a country will slow down consumption and therefore imports. However, other factors will explain some changes in the volume of world trade over a particular period.

25 The terms of trade

Activity 1

1

Year	1	2	3	4	5	6
Index of export prices	105	99	95	97	100	110
Index of import prices	110	107	105	102	100	105
Index of terms of trade	95.5	92.5	90.5	95.1	100.0	104.8

Table 1 (rounded to one decimal place)

2

(a) The terms of trade improve between:

- Years 3 and 4
- Years 4 and 5
- Years 5 and 6

This is because there is an improvement in the terms of trade when its numerical increases. This is when export prices rise relative to import prices.

(b) The terms of trade deteriorate between:

- Years 1 and 2
- Years 2 and 3

This is because there is a deterioration in the terms of trade when its numerical falls. This is when export prices fall relative to import prices.

Activity 2

1 The index of terms of trade = index of export prices \div index of import prices \times 100.

There has been a downward trend in Spain's terms of trade between 2007 and 2017. In 2007 the index of the terms of trade was 100. By 2017, this had fallen to approximately 94.5. This shows that Spain's terms of trade have worsened over this period. Export prices have fallen relative to import prices. However, there have been some fluctuations over this period. The index of terms of trade peaked at approximately 102 in 2009. Its lowest value of 94.5 has occurred in both 2012 and 2017.

Exam practice

1 (b)

In 2014 Russia's terms of trade were higher than in 2016. This means export prices were relatively higher than import prices in 2014, compared to 2016, so a given quantity of exports would buy more imports in 2014, compared to 2016.

2

(a) 'Terms of trade' is defined as the ratio of export prices compared to import prices. They are calculated as an index. The index of terms of trade = $\text{index of export prices} \div \text{import prices} \times 100$. In Figure 2 in the Students' book, Australia's terms of trade improved between 2000 and 2008, the index of the terms of trade increased from about 50 in 2000 to approximately 85 in 2008. Between 2011 and 2015, its terms of trade fell. Its terms of trade worsened over this period because in 2015 it was not able to buy as many imports, compared to 2011, with a given quantity of exports.

(b) The terms of trade are the ratio of export prices to import prices. They are measured as an index. The index of terms of trade = $\text{index of export prices} \div \text{index of import prices} \times 100$. Sub-Saharan Africa's terms of trade fell by 16 per cent. This means export prices fell relative to import prices.

Nigeria and Angola are two big oil exporters in the region. A fall in commodity prices, such as oil, caused the fall in the terms of trade. Since demand for oil is relatively inelastic, a fall in oil prices would have caused export revenues to fall in this region. This would have reduced export-led growth. Extract B states 'growth across the region slowed to about 3 per cent in 2016, down from 7–8 per cent a decade ago'. Living standards are often measured as GDP per capita. If growth slows to about 3 per cent and population growth is 2.7 per cent, then this means real GDP per capita will only record a very slight increase. It may stay stagnant in practice. A decade previously, with growth of 8 per cent and population growth of approximately 3 per cent, real GDP per capita would have increased by about 5 per cent over the year.

(c)

Introduction

- Understanding of terms of trade
- Understanding that a fall in the terms of trade is a worsening of the terms of trade. Australia can buy fewer imports with a given quantity of imports.
- Cause of terms of trade fall is the drop in the prices of Australia's main exports, iron ore and coal, which fell between 2011 and 2015 with only a slight rebound since then.
- Balance of trade in goods and services is exports – imports.

First point – Export revenues are likely to fall for Australia

- Demand for commodities, such as iron ore and coal, is likely to be price inelastic, so a fall in commodity prices would reduce export revenue. Extract A states that the fall in the terms of trade caused incomes to fall and unemployment to rise; this suggests export-led growth fell and therefore that export revenues fell. This would cause the balance of trade to deteriorate. Injections into the circular flow of income fell.

Evaluation

- Commodity exports make up over one half of all Australia's exports, so negative impact on balance of trade will be significant.

Second point – Australia's import values might also fall

- Australia's top two import categories are personal travel services and passenger motor vehicles. Since incomes in Australia have fallen as a result of the fall in the terms of trade, this is likely to reduce the demand for these imports. Demand for personal travel services is likely to be income elastic, so fall in incomes will cause demand for this to fall by a greater percentage. Import volumes might fall significantly, so the balance of trade might improve.

Evaluation

- How import values change will depend on the YED (income elasticity of demand) for imports and how much income has fallen in Australia as a result of the fall in commodity prices.

Third point – Australia may diversify its economy

- Australia may diversify its economy away from commodities if the terms of trade remain low. At the moment exports are dominated by commodities, with iron ore representing a 16.3 per cent export share and coal 12.8 per cent in 2016. However, the Australian government might introduce policies to encourage diversification in Australia's economy.

Evaluation

- The long-run impact of a fall in the terms of trade may change if Australia moves away from commodities. With other types of exports, a fall in the terms of trade, caused by a fall in export prices, might increase export revenues, so improving the balance of trade. If demand for exports is price elastic, then the balance of trade might improve.

Conclusion

- A fall in the terms of trade has had an almost direct relationship on the trade in goods, exports, for Australia. When Australia's terms of trade were at their highest index of 100 in 2011, Australia's export revenue of goods was approximately 270,000 million US dollars. By 2015, this had fallen to approximately 190,000 million US dollars. So the balance of trade is likely to have deteriorated, although import value data is needed to know precisely how much.

3

Introduction

- Understanding of terms of trade.
- Method of calculation.
- Improvement and worsening of terms of trade.

First point – Change in exchange rate

- Depreciation worsens the terms of trade./Appreciation improves terms of trade.
- Factors which affect the exchange rate will therefore affect the terms of trade; for example, a rise in interest rates should lead to an appreciation of the exchange rate.

Evaluation

- As the exchange rate often fluctuates in the short run, it will be underlying trends in the movement of the exchange rate which will be more significant.

Second point – High relative productivity rates

- High relative productivity rates may worsen the terms of trade. A rise in productivity compared to a country's main trading partners should reduce the relative price of exports.

Evaluation

- A rise in productivity may not occur throughout all sectors of the economy. If productivity gains occur in export industries, then the terms of trade should fall more significantly. A rise in productivity may be more likely in export industries as these sectors face more competition. Competition promotes innovation and productivity gains.

Third point – Change in the price of commodities

- The price of commodities is set globally. A country which is a commodity net exporter will experience an improvement in its terms of trade when the price of commodities increases.

Evaluation

- The impact of commodity prices on the terms of trade will impact some economies more than others. For example, the price of oil will be highly important in Saudi Arabia in explaining the index of export prices.

Fourth point – Relative labour costs

- Changes in relative wage and non-wage labour costs will affect the terms of trade. For example, trade union power may weaken in one economy but increase in another. A rise in relative labour costs will increase costs of production and push up prices. Export prices will rise relative to import prices.

Evaluation

- The impact of rising labour costs on the terms of trade will depend on whether a country tends to import and export labour-intensive or capital-intensive goods and services.

Conclusion

- Any factor which affects relative price of exports and imports will affect the terms of trade. For example, an increase in tariffs imposed on Chinese goods by the USA would cause the terms of trade for the USA to fall. Different factors will be more important at different times. For example, rapid growth of BRIC (Brazil, Russia, India, China) economies would cause a favourable movement in the terms of trade for net commodity exporters.

4 Try to include some real-world knowledge – the use of activities or reading the ‘Thinking like an Economist’ helps to do this. For example, the discussion on Japan’s improvement in the terms of trade.

Introduction

- Understanding of terms of trade.
- Understand that an improvement in the terms of trade means export prices increase relative to import prices.
- Measures of economic performance – balance of trade, unemployment rate, inflation rate, rate of economic growth.

First point

- Balance of trade likely to deteriorate. A country might be losing price competitiveness in international markets.

Evaluation

- Although this depends on the PED for a country’s exports and imports.
- For commodity net exporters, an improvement in the terms of trade more likely to improve the balance of trade since PED for commodities likely to be inelastic – so export revenues increase.

Second point

- If balance of trade worsens, then aggregate demand falls. So demand-pull inflation should fall. Rate of inflation would also fall if lower import prices had caused the improvement in the terms of trade.

Evaluation

- The extent the rate of inflation falls depends on level of spare capacity in the economy and the size of multiplier.

Third point

- Economic growth rates should fall if aggregate demand falls. Real GDP falls and cyclical unemployment increases. Use of AD/SRAS diagram.

Evaluation

- However, if improvement in the terms of trade was caused by falling import prices, then cheaper imports increases the SRAS so real GDP increases.

Fourth point

- If aggregate demand falls, then this might improve the environmental performance of the economy as production falls. Fewer non-renewable resources are used, fewer negative externalities.

Evaluation

- However, for most developed economies economic growth associated with environmental protection – more investment in green technology.

Conclusion

- Impact of an improvement in the terms of trade is hard to predict. PED for both imports and exports likely to become more elastic over time, so any negative impact likely to be stronger in the long run. Whether impact positive or negative might also depend on the current state of the economy. Impact will depend on what has caused the improvement in the terms of trade.

26 Trade liberalisation and trading blocs

Activity 1

1 Countries such as Vietnam and Peru are likely to benefit from cheaper wage costs, compared to the more developed member countries of the CPTPP trading bloc. The removal of trade barriers between the member countries will lead to trade creation as countries will buy goods from those who are lower cost producers. Vietnam and Peru will have a price competitive advantage, compared to other countries in the trading bloc, for the goods and services they produce. This means Vietnam and Peru are more likely to experience a significant increase in exports, compared to others. They will achieve more export-led growth. The extract states that these economies are expected to expand by 2 to 3 per cent more than they would have done, by 2030, as a result of joining the CPTPP trading bloc. This is higher than the average gain for the bloc as a whole.

Consumers in the trading bloc will gain from lower prices and more choice. Lower prices result from increased competition. With free trade, competition increases. Firms will need to remain price and non-price competitive. They will therefore have an incentive to increase efficiency, where possible, so they can remain competitive. This will result in lower prices to consumers. With a large market for firms to target, firms can gain from economies of scale which further help to reduce average costs that can be passed onto consumers in the form of lower prices. However, this assumes that markets do not become increasingly oligopolistic within the trading bloc. Even if the latter happens, consumers might gain if abnormal profits are used to fund innovation into new products. In this case consumers will gain from the development of new product ideas.

Activity 2

1 The WTO has two main aims. First it aims to reduce restrictions on free trade. It encourages member countries to lower protectionist barriers, such as tariffs and quotas, between its member countries. Secondly, it aims to make sure member countries follow the trading rules.

The USA has promised tariffs on aluminium and steel. Strictly speaking, the USA is acting legally under WTO rules because it has stated that it is acting in the interest of national security. However, the EU is arguing that the US move appears to be a 'safeguard' action which would mean that the EU can respond by imposing tariffs of its own. As a result, the EU is proposing tariffs on US Harley Davidson motorcycles. The EU appears to be stretching the rules to erect protectionist barriers on the USA. This will increase protectionist barriers between the EU and the USA, the very thing that the WTO wants to avoid. This may then spark a trade war. The EU seems to be deliberately interpreting the actions of the USA in such a way that would 'allow' it to impose protectionist measures themselves. The EU seems to be acting without involving the WTO in settling the dispute. Other countries might also start either using the national security rule or 'safeguard' response, when it is not entirely appropriate. All these actions go against the aims of the WTO, which is to reduce protectionist measures between its member countries and for trading rules to be followed in the spirit in which they were designed.

Exam practice

1

- (a) From Figure 1, the percentage of EU merchandise exports to North America in 2015 was $100 - (69.5 + 6.5 + 1.7 + 3.1 + 10.2) = 9$ per cent.

If the value of EU merchandise exports was \$5389.4 billion, then the value of EU merchandise exports to North America = $9 \div 100 \times \$5389.4$ billion = \$485.05 billion (2 d pl)

- (b) Membership of AfCFTA will see tariffs cut from their current average of 6.1 per cent to eventually zero. The removal of these tariffs will reduce prices in the member countries.

Extract A also states that 'As we trade more among ourselves, African firms will become bigger, more specialised and more competitive internationally'.

Prices will fall because the removal of trade restrictions will increase competition for firms. As markets become more competitive, it will be important for these firms to remain both price and non-price competitive. This will promote efficiency, so enabling prices to fall.

If firms increasingly specialise, then this should also increase productivity, so reducing unit costs and prices.

As 44 African countries signed the free trade agreement, this suggests that there is scope for large economies of scale gains. If firms can reduce their average costs as they target a large market, this will help to reduce prices for consumers.

- (c) Intra-African trade accounted for only 15 per cent of all trade in Africa in 2017. Only 24.2 per cent of all merchandise exports from countries within ECOWAS, an existing African trading bloc, were exported to African countries.

Intra-African trade should increase as a result of a continent-wide trade agreement. AfCFTA has 44 member countries signed up in Africa. The extract suggests that this is bigger than existing trading blocs, such as ECOWAS, in Africa. With more members, trade creation is likely to occur. With trade barriers reduced or removed,

some countries will now be able to import some goods from a lower cost producer inside the bloc. This will increase trade within the bloc. The extract also states that lower barriers to trade within the bloc will make it easier for African countries to develop regional supply chains. A regional supply chain means raw materials, components and finished goods will be exported and imported between African countries throughout the production process, so many intra-trade transactions will take place, increasing the volume of intra African trade. However, the impact might be limited. Firstly, poor infrastructure in Africa restricts the movement of goods, this will constrain the growth of intra-African trade. Also, excessive time spent at customs and borders increases barriers to trade between African countries. But in the long run a single currency, with lower transaction costs within Africa, and improved infrastructure should mean intra-African trade can increase more significantly.

(d)

Introduction

- Introduction of trading blocs – free trade between members; 44 member countries of AfCFTA.

First point – Trade creation: continent-wide agreement

- Countries can move from high cost producer to lower cost producer. Trade is created. More choice and lower prices for consumers.

Evaluation

- Although trade is created, trade diversion may take place if AfCFTA imposes external tariffs on countries outside. However, AfCFTA is a free trade agreement, so unless it moves to a customs union, this problem would not arise.

Second point – More exports

- African countries might be able to export more finished goods. More regional supply chains.
- Extract A states that lower barriers between African countries might enable African economies to start producing more finished goods rather than just raw materials. This might be beneficial as it might give Africa scope to benefit more from export-led growth. This will be an injection into the circular flow of income.

Evaluation

- Although African countries are likely to have a cost advantage, compared to many economies globally, there might not be the expertise or know-how to produce many types of goods and services.

Third point – Increase competition

- The increase in competition, due to free trade between more countries, might promote greater efficiency-productive, allocative and dynamic efficiency. This should promote supply-side growth (potential growth). A more intense competitive environment should also reduce prices. Consumers will gain consumer surplus.

Evaluation

- Non-tariff trade barriers are likely to remain high, so reducing the potential gains. Extract B talks about poor infrastructure reducing trade volumes as well as port handling and customs costs.

Fourth point – Economies of scale

- With 44 countries having signed this agreement, this trading bloc will be bigger than previous regional trading agreements. More scope to benefit from economies of scale. Consumers will gain from lower prices. African firms will also become more competitive if average costs can be further reduced.

Conclusion

- High potential benefits but depends on to what extent non-tariff trade barriers can be reduced. More likely to be gains in long run when infrastructure has improved.
- Some limitation of gains. At the moment Africa's two largest economies – Nigeria and South Africa – have not yet joined.
- In very long run the gains are potentially bigger if Africa adopts a single currency – this removes transaction costs.
- Some countries may benefit; some might lose – for example, those at the centre geographically may be more likely to gain. Those with better infrastructure more likely to gain.

2 Integrate some real-world examples.

Introduction

- The WTO has two main aims: reducing restrictions on free trade between member countries of WTO and making sure member countries follow the trading rules.

First point

- They do conflict because a trading bloc only has free trade between its members. A trading bloc which is a customs union will impose a common external tariff on countries outside the bloc. In practice the gains from trade creation may be less than the losses from trade diversion.

Evaluation

- An RTA may be better than no agreement at all.
- If new members join over time, this gets closer to the WTO aims.

Second point

- They do conflict because conflicts between trading blocs can lead to rising protectionism. WTO rules try to prevent protectionist measures increasing, but there are exceptions and member countries can also stretch the rules – see Activity 2 for development.

Evaluation

- In practice, WTO tries to resolve conflicts, but they are not always effective.
- But in practice trading blocs have often cut tariffs more quickly between member countries than WTO rounds have managed to do.
- Trading blocs negotiate as one body at the WTO, so they help to speed up decision making at WTO.

Third point

- The WTO aims to support development and yet it allows trading blocs to erect common external tariffs which can disadvantage developing countries more. So development gap grows.

Evaluation

- Many trading blocs now include both developed and developing countries – CPTPP, for example – so aims in common.

Fourth point

- In recent years the WTO seems to have less significance for some countries. Some countries might view joining trading blocs as more important than respecting the rules of the WTO.

Conclusion

- Potential for conflict between the two. The government views of countries, such as China and the USA, are likely to affect the extent to which conflicts may be large or small. Also depends on extent of protectionism used by individual trading blocs against non-members.

27 Restrictions on free trade

Activity 1

1 Dumping is when goods are sold below their cost of production, whether marginal cost, average total cost or average variable cost. Reasons why a Chinese ebike producer might dump products onto EU markets would include:

- the producer not finding a market in its domestic market for all the goods produced;
- a deliberate attempt to undercut EU manufacturers in an attempt to drive EU manufacturers out of business; the Chinese ebike producer might then increase prices in the EU market, once it has gained some monopoly power.

Provided the ebike producer prices its goods above the average variable cost, then goods sold in the EU market will still make some contribution towards paying off the fixed costs for the business.

- 2 Those who might benefit from duties imposed on imported ebikes from China:
- EU manufacturers remain in business. Without duties, the EU manufacturers would be facing unfair competition.
 - Consumers – consumers gain from more choice in the ebike market – they can choose ebikes made in China or EU ebikes – without the duties EU manufacturing might have been lost.
 - Workers – those EU workers in the ebike industry will retain their jobs.
 - EU economy – employment is protected (3,500 jobs in this industry in the EU). It also generates turnover of 1.3 billion euros, so contributes to GDP.
 - EU governments will raise tax revenue from the duties.

Those who might lose out from duties imposed on imported ebikes from China:

- EU consumers – more expensive ebikes from China, so consumers lose consumer surplus. Less real choice for consumers if Chinese ebikes become too expensive.
- Chinese ebike producers will lose sales in the EU.

Activity 2

1

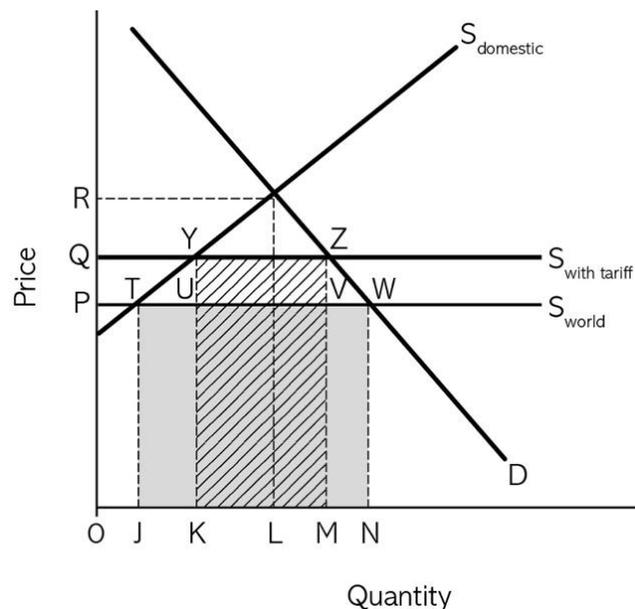


Figure 1

If the world price of aluminium and steel is OP , a tariff of PQ will shift the supply curve upwards from S_{world} to $S_{with tariff}$. The price to domestic consumers increases from OP to OQ .

US demand for steel and aluminium will fall by MN , while US production of steel and aluminium will rise by JK : – US metal producers have also increased their production, as prices have risen.

2 The effect of tariffs on steel and aluminium pushes up the prices of these metals for US consumers. US metal users, such as construction and car-making firms, will experience a rise in their costs. This makes it difficult for these firms to remain price competitive in global markets. As a result, sales volume will fall and some US jobs will be put at risk. A fall in profits will also make it hard for these firms to finance investment. This may reduce investment in innovation, which will further reduce their competitiveness in the long run.

Exam practice

1 (d)

2 Tariff revenue = $\$15 \times 20,000$ units (volume of imports = $35,000 - 15,000$)
= $\$300,000$

3

(a) 'Restrictions on free trade' refers to any measure which artificially restricts international trade. Usually restrictions on free trade will reduce imports or increase exports. The US government was using tariffs, a tax on imports, to reduce imports of Chinese goods, such as high technology products and industrial machinery. Other types of restrictions on free trade include quotas, subsidies, administrative barriers and exchange rate manipulation.

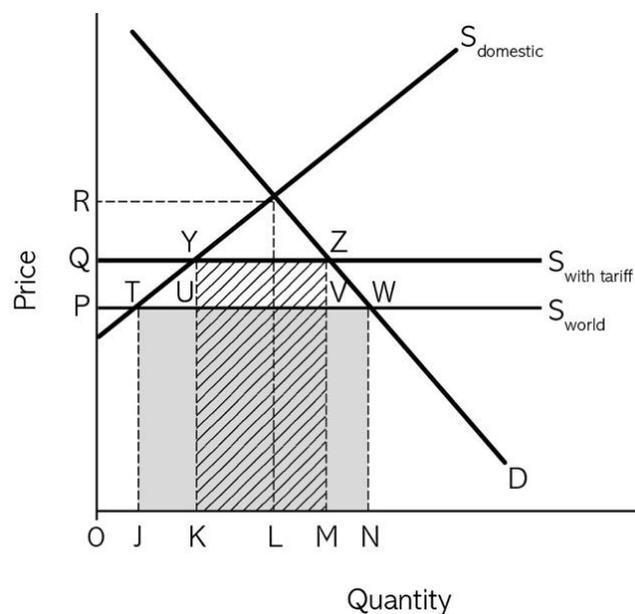


Figure 2

(b) The USA is proposing to implement 10 per cent tariffs on a further \$200 billion of Chinese exports, including some consumer goods, such as furniture. The impact of a tariff will be to increase the price of these goods to the US consumer from OP to OQ. This increase in price will cause an extension in supply for US firms. US production of these goods will rise from OJ to OK. In other words, US production of these goods will increase by JK (see Figure 2).

- (c) Between 1990 and 2016, the USA was consistently running a deficit on its balance of trade in goods and services. At its highest, this deficit was \$800 billion in 2006. The magnitude of this deficit contributes to the current account deficit experienced by the USA.

The likely impact of tariffs by the USA would be to reduce its current account deficit, which was \$568 billion in 2017. Imports fall from JN to KM. This fall in the volume of imports is likely to reduce the value of imports for the US. If the value of US exports remains unchanged, as might be expected, then the current account deficit will fall.

However, when China lowered tariffs, there is evidence to suggest that its export values increased. This suggests that if the opposite happens, and the USA increases tariffs, then its export values might fall. A rise in tariffs would reduce competitive pressures for US firms. This may reduce efficiency over time and cause prices to rise. More expensive imports might also increase the costs for some US firms, causing prices to rise. This may then cause export values to fall, particularly when demand is price elastic. So, despite import values falling, if export values fall by more, then the current account deficit could widen.

- (d)

Introduction

- Tariff and non-tariff barriers are restrictions on free trade. The US government has imposed tariffs on some Chinese goods, with more tariffs on other goods proposed.

First point

- The volume of exports, from China to the USA, is likely to fall. This will reduce export-led growth. Fall in aggregate demand. Show real GDP falling on an AD/SRAS diagram. Rise in cyclical unemployment but demand-pull inflation would fall.

Evaluation

- But China may shift to consumption-led growth.
- However, likely to be fairly significant for China since the USA would be a large export market for China.

Second point

- FDI inflows into China may fall as new factories are set up in countries such as Vietnam. Some existing Chinese factories may relocate abroad in an attempt to avoid the US tariffs. If so, economic growth will slow down in China. Workers will lose jobs.

Evaluation

- But other reasons why FDI might be attracted to China.
- Chinese manufacturers would find it difficult to relocate (for example, Chinese standards already meet US standards). It will depend how long tariffs might be expected to remain on Chinese imports. In the short run, manufacturers in China unlikely to relocate.
- USA might also extend tariffs on other countries, removing any advantage to relocate.

Third point

- China's current account surplus would be expected to fall if the USA imports fewer goods from China. Use of tariff diagram to show the fall in the volume of imports from China. In 2015, China's current account surplus was probably the largest it had been in the period 1990 to 2016 – its balance on the trade in goods and services was approximately \$400 billion (this is an important component of the current account) – so this surplus is likely to fall.

Evaluation

- But Chinese firms will send profits back to China – income credit on the current account.
- China might find new international markets to target. Other emerging economies with rapid economic growth will become new markets. Impact higher if YED for Chinese goods elastic.

Conclusion

- Impact on China's economy will depend on the magnitude of the tariffs and how long the tariffs are in place.
- Impact depends on the current state of the economy in China – for example, if China's economy is currently operating at beyond full employment, the impact may be positive since demand-pull inflationary pressures will fall.

4 It is important to give some real-world examples; for example the use of protectionism in 2018 by the USA. Rationale included protection of US jobs, unfair competition, national security, and so on.

Introduction

- Protectionism – measures to restrict free trade.
- Types of restrictions on free trade.
- Although theory of comparative advantage supports free trade, there are some justifications.

First point – To protect infant industries

- Support while industry is growing until it can fully benefit from economies of scale. Therefore, industry can be price competitive in international markets.

Evaluation

- Particularly justifiable when the industry would have a comparative advantage in the long run.
- However, government failure in practice. Resources therefore not allocated efficiently – reduces growth.
- Other government support might be more effective.

Second point – To prevent dumping

- Unfair competition. A country may be aiming to destroy a domestic industry, so it has a monopoly power in the long run.

Evaluation

- However, some groups, such as consumers, might benefit from dumping. Lower prices, higher consumer surplus. Dumping might only be a short-run hit to the economy, so erecting protectionist measures may create more costs than benefits.

Third point – To raise tax revenue

- Use of tariff diagram to show tariff tax revenue for the government.

Evaluation

- May be particularly useful for some developing countries where tax revenue, as a percentage of GDP, is often low. Possibly easier to collect, compared to other taxes, if infrastructure at ports is developed enough.
- For developed economies, this is unlikely to be a significant reason to use protectionist measures.

Fourth point – To correct a deficit on the current account

- Protectionist measures, such as quotas and tariffs, reduce imports. So current account deficit falls. Use of tariff diagram to explain the fall in imports.

Evaluation

- However, supply chains are increasingly integrated, so protectionism causes problems for other domestic firms. For example, their costs might rise.
- Tariffs are particularly effective in reducing imports if demand for imports is price elastic.

Conclusion

- The theory of comparative advantage supports free trade. However, this model makes unrealistic assumptions, so free trade not necessarily beneficial. Not all countries would gain from free trade if terms of trade do not lie between opportunity costs, so protectionism might be justifiable to some extent. May be particularly justifiable in the short run so workers have time to reallocate to other industries, once new skills have been learned, and so on.

28 Balance of payments

Activity 1

1 A rise in the value of the renminbi means more foreign currency, such as US dollars, exchanges for 1 renminbi on foreign exchange markets. In other words, the value of the dollar, in terms of renminbi, falls. Between 2006 and 2018, the value of the US dollar fell from 8 renminbi to 6.31 renminbi.

A rise in the value of the renminbi increases the price of Chinese goods, in terms of foreign currency. For example, Chinese goods and services become more expensive in terms of US dollars. This increase in the price of China's exports should reduce the volume of exports demanded. The value of exports is likely to fall.

At the same time, a rise in the value of the renminbi makes China's imports cheaper in terms of renminbi. This will increase the volume of imports demanded. The value of imports is likely to rise. As a result, a rise in the value of the renminbi would be expected to reduce China's current account surplus.

The yuan is also known as the renminbi. Figure 1 in the Students' book shows how a fall in the value of the dollar (that is, a rise in the value of yuan) seems correlated fairly closely with a fall in China's current account, as a percentage of GDP. In 2007 China's current account surplus was approximately 10 per cent of GDP; by 2017 this had fallen to less than 2 per cent of GDP. During this period the value of the yuan was largely on a downward trend. The extract says that the rising renminbi has had limited impact on the trade in goods surplus. The impact has been more on the balance of trade in the services component of the current account balance.

2 A fall in China's household savings ratio shows that households are spending more of their household disposable income, rather than saving it. A proportion of this extra spending will be on imports, so a fall in China's savings ratio will increase the amount spent on imports. As the extract states, a fall in the savings ratio would increase spending by the Chinese on foreign travel. This would increase the deficit on the trade in services, so therefore reducing the current account surplus.

Activity 2

1 An excess of savings in China would suggest that China's demand for imports, such as those from the USA, would be relatively low. A high savings ratio means spending, as a proportion of household income, is fairly low. As China has relied historically on export-led growth, this suggests the USA is importing more from China than it is exporting. So an excess of savings in China partly explains why countries such as the USA have a current account deficit. This means the financial account of the USA will show that the USA is a net borrower from the rest of the world. There will be inflows on its financial account, equal and opposite to its current account deficit. The excess savings in China means China is buying many US denominated assets.

2 The extract suggests that global imbalances are at risk of causing lower global growth. This is because the global imbalances risk fuelling new demands for protectionism. Protectionism will reduce global economic growth because the full gains from free trade cannot be gained. The theory of comparative advantage supports free trade. If countries specialise in those goods in which they have a comparative advantage and then trade, global output can be maximised.

3 The IMF says that the USA should use the following measures to reduce its current account deficit:

- Reducing its government debt – reducing government debt is likely to involve reducing government spending and/or raising taxation. This will reduce aggregate demand and therefore reduce the demand for imports.
- Improving competitiveness and productivity, through better education and training programmes – better education and training should increase labour productivity. This will reduce unit costs and help US goods and services become more price competitive in global markets. Better education and training also help to improve non-price competitiveness. For example, product innovation is likely to improve.

Exam practice

1 (b)

A low rate of economic growth, compared to main trading partners, means South African imports will grow at a slower rate than its exports. So its current account deficit should fall over this period.

2

(a) The current account balance + capital account balance + financial account balance = Balance on current, capital and financial account.

Therefore, financial account balance = Balance on current, capital and financial account – (the current account balance + capital account balance)

Financial account balance = $-3606 - (-15,818 + 408) = -3606 - (-15,410) = -3606 + 15,410 = 11,804$. So the financial account balance = \$11,804 million

As the balance of payments must balance, the drawing on reserves must be equal and opposite to the balance on the current, capital and financial account combined with the net omissions and errors. So drawing on reserves = + 4032.9 US dollars.

(b) The 'financial account' of the balance of payments records all the flows of financial capital in to and out of a country. It has three main parts: FDI flows, portfolio investment and other investments. For example, FDI inflows into Pakistan will be recorded as an inflow on Pakistan's financial account. The flow of savings, when a Pakistan citizen moves savings into a foreign savings account, will show up as an outflow on Pakistan's financial account. Since Pakistan has a combined current and capital account deficit, then Pakistan will have a financial account surplus of the same equivalent balance.

(c) A rise in import duties means Pakistan has increased taxes on imports. These are on 5,000 different items, such as cars and mobile phones. The impact of tariffs is to reduce imports.

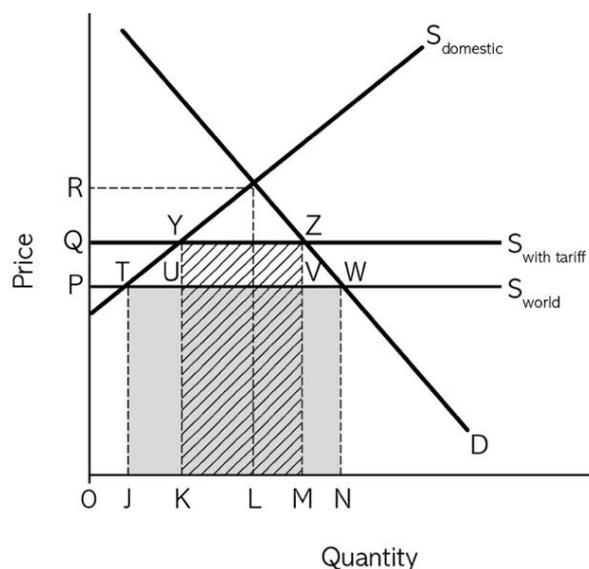


Figure 1

A rise in import duties will increase the price of these goods in Pakistan. If the existing price was OP, a tariff of PQ will shift the supply curve upwards from S world to S with tariff. Domestic consumption will fall by MN while domestic production will rise by JK. Imports will fall from JN to KM (see Figure 1).

This fall in imports should help to reduce Pakistan's current account deficit, which in 2017 was approximately 5 per cent of Pakistan's GDP.

- (d) The proposed cut in government spending and the increase in taxes will reduce aggregate demand in Pakistan. This is a deflationary policy as it creates a net withdrawal from the circular flow of income. The amount of aggregate demand that will depend on the value of the multiplier. A fall in spending and national income will cause spending on imports to fall, so the current account deficit in Pakistan should fall. The impact on imports will depend on the value of the marginal propensity to import. Domestic firms will also cut back on investment if aggregate demand falls. Some of this would have included purchases of imported capital goods, so this will also reduce imports for Pakistan. However, this might backfire if Pakistan, by cutting back on investment in product innovation, starts to lose some of its competitiveness over time.

This policy will be particularly effective if the marginal propensity to import is high and also if it helps to reduce rates of inflation in Pakistan (a fall in demand-pull inflation). This would increase the price competitiveness of Pakistan's goods in international markets, so further reducing the current account deficit in Pakistan.

(e)

Introduction

- Understanding of surplus on the current account.

First point – Low unit costs

- Wage growth lower than productivity, so unit costs fall. This has helped German firms to remain price competitive in international markets. This helps to keep export volumes high.
- At the same time, lower real wages will reduce spending, so spending on imports remains relatively low. Therefore, the combined effect helps to explain a surplus on Germany's current account.

Evaluation

- But if real wages fall too much, employees may start to bargain for higher wages to increase their purchasing power. So current account surplus may start to fall. This might explain why Germany's surplus on the current account fell from about 9 per cent in 2015 to 8 per cent in 2017.

Second point – Low consumption and low government spending

- Low consumption would partly explain why spending on imports is relatively low. Consumption is a lower proportion of GDP in Germany (54 per cent), compared to other economies such as the USA (69 per cent). Consumption is low partly because wage growth has been low, but also because of Germany's ageing population who tend to have a high savings ratio.

- Low government spending might also reduce import demand for some capital goods, since some government spending would be on imports. Low government spending also constrains economic growth. If economic growth rates of trading partners are higher than Germany, then this might explain why export values for Germany are increasing faster than import values for some years.

Evaluation

- But if infrastructure becomes too old, then Germany's government might need to increase its infrastructure budget.
- Once individuals retire, then savings ratio might start to fall.

Third point – Low value of the euro

- This increases the price competitiveness of German goods and services with countries outside of the Eurozone. This might explain why export volumes are high, compared to import volumes.

Evaluation

- The impact of a low value of the euro on the current account balance will depend on the PED for exports and imports.
- It will depend on how long the value of the euro has remained low. Germany has had a surplus on the current account for at least 7 years, as shown by Figure 2 in the Students' book. So it would be useful to know what has happened to the value of the euro over this period.
- It might be non-price factors which are more significant; for example, quality of German goods.

Conclusion

- Likely that there are a few causes of Germany's current account surplus.
- Criticism by the IMF and European Commission of Germany's low government spending might suggest this is a significant cause.

3

Introduction

- One country's current account deficit is another's current account surplus.

First point – This could be more than one point if a range of points are developed and analysed here. Possible problems of current account deficits for countries:

- May be unsustainable if the country cannot finance it with inflows on the financial account. This may mean that consumption, government spending and investment must fall sharply until exports = imports. This may cause a demand-side shock.
- May result in significant depreciation, which would lead to higher inflation. A particular problem if the economy already has high inflation.
- Deficit may imply over-reliance on consumer spending.
- Might indicate a lack of competitiveness.

Evaluation

- But a current account deficit might be easily financed by inflows on the financial account. Its foreign liabilities may be small in relation to the country's ability to repay its debts.

- But depreciation not likely to be a problem for causing inflation if the economy is in a negative output gap; for example, an increase in AD might have no impact on demand-pull inflation if the economy is operating well below full employment – Keynesian LR aggregate supply curve.
- But current account deficit might reflect high imports of capital goods, which promote supply-side growth. This might improve LR competitiveness, so current account deficit starts to fall.

Second point – Problems of current account surpluses for countries:

- Might reflect lower living standards than might be enjoyed; that is, consumers limiting their spending. Implies consumption is low.
- In the long run it might not help the economy achieve high economic growth. It will depend how these surpluses are invested in the economy.

Evaluation

- But current account surplus might help an economy achieve export-led growth, so helping to lift many of its citizens out of poverty.
- A current account may only be possible in the short run. For example, low wage costs helped China to be price competitive, but as GDP has risen, wage costs are now rising in China.
- Whether a current account surplus is a problem might depend on what is causing the surplus.

Third point – Responses to global imbalances might create problems

- A country that experiences a large current account deficit might experience high short-run costs, such as job losses in some industries. They might react to this by imposing protectionist measures. All countries could lose out from a trade war.

Evaluation

- But in the long run, a reallocation towards more productive industries might mean a current account deficit is corrected.
- Persistently running a current account deficit means a country is building up its liabilities to the rest of the world. Not necessarily a problem if these borrowed funds are being used to help finance long-term growth.
- But WTO rules might prevent protectionism.

Conclusion

- Generally global imbalances are not considered a problem unless they become excessive.
- Might be a problem for some countries, but not others. For example, running a current account deficit requires an inflow on the financial account. Might not be a problem for some countries, such as the USA, because others are prepared to lend or invest in the USA.

29 Exchange rate systems

Activity 1

1 The free market price of the naira in July was 308.5 naira per dollar. JPMorgan analysts said that the central bank had now 'stepped away from the foreign exchange market'. This suggests that the central bank was no longer using its foreign currency reserves to buy any excess supply of naira on the foreign exchange market to prevent the value of the naira falling. So a low of 308.5 naira per dollar suggests that this was the equilibrium exchange rate. The equilibrium value of the naira is therefore lower than the 16-month pegged value of the naira of 197 naira per dollar.

Note: The exchange rate information is expressed per dollar, so the value of the dollar had increased between June and July. In other words, the value of the naira fell.

2

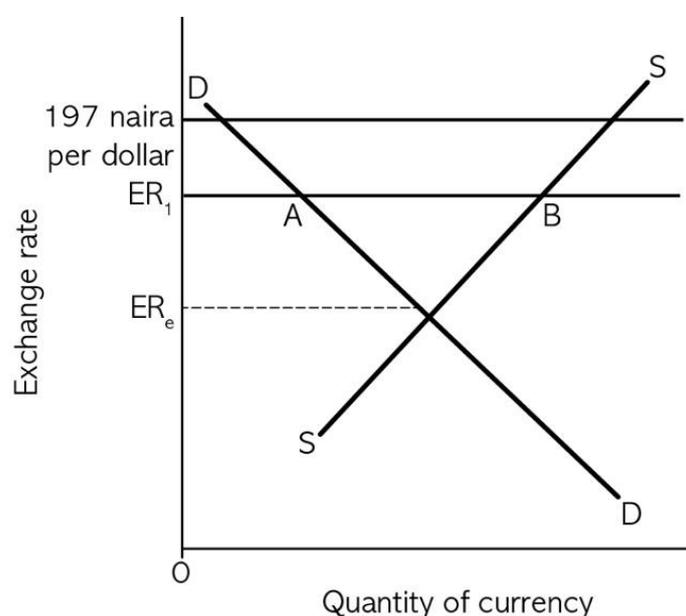


Figure 1

Figure 1 shows the value of the naira on foreign exchange markets. The 16-month old pegged value of the naira was set at around 197 naira per dollar. On the first day of the new currency system the value of the naira then fell more than 40 per cent against the dollar to ER_1 — so fewer dollars could be exchanged with each naira.

According to JPMorgan analysts, the Central Bank of Nigeria then spent \$35–60 million dollars a day to prevent the value of the naira falling further. This suggests that the central bank is buying the equivalent of AB naira in the foreign exchange market, using its foreign exchange reserves. This would remove the excess supply of naira, shown by AB , on the foreign exchange market. As a result, intervention by the central bank would keep the value of the naira at ER_1 rather than falling to its equilibrium value of ER_e .

Activity 2

1 In 2015 the value of the renminbi started to fall. There is no information given on the cause of this. However, the sense of panic prompted Chinese companies and individuals to start buying dollars. This means the supply of renminbi increased on the foreign exchange markets (buying dollars implies selling renminbi). This increase in supply of renminbi will cause the equilibrium value of the renminbi to fall.

Clearly the central bank wanted to prevent the value of the renminbi falling to its equilibrium value as it spent roughly \$1 trillion over 18 months to stop the decline. In other words, it was removing excess supply of renminbi on the foreign exchange market by buying this using its foreign exchange reserves, to prevent the value of the renminbi falling further.

The central bank also introduced measures to restrict capital flight – individuals selling renminbi to buy dollars to move this money abroad. These capital outflow restrictions would have prevented the supply of renminbi increasing too much. Therefore, the central bank would have stopped the equilibrium value of the renminbi falling further.

Another factor influencing the equilibrium value of the renminbi was China's falling current account surplus, with the chance that it may move into deficit. This means demand for the renminbi will be falling, as export demand slows, while the supply of renminbi will increase as China buys relatively more imports. This would cause the equilibrium value of the renminbi to fall.

Exam practice

1 (c)

An increase in interest rates in the USA attracts savings into US savings accounts. So demand for the dollar rises, thus pushing up the value of the dollar.

2

(a) The rate at which one currency can be converted (bought or sold) into another currency is known as the 'exchange rate'. For example, in August 2018 the value of the Indian rupee was Rs70 to the dollar. This means 70 Indian rupees would be converted into 1 US dollar on foreign exchange markets. This was an all-time low for the value of the rupee. So this means the number of rupees needed to be sold on foreign exchange markets to buy 1 dollar was the highest ever: 1 rupee would only buy 1/70th of a US dollar.

(b) Governments can intervene in currency markets through foreign currency transactions, the use of interest rates or quantitative easing.

In Extract A, India's central bank had tried to support the value of the rupee.

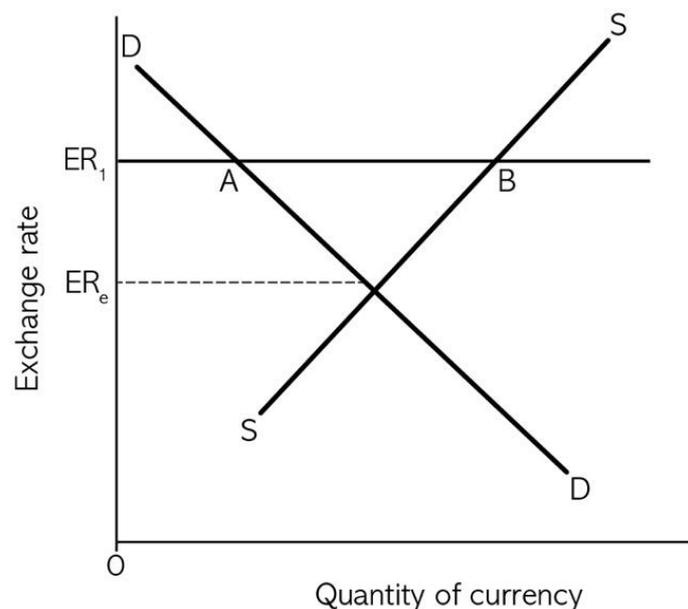


Figure 2

This means the equilibrium value of the rupee is lower than the actual value of the rupee. If the central bank of India wanted to maintain the value of the rupee at ER_1 (see Figure 2), then to do this it would have to remove the excess supply AB of rupees on the foreign exchange market. It will therefore have to buy AB rupees using its foreign exchange reserves. That explains why India's foreign currency reserves have fallen from \$426 billion in mid-April to \$399 billion by mid-September.

Alternatively, a government could increase interest rates to support or stabilise the value of its currency. For example, if Turkey increased interest rates then this would help to push up the value of the Turkish lira. Raising interest rates will encourage foreign savers to switch their funds into Turkey. This will increase demand for the Turkish lira, so causing the equilibrium exchange rate to rise.

However, government intervention may not always be effective. In the first case, the central bank in India may run out of foreign exchange reserves to support the value of the rupee. So foreign currency intervention may not be sustainable in the long run if the equilibrium exchange rate remains below the target exchange rate level. In the second example, extract B states that Turkey had increased interest rates in May and a few weeks later, but the situation remains the same. There might therefore be other reasons that are still discouraging savings into Turkey.

(c)

Introduction

- Introduction of what is meant by equilibrium exchange rate.

First point

- India's widening and current account deficit. This will cause the value of the exchange rate to fall. For example, rising imports will increase the supply of the

Indian rupee on foreign exchange markets. The equilibrium value of the Indian rupee will fall. An exchange rate demand and supply diagram showing this might be useful.

- The current account deficit was also widening in Turkey between 2016 and 2018.

Evaluation

- Extract A suggests this is a significant reason for India. The Indian rupee fell to an all-time low and the trade deficit of \$16.6 billion was at its highest for 5 years.
- However, although a current account deficit will partly explain why the value of the Turkish lira fell in 2018, there are clearly other important factors affecting the Turkish lira. The current account deficit for Turkey was actually the highest in 2011, at about 9.5 per cent of GDP. In 2018, the current account deficit was only just over 7 per cent. So if the Turkish lira hit an all-time low in 2018, then there will be other important factors which explain this.

Second point – High inflation

- High inflation in Turkey – running at more than 15 per cent. Relative inflation rate is one factor which influences exchange rates. The purchasing power parity theory states that the long-run exchange rates will change in line with changes in prices between countries. For example, if Turkey's inflation rate of 15 per cent is higher than the US inflation rate which, for example, might be 3 per cent, then the value of the Turkish lira will fall at an average annual rate of 12 per cent against the dollar.

Evaluation

- A 15 per cent inflation rate for Turkey seems high compared to countries such as the USA. Extract A says the Turkish lira lost 40 per cent against the dollar, so this suggests high inflation in Turkey might be a significant influence on the exchange rate.

Third point – The USA and Eurozone are putting quantitative easing into reverse

- Explanation of QE reversing: puts upward pressure on interest rates in the USA and the Eurozone. Extract B states that QE had helped Turkey attract funds – so evidence that Turkey's interest rates used to be relatively higher than the USA's.
- However, higher interest rates in the USA and the Eurozone would have attracted savings into the USA and the Eurozone. Savers would move funds out of Turkey into the USA and Eurozone. So supply of Turkish lira would increase and demand for dollar and euro would rise.

Evaluation

- This might be a significant factor because the QE had been used as a main policy tool by the USA and Eurozone to increase AD after the Global Financial Crisis.

Conclusion

- Many factors explain the fall in the value of the Indian rupee and Turkish lira. The significance of each factor is likely to be different between these countries.

3 It is important to make some reference to real-world examples in your answer.

Introduction

- Understanding of floating exchange rates.

First point – Monetary policy

- Relative interest rates and quantitative easing. For example, a rise in US interest rates will mean foreign savers will move funds into the USA. Demand for the US dollar will increase, so equilibrium exchange rate will rise. Show using an exchange rate demand and supply diagram.

Evaluation

- May depend on how long investors think the interest rate change will last.
- QE might have been a significant factor influencing exchange rates during the Global Financial Crisis and in the period after.

Second point – Strength of the economy

- The strength of the economy might affect portfolio investment. When the economy is strong, companies are more likely to perform well with rising share prices. The strength of the economy is also likely to increase FDI inflows. Both of these cause more money inflows on the financial account, so demand for the currency on foreign exchange markets increases.

Evaluation

- But FDI inflows depend on many factors, the strength of the economy is just one factor. However, economic and political stability is likely to be fairly important.

Third point – Capital flight

- Large sums of money are moved out of the country due to economic and political uncertainty. This might be triggered by speculation that the exchange rate is about to fall. Capital flight can occur in a freely floating or fixed or managed system – for example, there might be speculation that the currency is about to be devalued.

Evaluation

- But capital flight can be controlled to some extent by capital controls.

Fourth point – Relative inflation

- High inflation is likely to reduce the exchange rate.
- Explanation of purchasing power parity theory. Also linked to this is investors' views on whether a government seems committed to bringing down inflation. If investors are worried about this, they will start selling this currency on foreign exchange markets, so the supply of the currency increases – can be shown on a demand and supply exchange rate diagram.

Evaluation

- High inflation might also suggest interest rates are low, so both these factors often work together to explain why the exchange rate may be low.
- But small inflation rate differences might be offset by other factors.

Conclusion

- Most short-term movements are explained by speculation in the foreign exchange rate markets. However, underlying trends in movements will be explained by the factors outlined above.
- What affects the value of an exchange rate for a country might relate to a particular event specific to that country or region (for example, the UK's decision to leave the EU caused the value of the pound to fall immediately after the result and for many months after).
- In practice, a range of factors will affect the exchange rate.

30 The impact of changes in exchange rates

Activity 1

1 \$100

This is the volume \times price = 100 units \times \$1.

2

(a) 116 units.

If exporters keep their price in dollars the same, it means that the price of a unit of exports is \$1. However, for foreigners, the price in their currency is now lower because the value of the dollar has been devalued by 20 per cent. For foreigners, there has been a 20 per cent fall in price. With a price elasticity of demand for US exports of 0.8 (given in the question), the percentage change in quantity demanded, using the formula for price elasticity of demand, will be +0.16 (price elasticity \times percentage change in price = -0.8×-0.2). Given that 100 units were demanded before, the change in quantity demanded will be +16 units (100 \times +0.16). So the new quantity demanded will be 116 units (100 units plus the new 16 units).

(b) \$116

This is the volume \times price = 116 units \times \$1

3 \$120

This is the volume \times price = 200 units \times \$0.60

4 Importers will have to pay an extra 20 per cent for imports; 20 per cent of the average price of \$0.60 is \$0.12 – therefore the new price is \$0.72

5**(a)** 140 units

There has been a 20 per cent increase in price and the price elasticity of demand for imports is 1.5. Therefore, using the formula for price elasticity of demand, the percentage change in quantity demanded of imports is -30 per cent (20 per cent $\times -1.5$). The original quantity of imports is 200. So the fall in imports (remember the price has risen, which will lead to a fall in quantity demanded) is 60 (200×30 per cent). So the new volume of imports is 140 ($200 - 60$).

(b) \$100.80

This is the volume \times price = 140 units \times $\$0.72$

6**(a)** \$20

This is exports minus imports = $\$100 - \120

(b) \$15.20 – that is, a surplus

This is exports minus imports = $\$116 - \100.80

7

(1) \$100 (the change in elasticities does not affect this answer)

(2)

(a) 108 units**(b)** \$108

(3) \$120 (the change in elasticities does not affect this answer)

(4) The change in elasticities does not affect this answer.

(5)

(a) 192 units**(b)** \$138.24

(6)

(a) \$20 (the change in elasticities does not affect this answer)**(b)** $-\$30.24$ – that is, a deficit**Activity 2**

1 A fall in the value of the Egyptian pound would cause imported inflation because foreign goods and services become more expensive in terms of Egyptian pounds. It is possible that the devaluation triggered a cost-push inflationary spiral. The extract states that a cheese company in Egypt experienced a sharp increase in its production costs caused by the devaluation.

Demand-pull inflation might also have been caused by the fall in the value of the Egyptian pound. Egypt's exports would be cheaper in terms of foreign currency, so exports should increase. This creates an injection into the circular flow of income, so aggregate demand rises. The increase in demand-pull inflation will be more significant if the economy is close to full employment.

Over the 8 months after the devaluation, Egypt's inflation rose to 30 per cent.

2 Although devaluation should increase economic growth, because exports should rise and imports should fall, there is some evidence that economic growth might slow. This could be for two reasons.

Firstly, there might be a significant number of firms hit by rising costs. This shifts the SRAS to the left and would lead to falling real GDP. This might more than counteract any increases in aggregate demand caused by rising exports or falling imports.

Secondly, some firms which have foreign currency debt will see their debt increase when it is priced in Egyptian pounds. The same debt will double in terms of the number of Egyptian pounds needed to repay the debt. 'As a result, some companies are putting their expansion plans on hold'. So investment will slow quickly, causing a slow-down in growth.

3 Because devaluation makes exports cheaper in terms of foreign currency and imports more expensive in terms of Egyptian pounds, then the volume of exports should increase and the volume of imports should fall. However, the current account balance depends on the value of exports compared to the value of imports. The Marshall-Lerner condition states that the current account balance will improve, after devaluation, if the combined price elasticities of demand for exports and imports are greater than 1. This is more likely to be the case in the long run because demand is more responsive to a price change in the long run. In the long run, foreign consumers are no longer locked into contracts, so they can switch to Egypt's cheaper goods. Also, Egyptian firms have had time to find domestic suppliers rather than importing.

Exam practice

1 (c)

A rise in the value of exports relative to import values means the current account balance has improved. This is more likely to happen in the long run, after a fall in the value of the Indian currency, because PEDs for exports and imports become more elastic. Therefore, the Marshall-Lerner condition is more likely to be met.

2

(a) 'Devaluation' is when a government or central bank officially fixes a new lower exchange rate for a currency in a fixed or pegged system of exchange rates. For example, in February 2014, the Kazakh central bank devalued the tenge by almost a fifth. This means 1 unit of the tenge would exchange with less foreign currency than before.

(b) If a central bank deliberately intervenes to reduce the value of its currency, to gain competitive advantage, this can be motivated by a desire to improve the current account or to deal with other macroeconomic objectives, such as reducing unemployment. Any intervention in 2018 by Japan's central bank to reduce the value

of the yen would likely have caused problems for Japan's economy. This is because it may have triggered a trade war, particularly with the USA. From the data in Figure 2 in the Students' book, Japan has consistently run a current account surplus since 2012, so the USA might already consider the yen to be undervalued. If a trade war is triggered, then Japan's economic growth is likely to fall. Restrictions on free trade will reduce export-led growth for Japan if demand for its goods falls from the USA. If Japan retaliates by erecting its own tariffs on the USA, then this would increase costs for Japanese firms, therefore reducing real GDP as SRAS shifts to the left. Free trade between Japan and other countries is more likely to promote growth due to the theory of comparative advantage.

- (c) An appreciation of the yen means that 1 yen exchanges for more dollars. In other words, the value of the dollar falls against the yen – in this case from 110 yen against the dollar to 106.5 yen against the dollar.

The rise in the value of the yen is likely to lead to managers in large manufacturing firms to forecast lower sales and profits than originally expected. A higher value of the yen will push up the price of Japanese goods in terms of foreign currency. So if the price of exports rises, the volume of sales would be expected to fall. The extent depends on the price elasticity of demand. As a result, firms are likely to hold back on some of their original investment plans. This is partly because retained profit is one source of finance for investment and this will be lower for Japanese firms than originally expected. It is also linked to the lower confidence in the future that this would generate.

However, this might be offset if the cost of credit becomes cheaper. In this case investment may still be profitable if the expected return is higher than the new lower cost. The impact on investment might also depend on how long the value of the yen is expected to remain high.

- (d)

Introduction

- Understanding of devaluation and depreciation.

First point

- Improvement on the current account of the balance of payments because exports would become more price competitive and imports less price competitive.

Evaluation

- But depends on PED for exports and imports. In short run may worsen the current account as the Marshall-Lerner condition more unlikely to be met – J curve. There is evidence for this in Figure 2. After the 2014 devaluation the current account deficit continues widening, as a percentage of GDP. However, from 2016 current account balance as a percentage of GDP starts to improve.

Second point

- Higher inflation – a fall in the value of the tenge may cause cost-push inflation – the cost of imported raw materials and finished goods rises. Demand-pull inflation may also result if a lower value of the tenge leads to export-led growth. The extract states that inflation is likely to go above the central bank's target of 6 to 8 per cent.

Evaluation

- But this depends on the extent to which higher costs are passed on to the consumer. Firms might also cut profit margins or productivity might rise.
- But demand-pull inflation is only likely to be a significant problem if Kazakhstan's economy is close to full employment.

Third point

- More inward FDI and less outward FDI improving the financial account position.

Evaluation

- But other factors affect FDI decisions (for example, tax, confidence, political stability).

Conclusion

- Economic impact likely to be significant since there have been two sizeable falls in the value of the tenge – first by 20 per cent and then a further fall of 23 per cent in the value. Depends how long this fall lasts.

3

Introduction

- Understanding of appreciation.

First point

- Worsening of the current account of the balance of payments. But this assumes the sum of the PEDs for exports and imports is greater than 1 (Marshall-Lerner condition). In the short run an appreciation might improve the current account balance. It takes time for consumers to react to a price change and some consumers might be locked into contracts.

Evaluation

- The current account will worsen further when the price elasticity of demand for exports and imports is very elastic.
- Non-price competitiveness might be more important – so current account balance might improve.

Second point

- Fall in exports and increase in imports will reduce aggregate demand. So actual growth will fall.
- Use of AD/SRAS diagram.
- Cyclical unemployment will increase.

Evaluation

- Extent depends on the value of the multiplier.
- May be beneficial if economy had been operating in a positive output gap.
- Fall in aggregate demand might be offset by a rise in other components of aggregate demand.

Third point

- Rate of inflation should fall, both demand-pull and cost-push.

Evaluation

- Inflation will fall more significantly if the economy had been operating at beyond full employment.
- Diagram showing fall in AD on Keynesian LRAS curve (show the fall of AD on the vertical section of LRAS).
- But firms might use lower import costs to raise their profit margins – so inflation remains relatively unchanged.

Fourth point

- FDI flows – appreciation might decrease inward FDI and increase outward FDI. If so, further negative impact on economic growth.

Evaluation

- But many factors affect FDI decisions.

Conclusion

- The impact depends on the size of the appreciation and how long it lasts.
- It depends on the current state of the economy whether the impact is positive or negative overall.

31 International competitiveness

Activity 1

1 Between August 2014 and March 2015, the value of the rouble fell. This would have increased international competitiveness for Russia. A fall in the value of the rouble reduces the price of Russian goods and services in terms of foreign currency. At the same time, foreign goods and services become more expensive in terms of the rouble, so price competitiveness for Russia would have increased over this period. However, the extract implies that the value of the rouble has been rising recently, so 'this advantage is quickly disappearing'.

Other factors affecting international competitiveness in Russia since 2014 are the lack of investment, increasing bureaucracy and corruption. A lack of investment would reduce labour productivity in Russia, if the quality of capital goods declines as a result. Relative productivity rates in Russia would fall, so pushing up unit labour costs. This makes Russia

less price competitive. A lack of investment is also likely to negatively affect non-price competitiveness. For example, there might be a lack of investment in new product innovation.

Increasing bureaucracy and corruption also reduces efficiency in Russia and makes it harder for Russia to remain price competitive.

Activity 2

1 Measures which the government in Italy might use to become more internationally competitive include:

- De-regulation of labour markets – this includes introducing a decentralised wage setting process to make wages more flexible.

De-regulation of labour markets is the process of removing government controls from labour markets, such as introducing decentralised wage setting or reducing minimum wages. This should reduce wage costs and make labour more flexible. This promotes supply-side growth. A shift in the LRAS to the right reduces the price level. So international competitiveness improves.

- Cutting the costs of bureaucracy for firms and reducing taxes.

Reducing taxes on profits might help to promote investment as firms have a higher level of retained profit. More investment helps to reduce unit costs and increase productivity. Cutting bureaucracy costs also reduces costs. Both of these measures would encourage enterprise and so promote supply-side growth. This all helps to increase international competitiveness.

The extract also suggests taxes and bureaucracy were discouraging firms from growing too large, so reducing taxes and bureaucracy might help firms grow larger and therefore benefit from economies of scale. This would further help increase price competitiveness.

- Improvements in education and training, particularly at university level.

Both price and non-price competitiveness should improve. Labour productivity should rise and therefore unit labour costs should fall if the quality of human capital increases. Non-price competitiveness will increase if there are new and better products on the market as a result of more skilled labour.

Exam practice

1 (b)

Real GDP per hour worked is a measure of output per hour; in other words, productivity. In 2015 output per hour in Germany was approximately 38 per cent higher than the UK's. In 2016, output per hour in Germany was approximately 35 per cent higher than the UK's. This shows Germany's relative productivity with the UK fell, between 2015 and 2016. (Its productivity was still higher, but the difference was falling.)

2

- (a) The percentage change in unit labour costs

= change in the index of unit labour costs between 2000 and 2015 ÷ index of unit labour costs in 2000 × 100

= (100.3 – 85.6) ÷ 85.6 × 100

= 17 per cent

South Korea's unit labour costs increased by 17 per cent between 2000 and 2015.

- (b) 'International competitiveness' is the ability of a country to compete effectively in international markets. There are several measures of international competitiveness, which include relative productivity rates, relative unit labour costs and relative export prices. For example, Figure 5 in the Students' book shows South Korea's unit labour costs on an upward trend between 2000 and 2016, whereas Japan's are falling. This shows that South Korea is becoming less internationally competitive compared to Japan. South Korea's relative unit labour costs are rising compared to Japan's.
- (c) Extract A states that South Korea's international competitiveness is falling. Both Japan and China are becoming more competitive and posing a threat to South Korea's economy. Export industries in South Korea are likely to feel the first effects. For example, South Korean shipbuilding seems to have experienced a fall in demand. Export orders are falling. As a result, workers are being put on part-time contracts or being laid off. This will set off a negative multiplier throughout the whole economy. So real GDP will fall in South Korea and unemployment will rise. The car industry is also exposed. Since the hit is likely to be on some industries and not others, the lack of competitiveness will cause structural unemployment but may then trigger some cyclical unemployment. Demand-pull inflation is also likely to fall in South Korea.
- (d) According to Extract B, South Korea invests more than most advanced economies: it spends 4.23 per cent of GDP on research and development. This is likely to increase South Korea's international competitiveness: 'most R&D is applied research for industrial competitiveness'. R&D is likely to help a company develop a unique product that would help it to establish a non-price competitive advantage. For example, Samsung and LG have become world leaders in memory chip, displays and smartphones which may be linked to their innovative product designs. This helps non-price competitiveness.

Research and development might also help to increase productivity. This would increase relative productivity in South Korea and help to reduce unit labour costs. This should help South Korea be more price competitive on international markets. The data in Figure 6 show that labour productivity, as measured by output per hour worked, has increased at a faster rate in South Korea compared to Japan and the OECD average. This suggests high research and development is having a positive impact on international competitiveness, using this measure.

However, unit labour costs seem to be steadily rising in South Korea, compared to Japan. So wages rising too fast might explain why South Korea is losing competitiveness. R&D spending is having less impact on competitiveness under

these conditions. Extract B also suggests some R&D might not be as effective as it could be, due to a lack of competition caused by the chaebol system. There might be no incentive to be dynamically efficient. This means some R&D spending might be wasteful.

(e)

Introduction

- Understanding of international competitiveness.
- Introduction to measures.

First point

- Lack of non-price competition: 'South Korean brands failed to match the appeal of Japanese and European ones.'
- Some evidence of lack of new product innovation: 'left behind by China's efforts to shift to driverless vehicles.'
- The lack of competition caused by the chaebol system is causing too few new entrants with innovative ideas. Barriers to entry in markets might reduce innovation – lack of dynamic efficiency due to lack of competition.
- Likely tax increases on large companies would also reduce funds for investment, making it hard for international competitiveness to increase.

Evaluation

- But South Korea spends 4.23 per cent of GDP on R&D – higher than most advanced economies. This should help to increase competitiveness for South Korea over time. Figure 6 shows labour productivity rising at a faster rate than Japan and OECD average, so if this trend continues, South Korea's competitiveness should improve.

Second point

- Value of the yen has fallen. This has given Japan – which is likely to be a main trading partner – a price competitive advantage. A fall in the value of the yen makes Japanese exports cheaper, in terms of foreign currency. So relative export prices have risen for South Korea, making South Korea less internationally competitive.
- South Korea is also under pressure not to manipulate the South Korean currency by competitive devaluation. So South Korea's exchange rate is unlikely to fall to help it improve its competitiveness.

Evaluation

- But value of the yen might start to rise.

Third point

- High wage costs. Figure 5 shows a rising trend in unit labour costs in South Korea, despite labour productivity rising sharply over this period. This suggests wage costs are quite high in South Korea. If this trend in unit labour costs continues to rise, this makes it hard for South Korean firms to remain price competitive.

Evaluation

- This is likely to be a significant problem if the increase in the minimum wage by 15 per cent a year goes ahead. This is likely to increase all wages in South Korea, as workers aim to restore wage differentials.

Conclusion

- Evidence is mixed. It will depend on how the exchange rate changes over time for South Korea and what impact government policies have on productivity and unit labour costs, as well as how its R&D budget changes over time.

3

Introduction

- Understanding of international competitiveness.

First point – Exchange rate

- Exchange rate affects price competitiveness. A rise in the renminbi, for example, increases the price of Chinese goods on international markets, in terms of foreign currency. This would reduce the price competitiveness for China.

Evaluation

- Non-price competition might be more significant. The exchange rate is particularly important for goods and services whose demand is price elastic.
- Short run changes in the exchange rate are not as significant, as consumers take time to become aware of price changes or locked in contracts.

Second point – Relative productivity

- Relative productivity rates will affect price competitiveness. If a country's productivity is growing faster than its main trading partners, then it will become more price competitive as unit costs fall.

Evaluation

- If wage costs are low in a country, then relative productivity rates may not be so significant. This might explain why emerging economies, such as China, remained price competitive compared to most advanced economies.

Third point – Education and training

- This will affect labour productivity and therefore affect unit labour costs. This will therefore affect price competitiveness.
- Also, education and training will influence non-price competition. For example, new product design will improve if labour is more skilled.

Evaluation

- But labour productivity will also depend on capital investment.

Fourth point – Quality of infrastructure

- This will affect transport costs. Problems with infrastructure will likely disrupt production, so lowering productivity. This would reduce price competitiveness.

Evaluation

- But poor infrastructure might be addressed by TNCs that, for example, have built roads.

- Likely to be a significant problem, as high costs of infrastructure make it hard for many economies to fund infrastructure adequately, particularly for developing countries. Poor infrastructure likely to deter FDI inflows, which means transfer of know-how and skills cannot be gained by many countries (some developing countries in particular would be disadvantaged by this). This would lower relative productivity rates even more for these countries.

Conclusion

- Many factors affect international competitiveness; those which are most significant will differ between countries and regions. Government policy can also affect competitiveness (for example, a fall in tax rates might help improve price competitiveness as well as promoting more investment, which can improve non-price competitiveness).

32 Poverty

Activity 1

1 Absolute poverty occurs when individuals are not able to consume sufficient necessities to maintain life; in other words, they are not able to meet their needs. Poverty is extreme. Countries will measure absolute poverty by deciding the minimum income per day needed to escape extreme poverty. In South Africa, this has been set at R992 per person, per month. Using this measure, 55.5 per cent of the South African population was considered to be living in absolute poverty in 2015.

The international poverty line (which is based on the 15 poorest countries) is set at \$1.90 a day and is the main global measure on absolute poverty, used by the World Bank and the United Nations. On this measure, absolute poverty in South Africa was 18.9 per cent in 2015.

However, some would argue that a multidimensional approach to measuring absolute poverty might be more useful, since in practice absolute poverty has many dimensions. Using income alone may miss those who are living in extreme poverty but don't necessarily show up in these statistics. Also, a multidimensional approach might highlight particular aspects of extreme poverty that need tackling. For example, 23 per cent of South Africans still live in slums. Some of these people may have higher income than \$1.90 a day, but their housing standards are very deprived. Income also only captures some dimensions of extreme poverty, such as food intake. However, some aspects of absolute poverty, such as education deprivation, are not necessarily closely related to living standards.

Activity 2

1 A national poverty line is the minimum level of income considered necessary to meet a person's minimum needs for food, clothing and shelter in that country. So absolute poverty is often measured using national poverty lines. Since 2003, the percentage of the population living below the national poverty line in Brazil fell from 24.9 per cent to 8.7 per cent in 2015. Therefore, it can be said that absolute poverty in Brazil fell from 24.9 per cent to 8.7 per cent in 2015.

Relative poverty, however, is a measure of what proportion of households are poor by comparison with others in their country – usually by comparison with the median household income. For example, it may look at the proportion of households that earn less than half of the median household income.

The data in Activity 2 states that the income of the poorest 40 per cent rose on average by 7.1 per cent between 2003 and 2014. In contrast, average income only rose by 4.4 per cent. This shows that relative poverty has fallen in Brazil because the gap between the poorest and the average household is closing.

2 The Bolsa Familia is targeted at very poor families. Evidence shows that this money is largely spent on food, school supplies and clothes for the children. This suggests that absolute poverty is falling in Brazil because this money goes to the poorest families and is spent on necessities, such as food. However, very poor households in extreme poverty without children will not benefit, so absolute poverty for this group will not fall with this policy.

Increasing the incomes of some of the poorest households will reduce relative poverty rates. In the long run, absolute poverty might fall with this policy as it aims to get children attending school and attending health checks. This should increase educational outcomes for these children and equip them with skills to earn decent incomes in the future. The impact on relative poverty in the long run is not so obvious, as relative poverty can be high in a country even when absolute poverty is low.

Exam practice

1 (b)

By the \$1.90 a day measure of absolute poverty, this has fallen over this period. Relative poverty has also fallen.

2

- (a)** The percentage change in the real net official development assistance and official aid received by India between 2003 and 2016 = $(2.588 - 0.708) \div (0.708 \times 100) = 265.5$ per cent.
- (b)** Absolute poverty occurs when individuals are not able to consume sufficient necessities to maintain life. In other words, they are not able to meet their basic needs, such as food, clothing and shelter. Poverty is extreme. The UN and World Bank measure absolute poverty using \$1.90 a day as the minimum income needed to meet basic needs. In India those living in absolute poverty, using this measure, fell from 38.9 per cent in 2004 to 21.2 per cent in 2011. A multidimensional approach might also measure absolute poverty by considering a range of health, education and living standard data.
- (c)** A shift in the economic structure away from agriculture towards manufacturing and services is likely to reduce absolute poverty in India. This makes the assumption that many jobs in agriculture are likely to be low productivity activities and those in manufacturing and services are higher productivity activities. As a result, shifting workers into higher productivity activities, such as 'manufacturing, construction and labour-intensive services' will cause wages to rise for many in the economy. Higher wages will mean a lower proportion of India's population will be on less than \$1.90 a day. Also, if the economy has more 'higher productivity activities', this will increase

LRAS. Therefore, real GDP per capita will rise and absolute poverty will fall. The extract states that between 2004 and 2011 the increase in non-farm activity, especially in construction, helped to explain the fall in absolute poverty over this period.

- (d) Replacing the current welfare system with a universal basic income is likely to reduce both absolute and relative poverty in India. At the moment, some of the poorest in the population – 27 per cent of the poorest fifth – are not receiving subsidised food, even though they are entitled to it. At the same time, some of the richest in the population are benefitting from these schemes; for example, over 35 per cent of the richest 1 per cent of Indians benefit from subsidised food even though they are not entitled. This means absolute poverty is higher than it should be under these schemes and relative poverty will be higher, too.

A universal basic income of \$9 a month is likely to reduce absolute poverty. The extract states that this basic income should reduce those living below the poverty line, from 20 per cent to less than 0.5 per cent. This means the \$9 a month must have been set so that Indians can meet most basic needs. There also seems to be less scope for corruption and inefficiency leading to unintended consequences which make poverty worse. Relative poverty is also likely to fall as richer groups will not be in a position to gain at the expense of poorer groups, as under the current welfare system. If the government raises taxation to help fund this scheme, then this is likely to reduce relative poverty too if the tax system becomes more progressive.

However, to what extent the universal basic income reduces absolute poverty depends on whether this scheme is affordable over time and whether the

government can ensure that all adults receive the payment. There may be government failure in managing this new scheme. To what extent relative poverty falls will also depend on how tax rates are set on different income groups to fund this scheme.

- (e)

Introduction

- Understanding of absolute and relative poverty.
- Understanding of economic growth.

First point – Creates jobs

- Extract A states that absolute poverty (measured by international poverty line \$1.90 a day) fell from 38.9 per cent in 2004 to 21.2 per cent in 2011. At the same time economic growth averaged 8.5 per cent roughly over this period (2005 to 2012). If real GDP rises, then demand for labour increases. Unemployment should fall. Having a job is vital for reducing absolute poverty. If these new jobs are created in manufacturing, construction and labour-intensive services, then wages in these sectors are likely to be higher than those received in the agricultural sector. So lower unemployment, combined with higher wages, should reduce absolute poverty rates.

Evaluation

- But this is likely to increase relative poverty because some workers remain in lower paid sectors which are less productive, but others receive much higher wages. Some will also remain unemployed. As Extract A states, the annual consumption per capita growth of the bottom 40 per cent was slower than population as a whole between 2004 and 2011, which shows relative poverty increased.
- But economic growth does not always create jobs in more productive sectors.
- But if economic growth rates are lower than population growth, then real GDP per capita will fall, so absolute poverty could still rise.

Second point

- If economic growth is caused by improvements in education and training, then this will have a significant impact on absolute poverty reduction. This is because as well as economic growth itself reducing absolute poverty, better education and training will help individuals increase their productivity and so earn higher wages. There is usually a positive correlation between the number of years spent in education and the level of income of an individual. In Table 1, primary school completion rates increased from 72 per cent in 1995 to 98 per cent in 2014. This suggests income levels for many individuals rose, so absolute poverty fell.

Evaluation

- Not all individuals gain equally from education; for example, the quality of schools will vary widely, so relative poverty may increase.

Third point

- Economic growth will also raise more tax revenue for a government, which means they can afford more government spending on education and training or on health care, both of which help to reduce absolute poverty – particularly a multidimensional understanding of poverty. So rapid economic growth should help to significantly reduce absolute poverty.
- Economic growth should raise the level of taxation. This can be used to help finance welfare payments. For example, it might help the Indian government fund a universal basic income.

Evaluation

- Not all components of government spending would have such an impact on reducing absolute poverty (defence, for example).
- Tax revenue might not rise significantly with economic growth if tax evasion is high. For example, despite relatively rapid economic growth in India, government revenue was only 11 per cent of GDP in recent times.

Conclusion

- Rapid economic growth has the potential to reduce absolute poverty significantly but this will depend on what sort of jobs are created. It also depends on the population growth rates. Some causes of economic growth might increase relative poverty significantly, compared to others; for example, if India reduced top rates of income taxes to stimulate economic growth.

3

Introduction

- Understanding of absolute and relative poverty.

First point – Economic growth

- Real GDP rises, labour is a derived demand, so employment increases. Unemployment falls. Absolute poverty falls. Economic growth could cause relative poverty to rise; for example, some causes of economic growth likely to widen income distribution and therefore increase relative poverty.

Evaluation

- Depends on how the structure of the economy changes as a result of economic growth – between primary, secondary and tertiary sector and differences in productivity between these sectors. This affects to what extent wages will differ between these sectors and so whether relative poverty rises or falls.

Second point – A rise in tax revenue

- This could reduce absolute poverty because this can be used to fund more government spending on education, health and welfare payments. This sort of spending will reduce absolute poverty (multidimensional poverty includes education and health). If more tax revenue is collected from regressive taxes, then this could increase relative poverty.

Evaluation

- But a rise in tax revenue could be achieved by a fall in tax avoidance and tax evasion, so relative and absolute poverty could both fall.
- A rise in tax revenue would not reduce absolute poverty significantly if governments increase spending on components such as defence.

Third point – Improvements in education and training

- This helps to achieve economic growth as well as increasing individuals' productivity, which should increase their income from wages. Absolute poverty should fall. Relative poverty might increase if wage differentials widen between skilled and unskilled; that is, educational outcomes will differ between individuals.

Evaluation

- Education and training will not necessarily reduce absolute poverty significantly if there is a lack of job opportunities. Unemployment might remain high if aggregate demand is low.
- Relative poverty could fall over time if intergenerational poverty falls as the education system improves.

Fourth point – Changing economic systems

- Economic systems might have changed in some countries within Asia. For example, China moved from a planned economy towards a free market economy. This might have helped to achieve faster economic growth, but relative poverty would increase as free markets used to allocate resources (for example, market forces would determine wages).

Evaluation

- In the long run, many countries in Asia are likely to develop more comprehensive welfare systems that redistribute income more evenly. So relative poverty might start to fall.

Conclusion

- Reasons will differ between countries. Some causes will be due to deliberate government policies.
- As these economies develop, relative poverty may fall as more redistribution policies are introduced.

33 Inequality

Activity 1

1 Plot the following points on the same graph with cumulative percentage of households on the 'x' axis, and cumulative percentage of income on the 'y' axis. Then mark the 45-degree line – see Figure 1(a) and Figure 1(b).

Points to plot for Lorenz curve in 2001

Cumulative % of households	0	20	40	60	80	100
Cumulative % of income	0	2	8	18	36	100

Points to plot for Lorenz curve in 2015

Cumulative % of households	0	20	40	60	80	100
Cumulative % of income	0	3	11	24	44	100

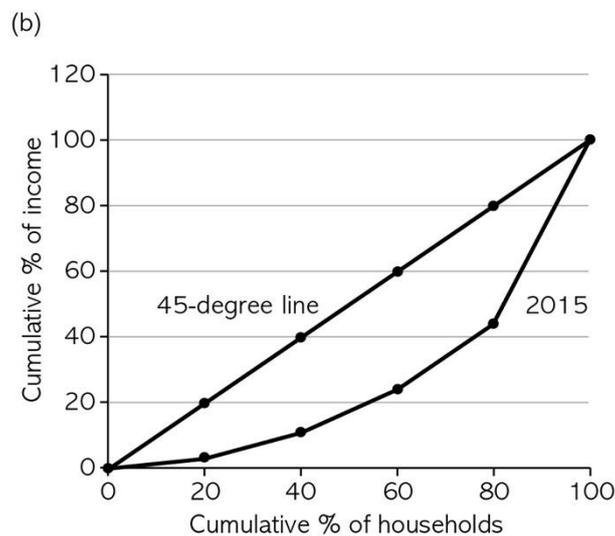
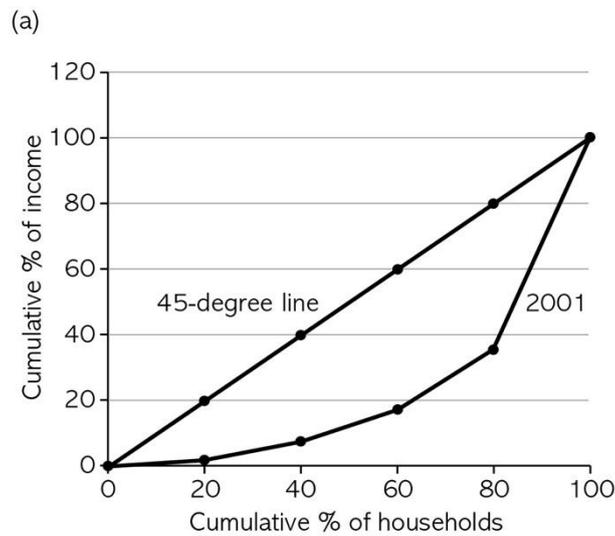


Figure 1(a) and Figure 1(b)

2 The Lorenz curve in 2015 is closer to the 45-degree line. This shows that income distribution in Brazil has become more equal over the period 2001 to 2015. The data in the table shows that poorer income groups receive a higher proportion of income in 2015 compared to 2001. For example, the poorest 40 per cent received 8 per cent of total income in 2001. This had increased to 11 per cent in 2015.

Activity 2

1 The Gini coefficient is the ratio of the area between the 45-degree line and the Lorenz Curve divided by the triangle representing the whole area under the 45-degree line. It has a value between 0 and 1. The Gini index is the Gini coefficient \times 100. The extract states that China's index rose from 31 in 1981 to 49.1 in 2008. With the assumption that this data is measuring income inequality, then income inequality has risen in China over this period. (A Gini index of 0 indicates perfect income equality and a Gini index of 100 indicates perfect income inequality.) However, since 2008 the Gini index fell to 46.5 in 2016. This shows that income inequality fell in this period.

2 Possible reasons for rise in inequality in China between 1981 and 2008:

- China's liberalisation policies since 1978. China has moved from a centrally planned system (command economy) to a mixed economy where markets are allowed to allocate resources.
- Kuznets curve suggests countries in early stages of development experience a rise in inequality. Wage differentials between those employed in agriculture and industry widen in this phase.

Possible reasons for fall in inequality in China between 2008 and 2016:

- Large-scale investment in education and health – if large-scale investment in education increases access to good quality education for everyone, then inequality should fall. FDI into China might also have raised the skills of relatively unskilled labour, so raising its productivity.
- Improved health care for poorer groups who traditionally would have received hardly any, would increase productivity for these groups. These people would also be less likely not to work as a result of ill health. This means their income is higher.
- Significant subsidy programme for poorer and rural areas – this raises income of poorer groups, so inequality falls.
- Wages rising faster in lower income areas.
- High rises in minimum wages over the last decade – this raises wages of the poorest groups. If minimum wages rise at a faster rate than average wages, then inequality should fall.
- The Kuznets curve suggests countries in later stages of development experience a fall in inequality. This is due to better education, productivity differences between sectors in the economy narrowing and growing demand for income redistribution.

Exam practice

1 (c)

Individuals in the bottom 50 per cent of income group experienced an 87 per cent rise in their real income over this period. This is much higher than the mean of 65 per cent and considerably higher than the real income gains of the richest groups.

2

- (a)** The income share held by the first quintile (the bottom 20 per cent) in 2003 was 7.2 per cent ($100 - 39.9 - 23.3 - 17.2 - 12.4$). In 2015 this was 5.9 per cent ($100 - 41.8 - 23.5 - 17 - 11.8$).
- (b)** The Gini coefficient is the ratio of the area between the 45-degree line and the Lorenz Curve divided by the triangle representing the whole area under the 45-degree line. It has a value between 0 and 1. India's Gini coefficient in 2011 was estimated to be 0.495 by the World Bank. In 1980 the Gini coefficient would have been lower than in 2014, because income distribution was more equal in 1980. The extract states that inequality rose after 1980 because median income has not even doubled, while the 'well-off are ten times richer now than in 1980'.

- (c) Inequality itself can have an impact on education because richer groups are more likely to be in education longer and can often access higher quality education. For example, in 2014 the poorest households' graduation rates increased by only 4 per cent, compared to the generation born in the 1960s. In contrast, graduation rates in the wealthiest households over the same period increased by almost 20 per cent. There are probably two reasons for this.

Firstly, those households on low incomes are unlikely to be able to afford the fees and living costs required for students who go to university. Even if loans are available, those from low income families may be more unwilling to take these out.

Secondly, poorer individuals might not have access to good quality secondary schools, so their chances of getting to university eventually and meeting the entry requirements will be lower.

In developing countries, the impact of inequality on education will be more extreme because poorer children may not have access to any school within walking distance, with no other option of transport, and children are often used by poorer families to help support the family.

- (d)

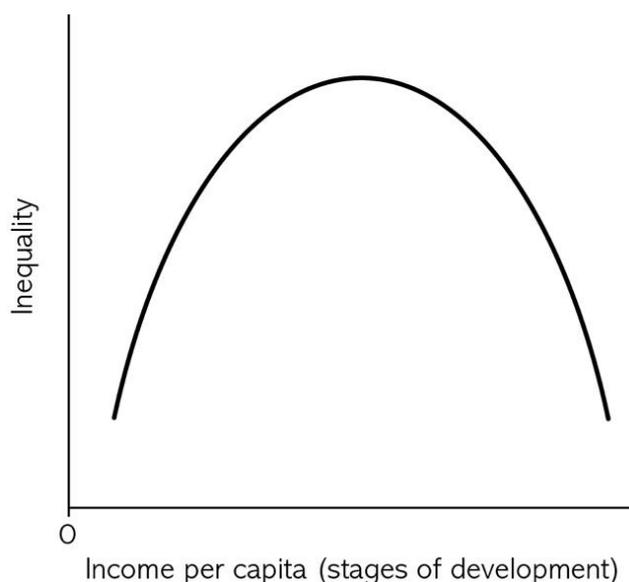


Figure 2

According to the Kuznets curve (see Figure 2), inequality rises in the early stages of development, but then falls. After India moved towards a free market economy from the late 1970s, its inequality rose. Between 1980 and 2014 its real GDP per capita rose from 390 US\$ to 1,645 US\$. This might suggest, according to the Kuznets curve, that India hadn't yet reached the stage of development where income inequality would fall as real GDP per capita rose. However, further economic change and development is eventually likely to lead to falling inequality. With economic development, the quality of education is likely to improve as the government can generate more tax revenue to fund it. As a result, more individuals will have skills to work in more productive sectors as these are created with development. The number of people working in the formal sector is also likely to increase with development, so

the number working in the informal sector should fall from the current high rate of 93 per cent of all Indians. All this should help push up wages for the poorest Indians.

How much inequality falls will depend on to what extent the government devotes its budget to education. It will also depend on whether the government places more emphasis on redistribution policies. A more progressive tax system combined with a comprehensive welfare system would have more impact on reducing inequality.

(e)

Introduction

- Understanding of rising income inequality.
- Understanding of Gini coefficient.

First point – Wage differentials between skilled and unskilled increasing

- In the EU, technological advances had increased the number of creative and analytical jobs by 15 per cent over the last 15 years, but manual jobs had fallen. Demand for skilled workers had risen, so this will push up wages for skilled workers, creating greater wage differentials between skilled and unskilled workers. At the same time, demand for unskilled workers had fallen, creating some unemployment for these workers.
- Extract B states that in India, when liberalisation came, only a few were able to benefit due to the poor education system, which meant millions of adults remained unskilled. This meant wages of these unskilled workers, often in the informal sector, grew at a much lower rate than wages for more skilled workers in the formal sector. This is partly due to the abundant supply of unskilled labour in India.

Evaluation

- But greater funding by the government on education and training programmes could help to reduce income inequality, provided the new skills needed by workers in the changing labour markets are addressed by education reforms.
- But as India further develops, it is likely that jobs in the formal sector will grow and the government will have more funds available to devote to education.

Second point – The impact of changes in tax and welfare benefits

- Income inequality would have risen in India between 1970s to mid-1980s as top rates of income tax fell from 97.5 per cent to the mid-50s. Income inequality would have continued to rise further if the tax system had continued to become less progressive. For example, it might be the case that some regressive taxes were introduced.
- In the EU, fiscal austerity in some countries, as a result of the Global Financial Crisis, might also explain why income inequality within some countries rose. For example, spending on welfare payments might have fallen in some countries.

Evaluation

- The extent to which income inequality rises would depend on to what extent tax rates change and whether the tax system as a whole becomes less progressive. India is likely to have a less well-developed welfare system compared to EU countries, so income inequality might be higher than in EU countries.

Third point – Changes to the economic system

- The rises in income inequality from the 1980s to 2000 are likely to have been more significant than recent increases in inequality within India, because India was moving towards a free market economy. With wages set by supply and demand in individual labour markets, wage differentials would have been much greater between workers than under a centralised or command economy system.

Evaluation

- But the impact of this would not explain increases in inequality since 2000, when these reforms had been largely completed.

Conclusion

- Causes likely to differ in importance between India and EU countries.
- In both cases, government policies on tax rates and level of welfare spending will have an impact. For India, the structure of its economy is likely to change significantly over time as it develops (for example, between agriculture, manufacturing and the tertiary sector, as well as between formal and informal jobs). This will have a significant impact on types of jobs created and therefore on whether inequality starts to fall.

3 Aim to make some real-world references to economies.

Introduction

- Understanding of income inequality.

First point – Impact on economic growth

- Rising inequality can increase incentives to work and therefore drive economic growth. Individuals may decide to invest more in their own education if the potential monetary reward seems greater. Rising inequality may also drive growth by providing entrepreneurs with incentives to invest and innovate – again the motivation for them is the chance to make high monetary rewards. Living standards might rise for all groups, even though inequality rises.

Evaluation

- But if inequality is extreme, this removes incentives because many poor groups cannot access the sort of education or health care needed to take advantage of any opportunities. So economic growth might be constrained.
- Some potential entrepreneurs from poor backgrounds cannot set up if they lack a stock of wealth, which is often built up from income. So economic growth might be constrained.

Second point – Impact on savings

- Rising inequality might increase the savings ratio if income is redistributed from poorer groups to richer groups. This is because higher income groups have a higher marginal propensity to save from the extra money earned. This might reduce the value of the multiplier in the economy as the MPC will fall if the MPS rises. This might impact negatively on growth.

Evaluation

- But many factors affect the marginal propensity to save.

Third point – Life expectancy may fall

- If rising income inequality pushes more people into absolute poverty, then life expectancy would be expected to fall. Differences in life expectancy between poor and rich within a country would widen. Even in developed countries, income inequality causes relative poverty. This often leads to low labour force participation among some poor groups and low educational attainment. This can then cause health problems, such as mental health problems for example. Increase in unhealthy behaviours, such as poor diet.

Evaluation

- But this depends on how much the government directs education spending towards the disadvantaged or whether health care is provided for all.

Fourth point – Impact on migration

- Rising inequality within a country can provide an incentive for skilled migrants from other countries to want to emigrate there, to take advantage of the opportunity to earn relatively high incomes. This helps to promote economic growth, so raising real GDP and increasing living standards.
- High inequality within a country might cause some disadvantaged groups to migrate abroad; for example, high youth unemployment in countries such as Spain incentivised some to emigrate abroad. This would have constrained Spain's potential growth, as the size of the labour force fell.

Evaluation

- The impact of inequality on migration can have a positive or negative impact for a country.

Conclusion

- The impact of a rise in inequality on an economy will depend significantly on what has caused the rise in inequality. For example, does the rise cause more people to move into absolute poverty? Does the rise in inequality create more tax revenue for the government? In this case, this gives the government scope to spend money on components of government spending which increase well-being.

34 Public expenditure

Activity 1

1 In a recession real GDP falls, so the economic growth rate is negative. Public expenditure, as a percentage of GDP, would be expected to rise for three reasons:

- In a recession a government is more likely to pursue an expansionary fiscal policy. This means government spending would rise relative to taxation. This injects money into the circular flow of income and so increases aggregate demand.
- In a recession unemployment is rising, so government spending on welfare payments would be expected to rise.

- Lastly, even if public expenditure levels remain the same, the fall in GDP means public expenditure, as a percentage of GDP, would rise.

The data for the USA during the Global Financial Crisis supports this. By 2009 the USA's economic growth rate fell to a low of -3 per cent. Between 2008 and 2009, public expenditure, as a percentage of GDP, increased from about 39 per cent of GDP to a peak of 43 per cent of GDP. Between 2007 and 2008, economic growth rates were slowing down as public expenditure as a percentage of GDP was increasing. Between 2009 and 2010, economic growth rates moved from negative to positive economic growth rates. During this period, public expenditure as a percentage of GDP remained broadly similar with a slight decline.

Activity 2

1 In 2016 India's tax revenue, as a percentage of GDP, was only 17 per cent. The Indian government has adopted policies to increase its levels of taxation. Demonetisation meant many individuals were forced to declare previously hidden money to the tax authorities. The introduction of the Goods and Services tax also had the same effect, causing more businesses to have to register to pay this indirect tax. Taxation levels will rise as tax evasion or tax avoidance falls.

2 The government's chief economic advisor says in the extract that having more revenue gives the government more scope for increasing spending on human capital, such as health and education. So the higher levels of taxation in India are likely to lead to higher levels of spending by the Indian government on health and education. So public expenditure, as a percentage of GDP, would be expected to rise.

Exam practice

1 (b)

Levels of taxation likely to be a lot lower in a developing country, compared to a high-income country. Partly due to tax evasions and a narrow tax base.

2

- (a)** In South Korea in 1990, government spending as a percentage of GDP was 21.4 per cent. If social protection by the South Korean government was 2.3 per cent of GDP in 1990, then the proportion of government spending on social protection is $2.3 \div 21.4 \times 100 = 10.7$ per cent.
- (b)** Current expenditure is day-to-day spending by the government. It is spending on goods and services that will be consumed within a short time. Examples are wages of teachers, or heating and lighting for a hospital. It is distinct from capital expenditure which is spending on investment goods. In Extract B, current spending by the government increased by five percentage points of GDP. Most of this was increases in the total wage bill in the public sector.
- (c)** Between 1990 and 2016, government spending as a percentage of GDP increased from 21.4 per cent to 32.3 per cent. At the same time, tax revenue as a percentage of GDP, increased from 18.8 per cent to 26.3 per cent. So this suggests an increase in

public expenditure (as a proportion of GDP) over time means taxation (as a percentage of GDP), has also increased. This is not surprising as public expenditure is mostly financed from taxation.

Public expenditure can be higher than levels of taxation, if the government runs a fiscal deficit. Extract B states that for Senegal, the increase in public spending was not accompanied by similar increases in tax revenues. As a result, borrowing by the public sector reached a deficit of 5.2 per cent. However, most governments will not want to run excessively high fiscal deficits. For example, in Senegal the fiscal deficit was already causing problems as it seemed to be causing financial crowding out, raising concerns that this debt would be increasingly 'costly as credit conditions tightened'. It is also true that some governments can finance government spending from other sources of income. For example, governments in oil-rich countries have revenue from the sale of oil to pay for some government spending. However, this would not be relevant for most governments. So the likely effect of differing levels of public expenditure, as a proportion of GDP, on levels of taxation is that they will be positively related; in other words, they move broadly in the same direction.

- (d) Public expenditure in South Korea, as a percentage of GDP, increased from 21.4 per cent in 1990 to 32.3 per cent in 2016. One reason that might explain this is changing expectations. For example, after the Asian financial crisis of 1997–98, many Asian governments, including South Korea's 'found it impossible to leave large numbers of unemployed people without support'. So the size of public expenditure on many components of government spending would be expected to rise over time as an economy develops.

Linked to this is the impact of changes in age distribution, as well as rising expectations on what the government should provide. In 2008, South Korea introduced a basic pension scheme providing long-term care for the elderly. Figure 5 in the Students' book shows the elderly form a much higher proportion of South Korea's population than they used to; this increased from about 5 per cent in 1990 to about 13 per cent in 2014. This would explain why both the size and pattern of public expenditure has changed in South Korea. Both social spending and health care spending has become an increasing component of government spending. Figure 6 shows that both social spending and health care spending increased at a much faster rate than other areas of government spending. By contrast, education spending increased at a much slower rate, so reflecting the falling share of younger people in the population.

Equally, it might be that the significant rise in spending on social protection, as a percentage of GDP, was perhaps due to South Korea being in a recession in 2014. Perhaps unemployment was particularly high. The size of government spending overall might also increase if the government wants to inject more government spending into the economy.

However, the impact of more elderly people on health care spending will depend partly on whether there is universal health care provision. So changes in age distribution might not have such a significant impact on health spending compared to other factors. The growth in the welfare state in South Korea might also be due less to changes in expectations on what the government should provide, and more to do with the government's ability to finance this.

(e)

Introduction

- Understanding of public expenditure.

First point – The impact on productivity and growth

- In 2003 Senegal's public expenditure was 21 per cent of GDP. By 2014 this had risen to 28 per cent. Despite Senegal having a higher level of public spending, as a percentage of GDP, in the region, its average growth was below the region's average, so the economic effect might have been to slow down growth. Free market economists might argue that efficiency in the public sector is lower than in the private sector because the government lacks the profit motive.
- An increase in government spending is an injection into the circular flow of income, so actual growth will rise. This will help to reduce absolute poverty. The spending on welfare, such as in Indonesia, will also target poverty reduction directly.

Evaluation

- But some goods and services provided by a government are vital for increasing supply-side growth. For example, spending on education and health.
- Extent AD might increase depending on the value of the multiplier.

Second point – Crowding out

- An increase in public expenditure, as a percentage of GDP, could crowd out the private sector. Illustrate using a PPF curve. If the economy is at full employment, extra public spending will crowd out private sector spending. This is called resource crowding out. Financial crowding out will also occur if the government has to borrow extra money. This will cause interest rates to rise. Higher interest rates cause less private sector borrowing – both for consumption and investment.

Evaluation

- But crowding in can occur if the economy is operating within its PPF. Extra government spending can increase private sector spending if it sets off a positive multiplier effect.
- But if the government spends extra money on investment (an infrastructure and public investment-led growth strategy called the PSE in Senegal), this will increase long-run growth – the PPF shifts outwards. So private spending increases, too. As Extract B states, 'that's not an issue so long as infrastructure ends up building the capacity of the private sector so that it can become more competitive and productive'.

Third point – Levels of taxation will rise

- In South Korea, rising public spending as a proportion of GDP was accompanied with rising levels of taxation as a proportion of GDP. Extract B also states that Senegal's continued support of the PSE will require raising tax revenues. Higher taxes might reduce incentives to work.

Evaluation

- Levels of taxation may not need to rise at the same rate if the government increases its fiscal deficit. However, this would cause financial crowding out.

Conclusion

- Increasing government spending which promotes supply-side growth will be particularly beneficial. For developing countries, spending on infrastructure will significantly boost growth as infrastructure gaps are often very high. This will then increase efficiency of the private sector.
- The effects depend on which areas of government spending increase.

3 It is important to make some references to real-world examples.

Introduction

- Understanding of public expenditure and GDP.

First point – Economic recovery should lead to fall in public expenditure as a percentage of GDP because:

- Positive growth should reduce unemployment, and so reduce spending on welfare spending (automatic stabilisers).
- Government may deliberately cut government spending to prevent the economy over-heating.
- Even if the level of public expenditure remains the same, because GDP is rising, this leads to fall in public spending as a proportion of GDP.

Evaluation

- Would not explain a long-run fall in public spending, as a proportion of GDP.

Second point – Age distribution

- Change in the age distribution so there is an increasing number of younger people in the population. Assumes that elderly people require greater public spending; for example, on health and social care.

Evaluation

- But younger people below 16/18 require more spending on education and health care programmes for immunisations, and so on.

Third point – Changing expectations

- Might be a change in attitudes towards views about the efficiency of the public sector compared to the private sector; for example, the austerity debate had led some people to prefer lower taxation since there is an increasing view that there is a lot of wasteful spending in the public sector. Changes in ideological views about the role of the state vs role of the market in an economy.

Evaluation

- But many people agree that some types of government spending are essential for increasing supply-side growth.
- Some goods and services would not be provided by the private sector. With rising expectation, too, these goods and services need to be provided by the state.

Fourth point

- The government wants to reduce levels of taxation. For example, to increase incentives to work. Disincentive effect of taxation and welfare payments. This might promote economic growth.

Evaluation

- But this has to be offset by increasing expectations of better-quality health care provision, better education, and so on.

Conclusion

- Reasons vary from country to country; for example, for Poland, this is to be expected since Poland used to be a command economy, so as it moved towards a free market system the size of the public sector would be expected to fall.

35 Taxation

Activity 1

1 A direct tax is a tax levied directly on individuals or companies. For Chile, examples of direct taxes are income tax, corporation tax and social security contributions. Chile raises over two times the amount of tax revenue from corporation tax receipts compared to income tax receipts.

An indirect tax is a tax levied on goods and services. Chile raises over half its total tax revenue from indirect taxes. Tax revenue from indirect taxes amounts to 55 per cent of its total tax revenue.

Activity 2

1 In 2018, South Africa increased VAT from 14 per cent to 15 per cent. The rise in VAT, which is a tax on goods and services, will increase costs for firms.

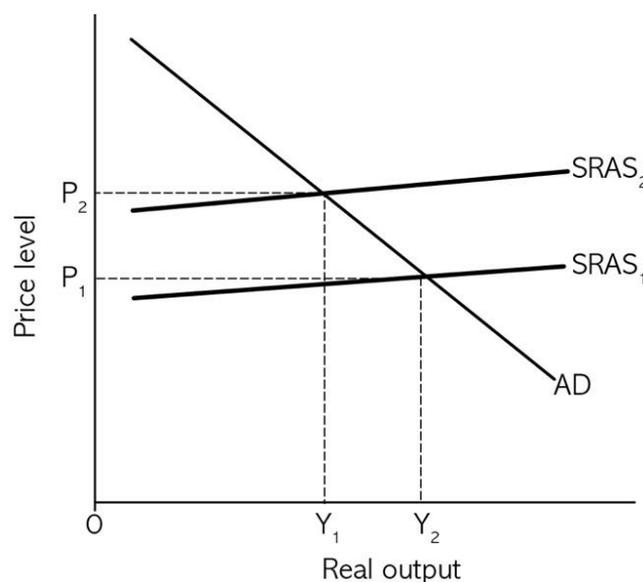


Figure 1

Because costs increase, the short-run aggregate supply curve will shift to the left. Real GDP falls from Y_1 to Y_2 . The price level increases from P_1 to P_2 .

The impact in the long run will depend on the position of the long-run aggregate supply curve. If the LRAS is at Y_2 , then Y_2 will represent the new long-run equilibrium with the price level at P_2 . If the LRAS is at Y_1 , there are two possible outcomes. Employment below full employment might lead to wage cuts as workers will lose some of their wage bargaining powers in times of unemployment. Therefore, the SRAS might shift back to $SRAS_1$. Workers may attempt to increase their wages to compensate for higher prices; they will attempt to preserve their real wage. This may cause a wage price spiral, so SRAS continues to shift left. However, eventually this cycle will break, either because unemployment becomes too high or because aggregate demand has increased. Eventually the economy should return to long-run equilibrium at Y_1 .

In contrast, a rise in personal income taxes will cause aggregate demand to fall. This will reduce real GDP in the short run, as with a rise in VAT. However, it will cause a fall in the price level, unlike a rise in VAT, which causes the price level to rise. A rise in personal income taxes will cause a fall in demand-pull inflation.

Exam practice

1 (c)

VAT is a regressive tax. Because essential items are included, the new tax system will be more regressive.

2

(a) After the tax reform, an individual can earn 5,000 RMB which is not taxed.

So taxable income = $10,000 - 5,000 = 5,000$ RMB

The first 3,000 RMB is taxed at 3 per cent

The next 2,000 RMB is taxed at 10 per cent.

So income tax paid = $(3,000 \times 0.03) + (2,000 \times 0.10) = 90 + 200 = 290$ RMB

So, proportion of income paid in income tax for individuals in China whose income is 10,000 RMB after the tax reform = $\text{income tax paid} \div \text{income} \times 100$

$$= 290 \div 10,000 \times 100$$

$$= 2.9 \text{ per cent}$$

Note: This is quite low because half of the income earned by this individual is not taxed at all as the tax exemption is half their total income.

(b) A regressive tax is a tax where the proportion of income paid in tax falls as the income of the taxpayer rises. As income increases, households tend to spend less as a proportion of income and save more. The result is that taxes on spending fall, as a proportion of income, as income rises. Value added tax, a tax on goods and services,

is a regressive tax. In China, VAT made up 39 per cent of tax collections in 2017. Social security contributions are seen as taxes and in China have recently been made less regressive than they were – ‘the government has reduced the cost of social security payments for its poorest citizens’.

- (c) According to the World Bank’s ‘Doing Business’ rankings, it is estimated that China’s total tax rate, as a percentage of profits, is 68 per cent – much higher than high income countries. Some firms in China are saying that they ‘will invest abroad if the government does not cut its tax bills’. It is therefore likely that some Chinese firms may relocate abroad to take advantage of lower taxes, so FDI outflows will increase.

It is also likely that China will start to attract fewer FDI inflows, from multinationals in higher income countries, if its tax system remains too high compared to other countries, such as Vietnam or Bangladesh. One advantage China used to offer overseas investors and domestic firms was cheap labour. However, wages have started to rise in China as the country has developed. So China is no longer such an attractive destination for FDI than previously.

- (d) Extract A states that a taxpayer earning US\$31,000 a year would see their effective tax rate fall 8.1 percentage points, while a person earning more than US\$90,000 would only see a fall of 4.2 percentage points. This suggests that income tax will become more progressive after the tax reforms. More progressive means the proportion of income paid in tax increases at a faster rate than it did before when income rises. However, the middle income group gains more proportionately than the poorest groups earning less than US\$27,000.

So it seems that income distribution will narrow between the middle income group and those on incomes above US\$90,000 but will widen between those on incomes less than US\$27,000 and those on middle incomes above this minimum. The overall effect is therefore difficult to predict. However, with such a high Gini coefficient, it is likely that the government has designed the income tax changes to narrow income distribution.

The overall impact of the proposed income tax changes on income distribution is unlikely to be significant because income tax in China raises only a relatively small proportion of total tax revenue – only 8 per cent in China compared to 50 per cent in the USA. In contrast, value added tax raises much more tax revenue in China, so China’s tax system will still remain very regressive overall.

- (e) Extract A states that China’s income tax plans will raise after-tax household income. Almost all individual taxpayers will receive a tax cut. A fall in income tax rates will increase aggregate demand in China.

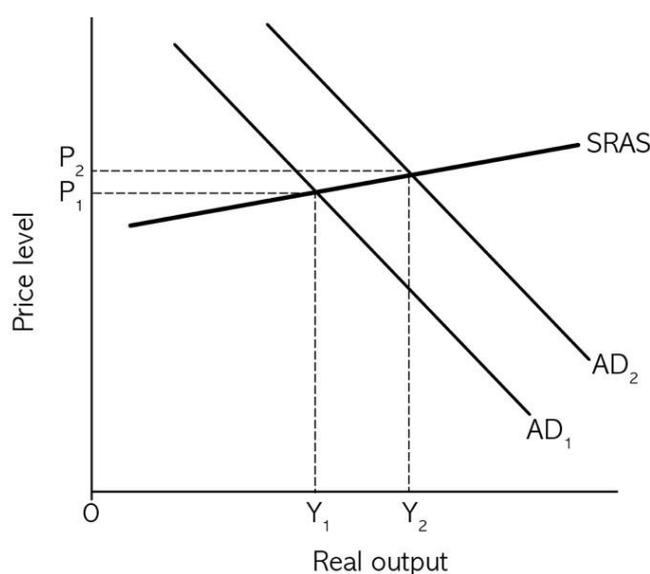


Figure 2

Aggregate demand will increase from AD_1 to AD_2 . In the short run, real GDP will rise from Y_1 to Y_2 and the price level will increase from P_1 to P_2 . Reducing income tax rates is an example of expansionary fiscal policy. Cyclical unemployment will fall as real GDP increases, but demand-pull inflation will rise. The extent aggregate demand rises will depend on the value of the multiplier as well as the size of the injection created. In this case, the impact on aggregate demand is likely to be relatively small because income tax makes up such a small proportion of total tax revenue.

In the long run the effect will depend on the position of the LRAS for China.

If the increase in aggregate demand has pushed China's economy into a positive output gap, so it is operating beyond full employment, then the impact will just be inflationary in the long run. Operating beyond full employment in the short run will just cause costs to rise, so the SRAS will start to shift to the left. Real GDP will fall back to Y_1 but the price level will now be higher.

However, if China's economy had been in a negative output gap, the rise in aggregate demand might help it move to its long-run equilibrium. So real GDP will rise with some demand-pull inflation. Figure 5 in the Students' book suggests that the economy may have been in a negative output gap in 2017, because consumption growth had been on a downward trend since 2012. So, a fall in income tax rates will help to reverse this trend.

3 Aim to make some reference to real-world economies. The use of AD/AS diagrams is useful to show the effects.

Introduction

- Understanding of indirect taxes.

First point – Impact on real GDP

- Abolishing the 6 per cent goods and services tax will reduce costs for firms, so the SRAS will shift to the right. Real GDP will rise. Unemployment will fall.

Evaluation

- Impact on real GDP depends on PED of AD curve.

Second point – Impact on income distribution

- Income distribution will become more equal. A tax on goods and services is a regressive tax. A regressive tax is a tax where the proportion of income paid in tax falls as the income of the taxpayer rises. As income increases, households tend to spend less as a proportion of income and save more. The result is that taxes on spending fall, as a proportion of income, as income rises. So abolishing this tax will make Malaysia's tax system less regressive.

Evaluation

- This assumes that essential items, such as food and energy, were not tax exempt. It is spending on these items that takes up a large proportion of a poorer person's income.

Third point – Impact on tax revenues

- The government might end up raising less total tax revenue. Abolishing this tax will mean there is no tax revenue from this goods and services tax. This might then reduce the level of public expenditure or the budget deficit will rise.

Evaluation

- But real GDP rises – so overall tax revenues will rise if the increase in income tax receipts (or other tax receipts such as corporation tax) is greater than the tax revenue lost on the goods and services tax.

Fourth point – Impact on the price level

- The price level will fall as the SRAS shifts to the right.
- Real incomes should rise if the price level falls; this raises living standards.

Evaluation

- But impact on individual goods and services will depend on the PED.

Conclusion

- Impact might be limited as a 6 per cent rate seems low by comparison with high income countries, such as those in the EU.

36 Public sector borrowing and public sector debt

Activity 1

1

- (a) A fiscal deficit is when government spending is greater than its income (also called revenue) in a given year. In contrast, a fiscal surplus is when government spending is lower than its revenue in a given year.

In Australia, it was forecast that the budget would return to surplus by 2019–20. In other words, there was likely to be a fiscal surplus from 2019–20 onwards. Prior to this period, Australia had been running a fiscal deficit.

- (b)** National debt is the total borrowing of the government which remains to be paid to lenders. However, a fiscal deficit is when government spending is greater than its income (also called revenue) in a given year. A fiscal deficit of say \$20 billion in a particular year adds \$20 billion to the national debt, whereas a fiscal surplus of \$20 billion would reduce the national debt by \$20 billion. Australia's national debt was expected to reach a peak of 18.6 per cent of GDP in 2017–18 and fall to 3.8 per cent of GDP by 2028–29. The passage also states that the forecast is for the budget to return to surplus by 2019–20. This means that in the period 2018 to 2029, Australia was expecting to make fiscal surpluses.
- (c)** Automatic fiscal policy is changes in government spending and tax revenue which occur automatically as GDP changes. These changes result from a set of rules, largely on welfare payments, income tax and goods and services tax. In Australia, economic growth was expected to be 3 per cent in 2018–19, so a rise in national income will automatically raise more income tax receipts. A strong job market also means unemployment will be low so government spending on welfare payments, such as unemployment benefits, will be low.

Discretionary fiscal policy, however, is deliberate decision making by government to change rates of tax, introduce new taxes or change levels of government spending. For example, in May 2018 the Australian government made a decision to cut taxes for lower and middle income earners.

Activity 2

1 Debt servicing costs include the amount of interest paid on the national debt. When the government borrows money it must repay this with interest. Debt servicing costs are rising because in 2017 the US government cut taxes but increased government spending. This would cause a fiscal deficit and therefore increase the national debt. Assuming interest rates are not falling, a rise in national debt would increase debt servicing costs. In the USA, the CBO predicts the national debt will rise to nearly 100 per cent of US GDP at the end of the 2020s. As a result, interest repayments were forecast to double from 1.6 per cent in 2018 to 3.1 per cent in 2028.

2 The extract states that 'rising fiscal deficits are projected to crowd out investment throughout the next decade'. A rising fiscal deficit is likely to increase interest rates. A rise in demand for borrowed funds will cause the price of borrowed money (the interest rate) to rise. The rise in the interest rate rations out scarcity in the borrowed funds market. As a result, private sector borrowing will fall. This is called financial crowding out.

Exam practice

1 (c)

GDP was falling every year between 2008 and 2013. IF GDP is falling and the national debt, as a percentage of GDP, is falling between 2009 and 2011, then the amount of money owed by the government to its lenders **MUST** be falling.

2

- (a) $\text{GDP} = 8.5 \text{ trillion} \times 100 \div 10.5 = 80.95 \text{ trillion Nigerian naira}$
- (b) Brazil has a huge structural fiscal deficit, which the IMF thinks will reach 11 per cent of GDP by 2022. A structural fiscal deficit is that part of a fiscal deficit that exists even when the cyclical deficit is zero, which occurs at the top of a boom in the trade cycle. The structural fiscal deficit is sometimes called the 'cyclically adjusted deficit' because the effect of automatic stabilisers on government spending and taxation have been taken out.
- (c) Economic recovery should increase revenue for the government. Economic recovery means aggregate demand is increasing, so as spending rises Brazil should raise more taxation from indirect taxes. Tax revenue from direct taxes, such as income tax, will also rise as national income rises. At the same time, government spending on components such as welfare payments will fall as unemployment falls. So economic recovery should reduce Brazil's fiscal deficit due to automatic stabilisers. Figure 4 supports this relationship. In times of rising economic growth, Brazil's fiscal deficit as a percentage of GDP tends to fall, and vice versa. However, this pattern does not follow in every time period, so other factors must be affecting the size of the fiscal deficit.

Extract A states that although the fiscal deficit will close with economic recovery, it will not be eliminated, because government spending would remain higher. Even in a boom, Brazil would still have a large fiscal deficit – the IMF estimates that the structural fiscal deficit will reach 11 per cent of GDP by 2022. So economic recovery will reduce the fiscal deficit because of the effect of automatic stabilisers, but it will not eliminate it.

- (d) Factors affecting the size of a fiscal deficit which could be developed from the extracts include:
- State of the economy (for example, when Brazil was in its worst recession in its modern history 2013–2016, its fiscal deficit increased from approximately 3 per cent of GDP in 2013 to 8 per cent of GDP in 2015). So the cyclical component of the fiscal deficit is explained by automatic stabilisers.
 - But Brazil's high fiscal deficit is also due to its very high structural fiscal deficit. So even in a boom, Brazil would have a high fiscal deficit.
 - The state of the economy might also influence discretionary fiscal policy. For example, in Extract B the Nigerian government said it wanted to borrow heavily to help the economy recover and so announced an increase in capital spending.
 - But in the long run this is likely to reduce fiscal deficits because an increase in real GDP, caused by supply-side growth, will raise more tax revenue.
 - The amount the government has to pay in debt interest will also increase the fiscal deficit. If national debt is high, which is the case for Brazil, then a large component of government spending is likely to be on debt interest. This, combined with 'high interest rates', means debt interest repayments will be high. This is likely to increase Brazil's fiscal deficit.
 - But even if national debt rises, the amount paid in debt interest might fall if interest rates fall.

- For Brazil, its high spending on pensions is likely to be increasing its fiscal deficit. This is because it has an ageing population, but also because it has increased pensions at the same rate as the minimum wage over the past decade.
- Japan has a larger ageing population, yet its spending to pensioners is lower than Brazil's, as a percentage of GDP. So Brazil's government could cut some of its pension spending.

(e)

Introduction

- Understanding of fiscal deficit and national debt.
- Understanding that a fiscal deficit increases the national debt.

First point – Opportunity cost of higher interest repayments

- High interest repayments in Brazil create a high opportunity cost. For example, money spent on interest repayments means less money spent on infrastructure, education and job creation. So potential (supply-side growth) will fall.

Evaluation

- But inflation might erode the real value of debt.
- But a large national debt can exist with low interest rates (for example, quantitative easing pushed interest rates to virtually zero).

Second point – Crowding out the private sector

- A high national debt and fiscal deficit could crowd out the private sector – both resource and financial crowding out. Evidence of this in Nigeria. A higher fiscal deficit had pushed up interest rates ('had raised bond yields'). 'Private sector credit had been crowded out'. So investment and consumption are likely to have fallen. This would reduce actual economic growth.

Evaluation

- But interest rates will not necessarily rise.
- But public sector spending might increase efficiency in the economy more than the private sector – such as vital spending on infrastructure and education, which increases productivity and growth.
- Crowding in rather than crowding out may occur.

Third point – Intergenerational equity

- In Brazil, the high fiscal deficit and growing national debt seems to be benefitting pensioners. If the rise in national debt is not sustainable, then future generations may experience the pain of austerity.

Evaluation

- But the fiscal deficit and national debt may fall as a percentage of GDP.
- But there may be long-term benefits if the debt has been used to fund investment in infrastructure, as with Nigeria.

Conclusion

- Depends largely on whether the national debt and fiscal deficit is large due to excessive current expenditure or due to capital expenditure.
- May not be a problem if the country has a high credit rating.

3

Introduction

- Understanding of fiscal deficit and how this increases the national debt.

First point – Expansionary fiscal policy

- Injection into the circular flow of income. Real GDP increases and unemployment falls. Demand-pull inflation will occur. Use of AD/SRAS diagram. Useful if the economy had suffered a demand-side shock.

Evaluation

- But it may cause the economy to overheat so it is operating in a positive output gap. Could illustrate using a LRAS, AD/SRAS diagram. This would not be beneficial in the long run; the only effect in the long run will be to cause inflation. If the economy is operating beyond full employment, then this will trigger cost-push inflation as labour has become very scarce.
- To what extent AD increases depends on the value of the multiplier.
- Particularly beneficial if the economy was in a recession (for example, could use Keynesian view of LRAS curve to illustrate).

Second point – Crowding out

- A high fiscal deficit will push up interest rates, causing financial crowding out.
- Resource crowding out also occurs.

Evaluation

- But public spending can increase potential growth more than some private sector investment.
- May be crowding in if the economy was currently operating inside its PPF.

Third point – Debt servicing

- Likely to increase interest repayments for the government in future years as the national debt grows. Creates an opportunity cost for government spending on components such as education, and so on.

Evaluation

- But a high cyclical fiscal deficit over a few years is less significant than if the government is running a high structural fiscal deficit.
- Less significant if the level of national debt is still low.

Fourth point – A high fiscal deficit

- A high fiscal deficit, if it leads to a high level of national debt, might cause intergenerational inequity. For example, government spending on pensions might be high today but, in the future, might have to be cut or retirement age increased, if the government wants to reduce the national debt to sustainable levels.

Evaluation

- But future generations might gain if the deficit is used to finance long-term growth.

Conclusion

- Depends on the current state of the economy.
- Depends on the current level of national debt.
- Depends on why the fiscal deficit is high – for example, what type of government spending has increased?
- If the increase in the amount of borrowing (the fiscal deficit) is less than the real GDP growth, then the national debt as a percentage of GDP will fall.

37 Using macroeconomic policies

Activity 1

1 Possible advantages:

- It will reduce the costs of financing the deficit – for example, debt servicing costs will fall. This will allow the government to spend more on components of government spending such as education, health and infrastructure spending.
- If debt is sustainable for the government, it will access funds to borrow when it needs to.
- If Argentina manages to increase the efficiency of the public sector and the efficiency of its tax collection, it can minimise the ‘real’ cuts to public sector services while still reducing the fiscal deficit and national debt as a percentage of GDP.

Possible disadvantages:

- Reducing transport and energy subsidies might impact the poor more than the rich, because spending on these is likely to represent a higher proportion of their spending.
- Cutting capital expenditure is likely to reduce supply-side growth. Reducing capital spending will reduce productivity and growth.
- Cutting government spending and raising taxation is contractionary fiscal policy. Real GDP will fall and unemployment will rise. With automatic stabilisers this will increase spending on welfare payments and tax revenue will fall as income levels fall. Therefore, the fiscal deficit may start to rise, even though the original intention was to reduce the fiscal deficit.
- Argentinian firms that export might lose international competitiveness due to the export taxes.

Activity 2

1 A rise in interest rates is contractionary monetary policy. A rise in interest rates will reduce a country’s inflation rate for the following reasons:

- A rise in interest rates will reduce aggregate demand. For example, consumption will fall because there is more incentive to save. Borrowing to finance consumption is also more expensive. An increase in borrowing costs will also reduce investment.

A rise in interest rates also causes the exchange rate to appreciate. This should reduce exports and increase imports. The fall in aggregate demand will reduce demand-pull inflation.

- Because a rise in interest rates causes an appreciation of the exchange rate, import costs will fall, so cost-push inflation will also fall.
- As real GDP falls and unemployment rises, this is likely to reduce wage bargaining pressures in the economy. A fall in wages will also reduce cost-push inflation.

Activity 3

1 The extract does not make it clear what policies Macron will use to help people exit poverty, other than they are policies designed to increase employment. These might include increasing incentives to work, government spending on schemes to help an individual improve their job search, government spending on training schemes to help the unemployed gain skills to make them occupationally mobile and policies to promote job creation. Creating more jobs might mean the use of reflationary fiscal and monetary policies to increase real GDP and therefore increase employment.

The French government also wants to spend money on breakfast clubs and subsidised school meals which are targeted at poor children in France. More money spent on education has also halved class sizes. Reducing class sizes benefits all children and the quality of education should improve. As a result, children from poorer backgrounds, who might have less parental help in their education, will leave school with better qualifications and skills. This will give them more job opportunities and more chance of earning higher wages, so the 'cycle of poverty' may be broken.

2 Increasing incentives to work, by lowering financial support for those who are currently unemployed, will not reduce poverty if jobs are not available.

Not all poverty is eliminated by working. Some work is at very low wages, so poverty can still exist.

Jobs created might not be in areas of the highest poverty concentration. It is unlikely that those who are currently poor are geographically mobile.

Providing support for children will only help families. There are likely to be many adults, with or without children, who are in need of financial support (two-thirds of all those in poverty are adults).

Exam practice

1

(a) Population in Greece in 2009 was 11.2 million.

The number of people who lived in households, whose income was lower than half the median household income = 0.13

Population: 1

Ratio is 0.13:1

The number of people who lived in households, whose income was lower than half the median household income = $0.13 \times 11.2 \text{ million} = 1.456 \text{ million}$

- (b) Macroeconomic policies are policies that are used to achieve the government's macroeconomic objectives, such as low inflation and full employment. Extract B focuses on macroeconomic policies that would be classified as fiscal policy. Fiscal policy is the use of government spending and taxation to influence the economy. Changing government spending or tax rates is the use of fiscal policy. Reducing tax rates is also viewed as a supply-side policy because the effect will be to shift the LRAS curve to the right, if incentives to work increase.
- (c) Fiscal austerity is when a government cuts government spending and/or raises taxation to reduce fiscal deficits. This is contractionary fiscal policy. The impact will be to reduce aggregate demand, causing real GDP to fall from Y_1 to Y_2 . Demand-pull inflation also falls from P_1 to P_2 . The extent to which AD falls depends on the value of the multiplier, as well as how much government spending is cut and taxes are kept high. See Figure 1.

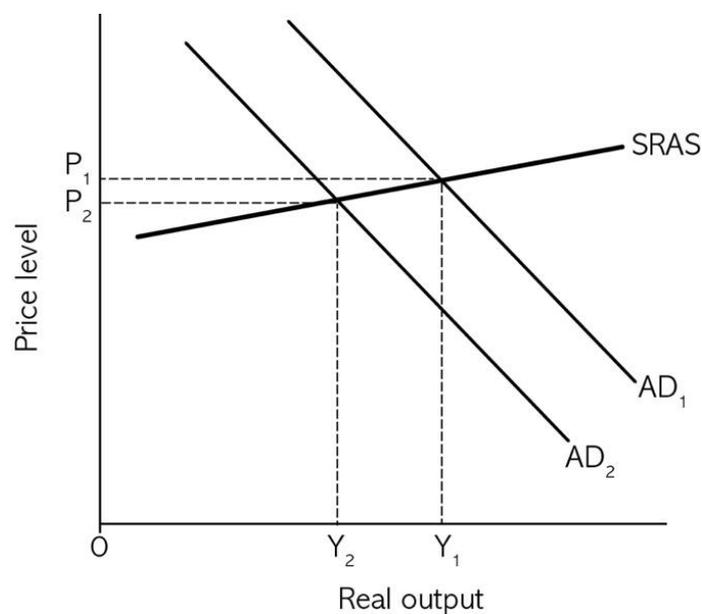


Figure 1

For Greece, austerity contributed to an 8-year recession, so it had a significant negative impact on Greece's economy.

- (d) The tight fiscal target to maintain a primary surplus of 3.5 per cent of GDP a year until 2022, means government spending will be lower than tax revenue (excluding debt repayments). This creates a net withdrawal from the circular flow of income, so aggregate demand will fall. This will reduce actual growth. Real GDP will fall from Y_1 to Y_2 . The extent to which aggregate demand falls will depend on the value of the multiplier. See Figure 1.

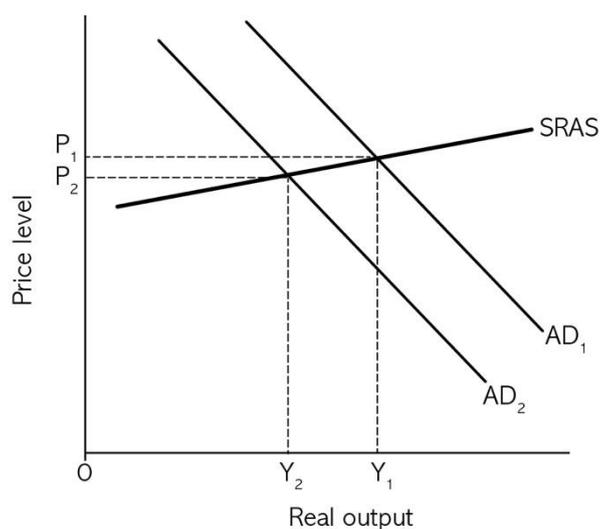


Figure 1

However, running a primary surplus might put downward pressure on interest rates. It will be a reversal of financial crowding out. As a result, private sector spending may rise as a result. This may offset the fall in aggregate demand caused by the primary surplus.

Creating this target also 'limits the government's ability to cut taxes'. This will restrict potential growth, because higher taxes can create a disincentive to work. Some cuts in government spending will also restrict potential growth. For example, if the government reduces spending on infrastructure.

So the extent of the negative impact on growth will depend ultimately on what components of government spending are cut. The negative impact on economic growth might be limited if the Greek government can make efficiency savings.

(e)

Introduction

- Understanding of poverty – both absolute and relative.

First point – Reduce the tax burden on middle income earners

- Although this group is not 'poor', the impact may be to increase incentives to work. If this is effective, this would shift the long-run aggregate supply curve to the right. Real GDP will rise and this will create jobs. This would be beneficial because the current unemployment rate in Greece is just over 20 per cent. The cause of poverty for many will be unemployment.

Evaluation

- But some jobs created may only be part-time, which has been the case in Greece in recent years. Underemployment may not lift people out of poverty.

Second point – A rise in the minimum wage (direct control) and rent subsidies for low income families

- A rise in the minimum wage reduces poverty for those in work. It might increase productivity in the economy if firms invest more in training to ‘justify’ the extra wages that they have to pay.
- A rent subsidy to low income families targets poverty.

Evaluation

- A minimum wage creates unemployment – so only reduces poverty for those in work. Some workers may lose their jobs as a result of a minimum wage. Minimum wage diagram – show unemployment caused when the minimum wage is set above the equilibrium.
- But a rent subsidy will increase government spending. Because the government is committed to running a primary surplus, other components of government spending might need to be cut (for example, capital expenditure). In the long run, this may prove more detrimental to reducing poverty. However, the increase in tax collection might help to pay for the increase in rent subsidies.

Third point – Cutting tax rates (for example, VAT, corporation taxes)

- Cutting VAT would help to reduce poverty because VAT is a regressive tax. So the tax represents a higher fraction for those on lower incomes. Relative poverty will fall. Cutting VAT also increases the SRAS, so real GDP will rise. More jobs will be created.
- Cutting corporation tax might also increase investment, as retained profits rise for firms. This will then create actual growth. Potential growth will rise, too. Real GDP per capita rises so poverty should fall.

Evaluation

- But many essential goods are likely to be VAT exempt. Therefore, cutting VAT might not benefit the poor to the same extent.
- The tax cuts might be very small – Extract A says that the primary surplus rule ‘limits the government’s ability to cut taxes’.
- Increasing retained profits might benefit shareholders more than it stimulates investment. Firms may also not increase investment until business confidence improves.

Conclusion

- All measures of reducing poverty are likely to be constrained by the ‘primary surplus’ rule.
- Some measures only target a particular group – for example, preventing further pension cuts will only benefit pensioners.
- In practice, a mix of measures would be more effective.

2

Introduction

- Understanding of demand-side policies.
- External shock caused by a fall in exports for China.

First point

- Reducing the value of the renminbi to increase exports. This would increase the price competitiveness of Chinese exports in terms of foreign currency.
- This might be achieved by foreign currency transactions. The central bank would sell its own currency, the renminbi, on foreign exchange markets by buying foreign currency. Its foreign currency reserves would increase.
- Reducing interest rates would also help to depreciate the value of the renminbi and lead to a rise in many of the other components of aggregate demand (that is, consumption and investment would rise as well as exports).

Evaluation

- But this may lead to 'currency manipulation' accusations. This would lead to more tariffs, so would not be an effective policy response.
- A fall in the value of the renminbi might only improve the current account balance in the long run – once the Marshall-Lerner condition is satisfied – J curve effect.

Second point

- Expansionary monetary policy – quantitative easing/reducing interest rates.
- More detailed explanation on why consumption and investment would be expected to rise.

Evaluation

- But interest rates may already be at virtually zero rates.
- QE may not create extra lending.

Third point – Increasing government spending

- Part of expansionary fiscal policy. As with expansionary monetary policy, it creates an injection into the circular flow. Actual growth will increase. May also increase the LRAS curve (for example, spending on education and infrastructure should increase productivity in the economy).

Evaluation

- But some government spending might just crowd out private sector spending (for example, it may cause financial crowding out).

Fourth point – Reducing tax rates

- This reduces withdrawals from the circular flow of income, so aggregate demand increases. Some tax cuts also create incentives. For example, cutting corporation tax may increase incentives to invest.

Evaluation

- But might widen income distribution. It depends on whether the tax system becomes more or less progressive.

Conclusion

- Some demand-side policies might take longer to have their full effect.
- If China promotes consumption-led growth, then any tariffs imposed by other countries will have less future impact on China's economy.

3

Introduction

- Understanding of interest rates.

First point

- Higher interest rates reduce consumption: more incentive to save; borrowing to finance consumer durables becomes more expensive; mortgage repayments increase.
- Higher interest rates reduce investment.

Evaluation

- But other factors affect consumption and investment, which might offset this. For example, consumer and business confidence may be high.

Second point

- Higher interest rates cause an appreciation in the exchange rate in a floating exchange rate system and a deterioration in the current account balance of the balance of payments.
- Demand for the currency increases. More incentive for foreigners to save money in the country, so more inflows on the financial account.
- Use of exchange rate diagram to show the impact on the exchange rate. This will then have an impact on the current account. In the long run, this is likely to cause a deterioration in the current account balance (Marshall-Lerner condition – J curve).

Evaluation

- But in the short run, the current account balance may improve.

Third point

- Higher interest rates to reduce inflation to the central bank's target inflation rate.
- The fall in aggregate demand will cause a fall in the demand-pull inflation.
- Use of AD/SRAS diagram to show the fall in the price level. It takes time for a rise in interest rates to have its full impact on aggregate demand.
- The appreciation of the exchange rate will also make imports cheaper, so reducing imported inflation. This reduces cost-push inflation.

Evaluation

- The extent to which the inflation rate falls will be difficult for policy makers to predict, because the precise value of the multiplier is unknown. It will also depend, in the long run, on whether the LRAS is vertical or whether the Keynesian view of the LRAS is accepted. For example, if aggregate demand falls and the economy is operating on the horizontal part of the Keynesian LRAS, then there will be no fall in the price level.

Fourth point

- The fall in aggregate demand will increase cyclical unemployment as real GDP falls. Labour is a derived demand.

Evaluation

- But if the economy had been operating in a positive output gap, then a fall in aggregate demand will not necessarily increase unemployment. The economy may just end up operating at full employment.

Conclusion

- Impact will depend on the current state of the economy.
- Impact will depend on how sensitive consumption and investment spending is to interest rate changes.

38 Impact and problems of macroeconomic policies

Activity 1

- 1 Expansionary fiscal and monetary policies will increase aggregate demand.
 - Expansionary fiscal policy is an increase in government spending and/or a decrease in taxation. This creates an injection into the circular flow of income. For example, the USA cut taxes for businesses and increased government spending on health, education, welfare payments and infrastructure.
 - Expansionary monetary policy involves reducing interest rates. This increases consumption and investment; one reason for this is the fall in the cost of borrowing to finance this spending. A fall in interest rates also depreciates the exchange rate. This should increase exports and reduce imports. Expansionary monetary policy was also achieved through quantitative easing; this freed up the availability of credit and put downward pressure on long-term interest rates.

The increase in aggregate demand will cause a rise in real GDP. This can be illustrated with an AD/SRAS diagram. The evidence suggests that in the USA, expansionary monetary and fiscal policy helped to achieve a rise in GDP: 'By the third quarter of 2016, the US economy was 11.5 per cent bigger than at its pre-crisis peak'.

- 2 Pursuing an expansionary fiscal policy can create large fiscal deficits and a sharply rising level of national debt. There is a risk of crowding out – so the effect may be to squeeze private sector spending.

Expansionary demand-side policies may also cause aggregate demand to rise too much. Because the value of the multiplier can only be estimated, aggregate demand may overshoot and so cause accelerating inflation. Once the economy is operating in a positive output gap, workers are in a strong position to bargain for higher wages. This fuels a wage-price spiral. So there was a risk of hyper-inflation as both monetary and fiscal policy were creating a large stimulus to the economy.

Activity 2

1 'Transfer pricing' is an accounting technique used by transnational companies for reducing taxes on profits by selling goods at a low price internally from a high tax country to another part of the company in a low tax country. The objective is to make the total amount of tax paid on total profits as low as possible. The multinational is effectively paying less tax than the tax rules originally intended. It is legal but 'unfair'.

2 Tax revenue as a percentage of GDP in developing countries is usually much lower than in developed countries. This severely constrains public expenditure in developing countries. This is particularly damaging for developing countries where absolute poverty is often high and living standards are low. Some government spending is particularly beneficial for promoting economic growth and development, such as infrastructure, health and education spending. However, in a developing country this government spending will be far too low.

Activity 3

1 Attracting FDI will be beneficial for Kuwait's economy for the following reasons:

- If the FDI brings in 'new technologies and innovations' this will help to promote supply-side growth (potential growth). The LRAS will shift to the right.
- The sectors that are being expanded from FDI inflows include water, urban development, housing, education and health care – all of which will help to improve living standards and will promote economic development. Potential growth will also increase as the quality of human capital will improve.
- Economic diversification, as a result of FDI, will also help Kuwait minimise the problems caused by some external shocks to the Kuwait economy. For example, it will be less negatively affected by a fall in oil prices.
- FDI in general will promote both actual and potential growth in Kuwait, particularly if it is greenfield FDI.

Activity 4

1 Problems facing policy makers in Asia when making decisions during 2018 were:

- They didn't know how long the USA would continue to raise interest rates or by how much.
- They didn't know how much the value of their exchange rate would fall. For example, it is hard to know to what extent capital flight will occur.
- The rise in the costs of government borrowing might prevent the use of expansionary fiscal policy as a policy tool – to prevent an excessive fiscal deficit.
- Policy in the USA, because it has caused an impact on Asian exchange rates, might cause inflation rates to rise above their target level.

- Asian economies are having to deal with external shocks. For example, the dramatic fall in the exchange rate will push up imported costs. Slower growth in China, caused by the tariff trade war between the USA and China, will also reduce China's demand for imports. So other Asian economies will experience a fall in their exports.
- Any policy response would also have to be made with inaccurate information (for example, the value of the multiplier is only likely to be an estimate).

Exam practice

1 (c)

This is quantitative easing.

2

- (a) 'Fiscal deficit reduction' is when a government attempts to reduce the size of its fiscal deficit. To do this requires cutting government spending and/or increasing taxation. In recent years this has been called 'austerity'. Fiscal deficit reduction would have the effect of reducing aggregate demand and, at least in the short run, real GDP would fall. Fiscal deficit reduction is thought by some economists to be beneficial, at least in the long run, because running a fiscal deficit, if it becomes too large, can create some problems (for example, it can cause crowding out).
- (b) Expansionary fiscal policy is the use of government spending and taxation to create an injection into the circular flow of income. The government will increase government spending and/or reduce taxation. In 2009, both the USA and the UK were in a recession with economic growth rates of (respectively) about -3 per cent and -4 per cent. Expansionary fiscal policy was used as a policy response to the Global Financial Crisis. By 2010 both these economies were experiencing positive economic growth rates again, so expansionary fiscal policy is partly likely to explain this.

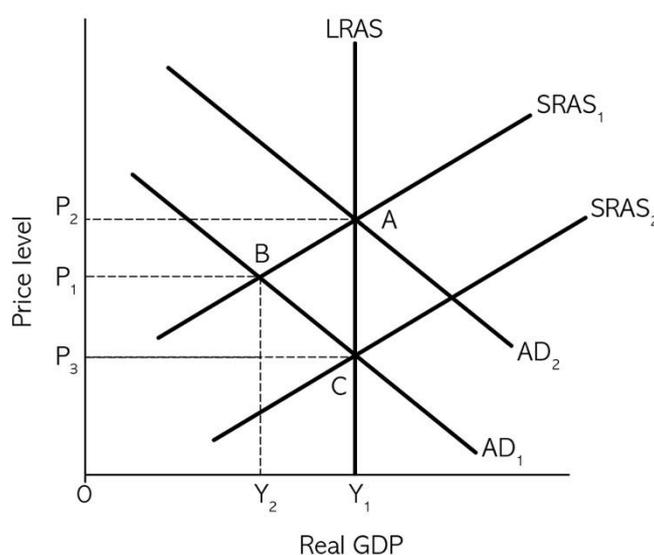


Figure 1

For example, in Figure 1, pre-crisis shows the economy at point A. The Global Financial Crisis caused aggregate demand to fall from AD_1 to AD_2 . The economy moves from point A to B, so real GDP falls. Expansionary fiscal policy would cause aggregate demand to increase from AD_2 to AD_1 , so enabling economic recovery.

Expansionary fiscal policy would be particularly effective if 'economies do not self-stabilise'; in other words, if the economy remains at point B without any intervention, then expansionary fiscal policy is one method to achieve economic recovery. The impact expansionary fiscal policy has on increasing real GDP will depend on the size of the fiscal deficit and the size of the multiplier.

- (c) A rise in US interest rates will cause some investors to move some of their money out of Indonesia and into the USA. This is sometimes called 'hot money flows' as investors move funds quickly in response to interest rate changes. This will be recorded on the financial account of the balance of payments for Indonesia as an outflow. As a result, the value of the Indonesian currency would start to fall as the supply of the Indonesian currency increases. However, the Indonesian government was worried that this would trigger 'capital flight'. To prevent this, the Indonesian government increased interest rates. This would have a deflationary effect on the Indonesian economy because a rise in interest rates causes a fall in aggregate demand. So the rise in interest rates in the USA ultimately caused a rise in interest rates in Indonesia. Real GDP would fall, as well as the price level.

(d)

Introduction

- Inaccurate information, risks and uncertainties, and inability to control external shocks.

First point – Different views between economists

- Classical economists tend to believe the economy self-stabilises. For example, in Figure 1, when the economy is at B, classical economists would argue that there will be downward pressure on wages because workers have less bargaining power in times of rising unemployment. So a fall in wages will cause the SRAS curve to shift from $SRAS_1$ to $SRAS_2$. The economy moves back to full employment over time, without any government intervention. However, other policy makers would argue that the economy may remain stuck at point B unless the government uses expansionary demand-side policies.

Evaluation

- Views change over time, so this makes it particularly hard for policy makers. 'We've also learned, at least from the experience of the UK and US, that we would have benefited from turning less immediately to measures aimed at fiscal deficit reduction'.
- The Keynesian view of LRAS shows expansionary fiscal policy may be particularly effective when real GDP levels are currently at very low levels – so real GDP will increase without causing the price level to rise.

Second point – Lack of information

- Data used is often out of date.
- Views on running fiscal deficits are likely to depend partly on estimates of the cost of debt servicing. The problem for policy makers is that the interest rates might have been low in recent periods, but they might suddenly rise.
- Policy makers do not know how long it will take for a change in interest rates or quantitative easing to have its full effect on aggregate demand. So they might intervene again, and then cause the economy to overshoot. Extract B states ‘some economists worry that removing the stimulus too early will restrict growth too much’.
- Policy makers do not know the exact value of the multiplier at any one time.
- The size of any output gap is difficult to measure.

Evaluation

- But economic modelling has improved and policy makers can make frequent changes to fine tune their management of the economy.

Third point – Inability to control external shocks

- The Global Financial Crisis, as mentioned in Extract A, is an example of a major demand-side shock to many economies – expand on this. Make reference to negative growth rates in the UK and USA in 2009 (Figure 2 in the Students’ book).

Evaluation

- External shocks have arguably become more problematic due to globalisation (a rising share of exports and imports as a share of GDP) and integration of supply chains.

Conclusion

- There will always be problems facing policy makers, but governments can minimise some of these by investing in collection of data and skilled public sector workers whose job it is to implement policies successfully. Therefore, government failure can be minimised.

3 Make reference to real-world examples – for example, the use of fiscal policy used by the UK and the USA during the Global Financial Crisis.

Introduction

- Understanding of fiscal policy and expansionary fiscal policy.

First point

- Real GDP will rise.
- Expansionary fiscal policy injects money into the circular flow.
- Use of AD/SRAS diagram to show shift to the right of aggregate demand.

Evaluation

- The extent to which aggregate demand increases depends upon the value of the multiplier: the higher the value of the multiplier, the greater the impact on real GDP.
- This is particularly beneficial if the economy was in a negative output gap. Keynesian LRAS curve – show aggregate demand increasing along the horizontal section of the LRAS.

Second point

- The use of fiscal policy is particularly effective at increasing real GDP if the government increases spending on education, health care and infrastructure because these are likely to increase the productive capacity of the economy (supply-side growth/potential growth).

Evaluation

- But spending on infrastructure can be very expensive and takes time, so this might be wasteful if projects are not completed. Spending on education also takes time to have its full effect on the economy.

Third point

- The use of fiscal policy to stimulate an economy may also achieve other objectives (for example, increasing government spending on benefits will stimulate aggregate demand as well as reducing relative poverty).

Evaluation

- However, there may be a trade-off with inflation.
- The use of fiscal policy to stimulate the economy may increase aggregate demand too much, so causing a wage-price spiral if the economy moves into a positive output gap. This might happen due to a lack of accurate information about the current state of the economy (for example, it's difficult to measure size of negative output gap). Also the size of the multiplier is unknown, so a fiscal stimulus may cause too much inflation.
- Use of vertical LRAS curve diagram.

Fourth point

- The fiscal deficit will increase, so increasing the national debt.
- This may create problems such as: crowding out; debt servicing costs; intergenerational inequity.

Evaluation

- But a rise in the fiscal deficit may create 'crowding in'.
- But the fiscal deficit, as a percentage of GDP, may not be too high.
- But interest rates might be low, so debt servicing costs low.

Conclusion

- Views on the effectiveness of fiscal policy will depend on whether the economist is a classical or Keynesian economist.
- Likely to be more effective if the economy is currently stuck in a large negative output gap.
- Use of fiscal policy might be particularly useful if interest rates are already at an all-time low.

39 Measures of economic development

Activity 1

1 The Human Development Index (HDI) is a composite index based on three dimensions, or components, of development. These three components are given equal weighting. The three dimensions are measured using four indicators:

- Health, as measured by life expectancy at birth.
- Education – mean years of schooling of adults aged 25 years or over and expected years of schooling for current 5-year-olds.
- Income as measured by GNI per capita at purchasing power parity.
- The HDI score for a country will range from 0 to 1. The higher the HDI score, the higher the level of economic development.

The inequality adjusted HDI adds a fourth component of development – inequality. The HDI is adjusted for inequality. The greater the inequality, the greater the negative impact on the inequality adjusted HDI score. Again, the higher the inequality adjusted HDI score, the higher the development.

2 The HDI is a composite index, with GNI per capita just one of three components of development. The three dimensions used to calculate HDI – income, education and health – are given equal weighting.

Although GNI per capita is higher in Botswana than in Brazil, the life expectancy at birth in Botswana is about 10 years less than in Brazil – this seems a significant difference. Expected years of schooling is also less than in Brazil. Although GNI per capita and the mean years of schooling of adults who are aged 25 years or older is slightly higher in Botswana, the other indicators used in this index are sufficiently worse to give a lower HDI score for Botswana compared to Brazil.

3 Indonesia's HDI ranking is only 113, compared to Sri Lanka's ranking of 72. This seems a surprising jump as GNI per capita in Indonesia is fairly similar to Sri Lanka's (\$10,053 compared to \$10,789). However, the health and education components suggest development in Indonesia is significantly lower than in Sri Lanka. For example, life expectancy at birth is almost 6 years less in Indonesia, mean years of schooling is about 3 years less and expected years of schooling for current 5-year-olds is about 1 year less. These factors explain Indonesia's much lower HDI ranking.

4 Botswana's inequality adjusted HDI ranking is 130, compared to its HDI ranking of 107. This suggests Botswana has very high inequality, making its level of development lower than an HDI measurement would suggest. In contrast, Cambodia's inequality HDI ranking pushes Cambodia up. Cambodia's inequality HDI ranking is 132, compared to its HDI ranking of 143. This shows that inequality in Cambodia is much lower than inequality in Botswana.

5 Economic development is a much wider concept than economic growth. Economic development implies an increase in the quality of life and well-being for its citizens. Although an increase in GNI per capita can often lead to a higher level of economic development, this measure does not consider how education and health outcomes are changing in the economy. The HDI takes three components into account in its measure of development. GNI per capita is important because this indicates the material standard of living in the economy.

However, education is also considered important because knowledge provides individuals with capabilities to make choices about their lives and contributes to their well-being. Equally, good health also matters to people. As the United Nations has stated: 'Income is a means to human development and not the end.' So HDI is a better indicator of development than GNI per capita alone. The main limitation is that this can also be quite simplistic as a measure of economic development. For example, a higher life expectancy does not necessarily mean people are living with more years of good health. However, HDI seems to have fewer limitations than using GNI per capita alone.

Exam practice

1 (b)

The higher the HDI, the higher the level of development.

2

(a) Rwanda's GNI per capita, as an index number in 2016, with 2010 as the base year = $1,744 \div 1,355 \times 100 = 128.7$

(b) 'Economic development' is a much wider concept than economic growth. Economic development suggests that quality of life and well-being is improving in a country and often a wide range of indicators show improvement. These include GNI per capita, life expectancy, educational achievement, access to clean water, mobile phone connections, and so on. Often, economic growth can lead to higher levels of economic development, but not necessarily. That is why a distinction is often made. There is evidence that Rwanda has made progress in economic development over the last few decades. For example, it has achieved rapid growth, mortality during childbirth has fallen and Rwanda has better infrastructure, including high-speed internet.

(c) Figure 3 in the Students' book shows that Rwanda has a high proportion of male employment in agriculture. In 2017 approximately 55 per cent of all male employment was in the agricultural sector. This is higher than in economies such as Vietnam, Philippines, Thailand and Malaysia.

The percentage of adult male labour in agriculture is a useful indicator to use as a measure of economic development for an economy. Such a high proportion for Rwanda suggests it is at a low level of economic development. This is because it is normally assumed that as an economy develops, labour will flow from agriculture and other labour-intensive primary activities to industry, and finally to the services sector. It is through industrialisation that an economy can significantly increase its productivity. Advanced economies also employ less labour in the agricultural sector, because they can afford to use more capital-intensive methods.

(d) There are limitations to using the HDI as a measure of Rwanda's human development progress. Extract A says that when inequality is taken into account, Rwanda's inequality-adjusted HDI score falls more than most other countries. This suggests that inequality is particularly high in Rwanda compared to many other economies. Inequality is assumed to reduce the potential for development.

This means the HDI is quite misleading for Rwanda in particular as a measure of development. Extract B also mentions the lack of political freedom, which would negatively affect the quality of life for many Rwandans. The lack of freedom extends to crop selection, living arrangements or moving house.

However, if Rwanda has made the greatest progress in human development between 1990 and 2015, according to the Human Development Index, this suggests that GNI per capita, life expectancy and years in schooling have improved significantly compared to other countries. These components of HDI are usually considered crucial indicators of development, so the HDI is often considered a useful measure of human development. In practice, the addition of further data to the HDI can make it easier for an analyst to fully assess human development progress. For example, access to the internet and access to clean drinking water can help assess countries' improvement at lower levels of development.

(e)

Introduction

- Understanding of difference between economic development and economic growth.

First point – Positive impact on living standards and well-being

- A rise in GNI per capita is likely to have a positive impact on the level of economic development. The HDI uses three components to measure economic development. These are income, education and health.
- A rise in GNI per capita suggests material living standards have risen and is one component of the HDI which is linked to economic development.
- A rise in GNI per capita, by increasing living standards, is also likely to have a positive impact on life expectancy. For example, better housing, more calories and better sanitation would all improve health outcomes.
- Table 3 largely supports this. Countries with higher GNI per capita tend to have higher HDI values.

Evaluation

- However, Table 3 shows that Vietnam, despite having a lower GNI per capita, has higher life expectancy and higher expected years in schooling for current 5-year-olds. This shows that some measures of development do not necessarily have a direct relationship with changes in GNI per capita.

Second point – More scope for government spending on education

- A rise in GNI per capita also suggests a government has more scope to raise tax revenue, which can be used to fund more years in schooling and a higher quality education as well as better health care.
- Government officials in Rwanda say, 'progress in poor countries is more about access to food, schooling and healthcare'. This suggests the government in Rwanda would spend more on education and health if resources were available.

Evaluation

- But the government might use extra tax revenue to spend on other components of government spending less linked to economic development, such as defence.

Third point – Other measures of development are also likely to have a direct relationship with changes in GNI per capita

- For example, Table 4 and Table 5 show individuals using the internet (percentage of population) and people with access to at least basic drinking water (percentage of urban population) tends to be higher in countries which have higher GNI per capita (some exceptions). This is not surprising as economic growth helps governments fund investment in infrastructure.

Evaluation

- Not all measures of development are necessarily directly related to GNI per capita; for example, lack of freedom and environmental measures.
- A rise in GNI per capita might coexist with rising inequality. Inequality in Rwanda is clearly very high compared to other countries, so this will limit improvements in development.

Conclusion

- A rise in GNI per capita essentially just shows that income has risen in an economy. However, income is a means to development and not necessarily an end. So government policies that direct more resources to health and education, as a result of economic growth, will make the link stronger between rises in GNI per capita and progress in development.

3 Aim to make reference to real-world examples in your answer.

Introduction

- Understanding of development.
- Introduction of HDI.

First point

- Explanation of why HDI more useful than using GNI per capita alone.

Evaluation

- But HDI alone might not be so useful unless a breakdown is given of the individual components which make it up.
- For comparison of fairly advanced economies, where life expectancy and years in education are fairly similar, it might be more useful to just use GNI per capita, along with other measures such as types of jobs, number of hours worked, quality of housing, and so on, to better judge development differences.

Second point

- Explanation of why HDI is useful because it is a composite index that uses three important dimensions of development. An explanation of why lots of individual measures of development, such as access to drinking water and employment in agriculture might make it harder for analysts to get an overall assessment of development in a country quickly.
- HDI easy to calculate.

Evaluation

- Does not capture all dimensions of health or education. For example, health only considers life expectancy. This might not relate well to quality of health while alive (for example, obesity crisis, rise of diabetes in some countries, which reduces quality of life). Quality of education is also not considered.

Third point

- Inequality not considered in HDI. Inequality does impact on development as it might be the case that only a very small proportion of a society is experiencing any gains in quality of life.

Evaluation

- HDI can be adjusted for inequality.

Fourth point

- HDI not useful because a wide variety of measures of development are not considered in the HDI, such as access to internet.

Evaluation

- Many indicators indirectly link with HDI – for example, access to clean water likely to affect life expectancy in a country.

Conclusion

- HDI generally considered useful, although for some countries it might give a misleading impression.
- Designed in a fairly sophisticated way; for example, in the method of calculating HDI it is recognised that an increase in income has a diminishing impact on living standards.
- It has particular advantages in comparing countries as most governments collect the statistics needed to calculate the HDI.
- Ideally, HDI is used along with other measures to obtain a complete picture if detailed analysis is required.

40 Constraints on growth and development

Activity 1

1 If China's economic growth continues to be weaker than it was pre-2011, with commodity prices dampened as a result, then Indonesia will experience lower export revenues if it continues to remain dependent on commodities, such as palm oil and rubber. This will limit its export-led growth, so its economic growth may remain at relatively low levels. This would cause further negative multiplier effects if lower economic growth starts to attract less FDI into Indonesia.

The Prebisch-Singer hypothesis also states that commodity prices tend to fall over time compared to other goods such as manufacturing. This is because YED for commodities tends to be more inelastic than other goods. This would suggest Indonesia might continue to

experience problems with its economic growth, unless it diversifies its economy. However, since the government in China is keen to promote consumption-led growth, this might increase commodity prices in the future. So a commodity-dependent exporter, such as Indonesia, may start to experience faster growth rates compared to non-commodity exporters.

Activity 2

1 Financing infrastructure projects can be difficult for governments. If government spending is more than tax revenue, then this causes a fiscal deficit. This will add to the national debt. There are problems which can arise when fiscal deficits and national debt become too high. For example, financial crowding out can occur, so interest rates rise. This will then cause a contractionary effect on aggregate demand. Infrastructure spending is likely to be very expensive, so governments may find it hard to spend enough money on it when they are aiming to bring down fiscal deficits (austerity) which requires cutting government spending. Equally, trying to get the private sector to spend money on infrastructure is hard to do. This is because these projects do not tend to generate a return for firms in the short run due to the time needed to complete projects. Also, extracting payment from the general public often causes discontent; for example, having to pay to use a new road might be considered unacceptable.

2 An infrastructure gap is likely to constrain economic growth because it causes a supply-side constraint. These can include production disruptions caused by poor road networks, a lack of good quality school buildings can harm education and poor hospitals which reduce the quality of human capital, and so on.

An infrastructure gap constrains economic growth and development. This is partly because of the impact on reducing economic growth, and therefore GNI per capita, but also because of the impact on all the dimensions of development; for example, an infrastructure gap reducing the quality of education or health care. Other measures of development are also likely to be affected by an infrastructure gap; for example, a fall in the access to the internet or access to clean water.

Exam practice

1 India's population = India's GDP ÷ India's GDP per capita = 2,264,000,000,000 ÷ 1710 = 1,323,976,608 (that is, 1.3 billion)

Note: A trillion is 1 million million. A billion is 1,000 million.

2

(a) Corruption is when the state can effectively steal assets of individuals or businesses. Corruption is dishonest or fraudulent conduct by those in power, often involving bribery. Extract A mentions that international surveys give India a low rank for the efficiency and honesty of the state. A low rank for honesty of the state suggests that there is corruption among some government officials. An impact of corruption is lower growth: corruption tends to lead to tax evasion (as mentioned in Extract A) and less efficiency in the public sector. Both of these can lead to lower economic growth than might otherwise be achieved.

- (b)** Between 1947 and 2018, savings as a percentage of GDP has increased from 10 to 30 per cent. This is likely to increase India's trend growth rate. A trend rate of growth is the long-run average rate of growth of the productive potential of the economy. The Harrod-Domar growth model states that investment, savings and technological change are the key variables which affect economic growth. Because savings approximately equals investment in an economy, an increase in savings leads to an increase in investment. This increase in investment will increase India's production possibility frontier, so India's trend growth rate will increase. This assumes that the investment is not wasteful. As Extract A states, 'Much of India's success is a result of savings being put to productive use'.
- (c)**
- Extract A states that India has one of the world's youngest populations with a median age of 28. This places a large burden on the education system to provide education and training for such a large number. However, it is likely that India does not have sufficient resources to spend on this. This is because tax revenue is likely to be relatively low for India's government.
 - Extract A talks about India's 'long term problem of inadequate education'. As a result, a third of 15 to 29-year-olds are not in school, training or jobs. This will constrain economic growth.
 - Actual growth will be constrained by the lack of spending and potential growth will be constrained if the quality of human capital remains weak. Since education is also a key dimension of development, this will constrain India's development too. A young population also suggests India's dependency ratio is high. This will further constrain economic growth as it will depress savings and therefore investment. As shown in Figure 1 in the Students' book, India's growth per capita is consistently lower than China's between 2000 and 2017, so the data supports this.
 - However, technological change might make it easier to improve educational outcomes more cheaply; for example, through distance-led learning. India's young population might then have a positive impact on India's economic growth and development. But unless enough skilled jobs are created, the more skilled youth might migrate to countries that offer more job prospects and a higher living standard. This is likely because India has only been able to create half the jobs it needs to provide employment for the 12 million young people who enter the workforce each year. So economic growth and development might be further constrained.
- (d)** There are a range of factors mentioned in the extracts which include savings gap, young population, corruption, too much bureaucracy, poor infrastructure, a complex tax system, lack of availability of credit. Any of these could be discussed. Avoid lists though – better to pick a few themes analysed in depth with evaluation.

Introduction

- Explanation of the distinction between economic growth and development.

First point – The savings gap

- India has a fairly low per capita growth, at least compared to China, so it is likely that India has relatively low savings as households will spend most of their money simply to meet their needs.

- The Harrod-Domar model states that investment, savings and technological change are the key variables in determining economic growth. As savings approximately equals investment, the likely low savings in India would constrain investment spending. India is likely to have a savings gap where current levels of saving are insufficient to support the rates of growth needed.

Evaluation

- But Extract A states that the savings rate has increased significantly between independence and the present day – from 10 per cent to 30 per cent of GDP. And the savings have been spent on ‘productive’ investment. So economic growth rates would have been increased by this. However, economic growth rates are not increasing fast.

Second point – Access to credit and banking

- A lack of credit available for poor households may lead to borrowing from loan sharks – repayments will be too high and quality of life negatively impacted.
- A lack of financial institutions may limit savings, increasing the savings gap.
- A lack of access to credit and banking constrains investment for firms in India.

Evaluation

- Extract B states that bad lending by banks in the past has limited funds available for lending now – this suggests that this constraint on growth is significant: in 2016–2017 ‘loan growth fell to 5.1 per cent, the lowest in 63 years’.

Third point – Poor infrastructure

- Could refer to poor roads – this raises costs for firms and reduces ability to get goods to markets, both regional and global. This is a supply-side constraint.
- Weak infrastructure also reduces labour mobility and ability for children to get to school. Again, potential growth limited. Education is also crucial as a dimension of development.
- Lack of hospitals also impact on Human Development Index.
- Poor infrastructure also leads to less FDI – constraint on growth.

Evaluation

- Likely to be significant for an economy such as India. Infrastructure is expensive and hard for a government to finance when tax revenue is a fairly low proportion of GDP. Also, getting the private sector involved can be difficult.

Conclusion

- Constraints are likely to be many, since India is a poor developing country. Some are likely to be significant until India moves to a higher level of development. Others, such as corruption, could be tackled more immediately.

3 Make sure some examples of countries are used.

Introduction

- Understanding of economic growth.
- Distinction between actual and potential growth.

First point – Savings gap

- The Harrod–Domar model states that investment, savings and technological change are the key variables in determining economic growth. Since savings approximately equals investment, low savings would constrain investment spending.
- Actual growth constrained since investment is a component of aggregate demand.
- Potential growth constrained since a lack of investment reduces supply-side growth.
- In developing countries, the need for households to spend most of their income to meet their needs means savings likely to be too low.

Evaluation

- But savings rates do vary, even between developing countries. For example, Bangladesh's savings rate is much higher than Kenya's.
- Savings gap might not be significant as a constraint if foreign aid, FDI or debt cancellation fills the savings gap.

Second point – Low quality human capital

- Developing countries often have fewer resources available to invest in education as there is a lower income per capita, which restricts tax revenues. A lack of basic skills keeps wages low, so constrains aggregate demand. Potential growth is also constrained when labour productivity is low.

Evaluation

- But learning outcomes differ between countries, even when income per capita is similar.
- Advances in technology might mean these constraints become less over time. For example, growth of IT means distance learning is more effective and can be a cheap way of providing a quality education.

Third point – Primary product dependency

- The Prebisch-Singer hypothesis – suggestion that a developing country with a high export dependency on primary products might experience a continuing worsening of their terms of trade. This reduces export revenues and therefore export-led growth and makes it harder to import capital goods from developed countries. Both of these would restrict growth.

Evaluation

- But terms of trade do not necessarily worsen – price of commodities has risen when there is a world commodity boom.
- Not a constraint if a developing country increases spending on components of government spending that most increase growth, such as education and infrastructure, when commodity prices are unexpectedly high.

Fourth point – Debt

- Governments may end up paying a large component of government spending on interest repayments. Often this is in foreign currency. This reduces government spending on education and other components of government spending – opportunity cost.

Evaluation

- More significant when interest rates rise or value of a foreign currency appreciates.
- Debt can be written off, so it's no longer a constraint.

Conclusion

- There are many constraints on economic growth. Developing countries are likely to face many constraints but some will be more significant than others. For example, some developing countries are less export-commodity dependent than others. A savings gap is likely to be more of a constraint when the banking system is very underdeveloped and limited foreign aid is available to that country.

41 Measures to promote growth and development

Activity 1

1 The Rwandan government promotes foreign direct investment inflows by being 'business friendly'. It offers large tax rate reductions – this provides a profit incentive for foreign firms to locate in Rwanda.

It has also set up special economic zones that offer reliable supplies of power and water, road links and land – this means foreign firms do not need to worry, to the same extent, about poor infrastructure constraints.

There are other factors, such as low wages and relatively skilled workers, which attract foreign direct investment. However, these advantages are not directly a result of specific government policies designed to attract FDI.

2 Economic development involves three key dimensions: living standards, education and health. FDI inflows will promote economic growth and so will increase real GDP per capita. If economic growth increases, the Rwandan government will raise more tax revenue, and this can be used to help fund more government spending on education, health and infrastructure, which are essential for development.

The transfer of knowledge and skills gained from FDI will also promote development.

The expansion of special economic zones will improve the infrastructure in Rwanda and there will be more drive to invest in infrastructure to continue to attract FDI. So access to water and internet access (among other things) start to increase.

Activity 2

1 The growth of the middle class in China should lead to an increase in demand for Indonesia's tourism services. Because demand for tourism services is likely to be income elastic, the demand will rise more proportionately than the rise in middle incomes in China. The World Bank estimates that Indonesia could create 1 million new jobs and add US\$27 billion to GDP. Attracting 10 million new visitors will not only create tourism jobs but will have a positive multiplier effect on the Indonesian economy – so the growth of the middle classes in China helps to promote economic growth in Indonesia. This will help to raise living standards and reduce absolute poverty.

As well as this, foreign currency earnings will increase. This may help Indonesia finance imports of capital goods, so further promoting economic growth.

Tourism may also help Indonesia diversify its economy away from dependency on commodities.

2 The development of tourism may have some advantages over manufacturing. These include:

- Demand is income elastic – so when GDP is rising abroad, tourism will grow quickly. Foreign currency earnings will also increase quickly.
- It is labour intensive so creates many jobs that are also relatively unskilled. This may lift the very poor out of poverty.
- The multiplier effect may be large if local firms can sell their goods to tourists or hotels, and so on.

However, there can also be risks of specialising too much in tourism. For example:

- A recession in main tourist markets will cause a fairly large demand-side shock.
- Relatively skilled workers may not find suitable employment.
- It may be seasonally dependent.

So, it is usually sensible for an economy to have a diversified economy. An economy needs some sectors where productivity is high and there is scope for high wage earnings. That way the economy achieves both high actual and potential growth.

Exam practice

1 (b)

A low value of the renminbi makes Chinese goods cheaper in terms of foreign currency but import prices, in renminbi, more expensive.

2

(a) The percentage change in real GDP per capita, between 1960 and 2016

$$= (3974 - 690) \div 690 \times 100$$

$$= 475.9$$

(b) 'Development of human capital' are measures to improve the quality of human capital. The focus is largely on improving education and skills to improve labour productivity. Although universal primary school education has increased substantially in many developing countries, the quality of education can still be very poor. Extract B states that Indonesia's development plan sets out objectives to improve learning outcomes in schools, particularly in rural areas, which are inferior to urban areas. The development of human capital should raise productivity and bring Indonesia more in line with middle income countries such as Malaysia.

(c) Trade liberalisation is the removal or reduction in trade barriers between countries. Extract B states that in the mid-1980s trade barriers were reduced and Indonesia became more integrated in the global economy. By 1999 both exports and imports, as a share of Indonesia's GDP, had reached their highest peak – 36 per cent and 27 per cent respectively. Trade liberalisation is likely to have helped Indonesia increase

its economic growth. This is because trade liberalisation may have helped Indonesia achieve export-led growth, forced domestic firms to become more efficient and helped it have more access to imported capital goods – so both actual and potential growth is likely to have increased. Since Indonesia's export and import share, as a percentage of GDP, has fallen between 1999 and 2016, further trade liberalisation achieved by joining the CPTPP might help to further promote economic growth for Indonesia.

- (d) In 2014 the Indonesian government launched a US\$355 billion infrastructure programme. This included building 1,000km of toll roads, 3,000km of railways, 24 sea ports and an increase in capacity of power. This is likely to increase Indonesia's economic growth and development.

An improvement in transport links will help Indonesia export and import more efficiently. If Indonesia does join the CPTPP, this should make the gains from further trade liberalisation greater.

The infrastructure programme will also act as a stimulus to economic growth as it will improve the efficiency for all firms. This will increase potential growth as the productive capacity for the Indonesian economy increases. The gains for the Indonesian economy assume the infrastructure projects are not delayed by legal challenges, funding shortfalls or the inability to acquire land.

Extract B also mentions that poor infrastructure has been the main obstacle in attracting more FDI. So an improvement in infrastructure for Indonesia might cause a significant rise in FDI inflows as Indonesia offers many other advantages, such as low wages. An increase in FDI, particularly greenfield FDI, will inject money into the circular flow of income and help Indonesia make productivity gains, due to transfer of knowledge and skills. This would further help Indonesia raise its gross production per worker to similar levels as countries such as Malaysia.

- (e)

Introduction

- Understanding of the terms: industrialisation, economic growth and development.

First point – Increase in national income/higher economic growth

- The Lewis structural change (dual sector) model – development occurs as labour shifts from unproductive traditional sector activities, such as rural subsistence farming, into the higher productivity urban manufacturing sector. The rise in productivity (output per worker) increases economic growth. (SRAS and LRAS shift to the right).
- 'From 1990 to 1996, Indonesia's manufacturing sector, excluding oil and gas, expanded 12 per cent a year, contributing one-third of total growth'.
- As industrialisation slowed in Indonesia 'as the focus shifted away from industry back to natural resources', economic growth in 2014 had slowed to 5.6 per cent. This data suggests industrialisation does promote economic growth and development.

Evaluation

- But further industrialisation may not create as many productivity gains. The gains from industrialisation might already have largely been made because agriculture output, as a percentage of GDP, has already fallen from just over 50 per cent in 1967 to about 15 per cent in 2009.
- Further industrialisation may also be limited until Indonesia's infrastructure is fully developed – there is currently a \$700 billion infrastructure gap (the infrastructure programme was only launched in 2014, so it is unlikely this has been completed yet).
- But FDI (which helps to achieve further industrialisation) will not be attracted into Indonesia until its employment laws are reformed. However, this will be resisted by trade unions because it will push those who are laid off into poverty.

Second point – Industrialisation helps to reduce poverty

- In 'the agricultural sector, incomes are considerably lower compared to major urban areas, such as Jakarta'. This suggests wages could rise if further industrialisation takes place. If industrialisation creates job opportunities, living standards should improve as wages increase and real GDP per capita rises. This will raise extra tax revenue, so more money can be spent by the government on education, health and infrastructure, which are essential for poverty reduction and economic development. Living standards might also rise if the growth of industries results in large-scale production of goods available to consumers at low prices – increases consumer surplus and quality of living.

Evaluation

- But technology is having a greater impact on jobs in the manufacturing sector. So further industrialisation today might just lead to automation. The displacement of manpower in industries will lead to unemployment and therefore more poverty.
- But poverty reduction might also be achieved if modern farming techniques and better irrigation systems are invested in. Productivity could increase in the agricultural sector, so wages might rise for those working in the agricultural sector.
- Lower priced goods could be achieved by buying low priced imports.

Third point – Industrialisation might provide economic stability

- Fluctuating prices of agricultural commodities create an unstable economy. If agricultural commodity prices fall, export revenues can be very low. This reduces export-led growth. Industrialisation is one way of diversifying the economy and so prevents an unstable economy.

Evaluation

- Industrialisation would not be desirable if Indonesia has a comparative advantage in primary products.

Conclusion

- Extract A states that the government wishes to diversify the economy by 'doubling tourism, improving the use of its fertile agricultural land and boosting manufacturing'. So industrialisation, combined with investment in the other sectors of the economy, may be the best strategy for promoting economic growth and development.

3

Introduction

- Introduce development of tourism as one measure to promote economic growth and development.

First point – Increase in GDP

- During a period of world economic growth, demand for tourism services would rise.
- Demand for tourism is likely to be income elastic. This would increase net exports (there would be more credits on tourism services on the balance of trade in services), so aggregate demand would rise.
- Use of AD/SRAS diagram showing an increase in real GDP.

Evaluation

- Significant multiplier effect if the local firms can supply locally made products for tourists to buy, as well as local firms being integrated into the supply chains needed to service hotels, and so on.
- But tourism revenues would fall significantly during a recession in countries whose citizens are attracted to this tourist destination. This is because demand is income elastic. This would cause a demand-side shock to Indonesia if it had become over reliant on tourism.

Second point – Increased employment opportunities

- Tourism tends to be labour intensive, so a significant number of jobs may be created.
- Labour is a derived demand, so as real GDP rises, unemployment falls.
- May increase labour participation if more women are attracted to jobs in tourism.

Evaluation

- But employment is seasonal, so unemployment would be high in some parts of the year.
- Jobs created may be unskilled – this will constrain potential growth.
- Jobs created may be fairly low paid, so may not lower poverty reduction, compared to industrialisation.

Third point – Credits on the balance of trade in services on the current account increase

- This will help to fill a foreign currency gap as vital foreign exchange earnings are earned. This can help the developing country finance the import of capital goods.

Evaluation

- But foreign exchange earnings from tourism may be small as a percentage of GDP compared to the development of other sectors, such as manufacturing or mining.

Fourth point – Helps attract FDI by TNCs

- Might invest in infrastructure, hotels and associated services to promote development.
- FDI can be beneficial for a recipient country (for example, greenfield FDI as an injection into the circular flow, productivity gains, and so on).

Evaluation

- This would be particularly beneficial if a country currently has an infrastructure gap.
- But profits may be repatriated to foreign shareholders – this causes a deterioration of the current account balance on the primary income component (investment income).
- Also, imports of goods are likely to increase because some food/gifts might be demanded by tourists and materials needed for hotels (this affects the trade in goods component).

Conclusion

- Promoting tourism does have potential benefits for a developing country but there are also potential costs.
- To what extent a country should develop tourism might depend on whether a country is likely to be able to develop a comparative advantage in tourism.
- Governments will need to decide whether the gains from developing tourism are likely to be higher than if they developed their primary or manufacturing sector.