Edexcel

IGCSE

Economics

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Section 2.2

The global economy

Chapter 35 – Globalization

SUBJECT VOCABULARY

globalisation growing interconnection of the world's economies

interdependence where the actions of one country or large firm will have a direct effect on others

What is globalization?

Many markets today are global. This means that some firms expect to sell their products anywhere in the world. Today, the same firm could have a head office in London, borrow money from a bank in Japan, manufacture products in China, deal with customers from a call centre in India and sell goods to countries all over the world. Firms and people are behaving as though there is just one market or one economy in the whole world. This development is called globalisation. It is often defined as the growing interconnection of the world's economies. Some of the key features of globalisation are outlined below.

■Goods and services are traded freely across international borders. There are no government laws that prevent firms from selling goods in overseas markets.

■ People are free to live and work in any country they choose.

■There is a high level of interdependence between nations. This means that events in one economy are likely to affect other economies.

■Capital can flow between different countries.

■There is a free exchange of technology and intellectual property across borders.

Reasons for globalization

There is a general agreement that modern globalisation began in the 1980s and has grown rapidly. There are a number of reasons for this trend.

FEWER TARIFFS AND QUOTAS

Countries use tariffs and quotas to restrict the flow of imports so that domestic industries are protected. Consequently, they restrict the development of foreign businesses when they try to sell their goods overseas.

REDUCED COST OF TRANSPORT

International transport networks have improved in recent years. In particular, the cost of flying has fallen and the number of flights and destinations has increased. This means that people can travel to business meetings more easily and goods can be transported more cheaply.

REDUCED COST OF COMMUNICATION

Developments in technology have helped globalisation to accelerate. Modern computing allows firms to transfer complex data instantly to any part of the world. It also means that more people can work at home, or any other location that they choose.

INCREASED SIGNIFICANCE OF MULTINATIONALS

Many firms want to sell abroad, perhaps because domestic markets have been **saturated**. Large **multinational corporations (MNCs**), which have a global reach, dominate some markets. They benefit considerably from having international markets and producing goods anywhere in the world where costs can be minimised.

SUBJECT VOCABULARY

multinational corporations (MNCs) that operate in many different countries

saturated market in which there is more of a product for sale than people want to buy

INDIVIDUAL COUNTRIES

The impact of globalisation on individual countries is likely to vary. The countries where multinationals are based will benefit from globalisation. Most multinationals are based in developed countries and the gains generated from business development overseas, such as growth, will contribute to an increase in the wealth of that country. Even though many traditional industries, such as shipbuilding, mining, steel production and manufacturing, are declining in the West, other types of jobs are being created at a faster rate.

GOVERNMENTS

The profits made by global companies are taxed by the host nation. This increases tax revenue for the government. This money can be spent to improve government services or lower taxes. Some argue that globalisation has resulted in more people setting up businesses. The arrival of global companies may have provided the encouragement, and the skills required to develop new businesses.

PRODUCERS

Many would argue that the main winners from globalisation are the global companies that develop business interests overseas. Some specific benefits include the following.

■Access to huge markets: Global markets are much bigger than domestic markets. If a business has access to billions rather than millions of customers, this provides huge opportunities to increase sales. This should result in higher sales revenue and increased profits for businesses.

■Lower costs: If businesses can grow by selling more output to larger markets, they may be able to lower their costs. This is because as firms grow, they can exploit economies of scale. These are the cost reductions that firms enjoy as they grow.

■Access to labour: One of the benefits of globalisation is the free movement of labour. This means that people are free to move around the world and find employment in other countries (subject to border controls that still exist in some countries).

■Reduced taxation: Global businesses can reduce the amount of tax they pay. They can do this by locating their head office in a country where business taxes are low. Ireland has proved a popular destination for businesses in recent years since its rate of corporation tax is just 12.5 per cent (on trading income). This is well below other rates in the world, which are generally higher than 20 per cent.

CONSUMERS

If a multinational can produce goods more cheaply in foreign factories, prices are likely to be lower. One of the main benefits of the movement of some manufacturing from the West to countries like China and India is that many goods are cheaper for consumers. Globalisation has also resulted in a much wider range of goods and services for consumers, particularly in developed countries.

WORKERS

Globalisation creates new jobs, particularly in developing countries when multinationals open new factories. However, local suppliers might also benefit if they get contracts with a new business venture set up by a multinational in their region.
Greater freedom of movement has allowed workers from less developed nations to look for jobs in developed countries.

However, some workers lose out because of globalisation. This is because global companies will tend to locate operations where labour costs are low. This has resulted in a trend called **offshoring**.

SUBJECT VOCABULARY

offshoring practice of getting work done in another country in order to save money

THE ENVIRONMENT

Many environmentalists oppose globalisation because global economic growth usually means more environmental damage. Some global companies have been criticised in the past for the environmental damage they cause.

Chapter 36 – Multinational companies (MNCs) and foreign direct investment

What are multinational companies

One of the reasons why globalisation has been successful in recent years is because a growing number of firms - called MNCs - have developed significant business interests overseas. These firms are very large and powerful. They contribute about 10 per cent to world GDP and about two-thirds to global exports. Some of the key features of MNCs include:

■Huge assets (land, buildings, plant, machinery and money, for example) and revenue: MNCs are extremely well-resourced and can often afford to take on large-scale contracts and projects that many other firms could not cope with

■Highly qualified and experienced professional executives and managers: MNCs can afford to hire the very best people from anywhere in the world

■Powerful advertising and marketing capability: they can invest huge amounts of money in impressive advertising campaigns to outcompete smaller rivals

■Highly advanced and up-to-date technology: MNCs can afford to keep right up to date with technological developments so that they always have the most efficient factories, machinery and equipment, which can help to lower costs

■Highly influential both economically and politically: they can be very powerful and even influence government decision making

■Very efficient since they can exploit huge economies of scale: because MNCs are so large, they have the ability to reduce their costs significantly- they can buy huge quantities of raw materials more cheaply, for example.

What is foreign direct investment

FDI, or inward investment, occurs when a company makes an investment in a foreign country. This may involve the construction of a factory, distribution centre or store or the development of a mine or tea plantation, for example. Another part of FDI is the purchase of shares in a foreign business (10 per cent or more). Most FDI comes from MNCs.

Reasons for the emergence of MNCs/ FDI

ECONOMIES OF SCALE

In some industries, firms that exploit economies of scale can reduce costs. MNCs will be in a better position to exploit economies of scale because they are so large. Firms that sell to global markets will produce more than those who just sell to domestic markets. They can therefore lower costs.

ACCESS TO NATURAL RESOURCES/CHEAP MATERIALS

SUBJECT VOCABULARY

reserves amount of something valuable, such as oil, gas or metal ore

Many large companies are happy to invest overseas because they need to buy huge quantities of resources. A significant proportion of FDI is targeted at the mining industry. Many African states have attracted FDI because they have large **reserves** of valuable resources.

LOWER TRANSPORT AND COMMUNICATION COSTS

Developments in transport and communications have helped to drive the growth in MNC/FDI activity. Transportation costs have come down and the speed with which goods can be delivered has gone up. This makes distribution in overseas markets much more attractive. Air travel is now relatively cheap with the number of destinations growing. This means that managers and other staff can travel around the world more easily to discuss and organise business activity.

ACCESS TO CUSTOMERS IN DIFFERENT REGIONS

One of the main reasons why MNCs have developed successfully is because they can sell far more goods and services in global markets than they can in domestic markets.

Advantages of MNCs / FDI

Many countries are keen for foreign MNCs to develop business interests in their countries. Indeed, many governments actively seek FDI by:

- offering tax breaks, subsidies, grants and low interest loans
- lifting restrictions and relaxing regulations to make it easier for foreign firms to invest
- investing in their own infrastructure
- investing in education so that people can get jobs with foreign companies.

Governments are prepared to do this because the advantages of FDI are generally so attractive.

JOB CREATION

One of the main benefits of FDI is the employment created when MNCs arrive and establish factories, warehouses, shops and other business facilities. When MNCs set up operations overseas, income in those countries rises. Local suppliers are also likely to get work when a multinational arrives. The extra output and employment generated by MNCs will increase economic growth and raise living standards for people in these countries.

INVESTMENT IN INFRASTRUCTURE

Countries with poor infrastructure often struggle to attract FDI. If a country has inadequate road networks, ports, railway networks, bridges, power distribution, airports, telecommunications, industrial parks and other facilities, it is more difficult to do business in that country.

Also, sometimes foreign investors contribute to a nation's infrastructure, such as building a new road, if it is allowed to develop a specific business interest.

DEVELOPING SKILLS

MNCs provide training and work experience for workers when they locate operations in foreign countries. Also, governments in less developed countries often spend more on education to help attract MNCs. This happened in India, where the government invested heavily in IT education and training. The arrival of MNCs may also encourage local people to set up businesses. MNCs may have provided the skills and motivation needed for enterprise.

DEVELOPING CAPITAL

The arrival of MNCs will help to boost the stock of capital in host countries. One reason is because when a business sets up a new facility, such as a factory, it is likely to install up-to-date technology.

SUBJECT VOCABULARY
tax avoidance practice of trying to pay less tax in legal ways

CONTRIBUTING TO TAXES

The profits made by MNCs are taxed by the host nation. This increases tax revenue for the government that can be used to improve government services.

GENERAL VOCABULARY
boycott to refuse to buy something, use something, or take part in something as a way of protesting

Disadvantages of MNCs / FDI

Unfortunately, there are some disadvantages associated with MNCs/FDI. Some might argue that the benefits are exaggerated and that MNCs are only interested in maximising profits for their shareholders. As a result, MNCs locate operations overseas merely to exploit a nation's resources. However, some specific disadvantages include the following.

SUBJECT VOCABULARY
repatriation (of profit) where a multinational returns the profits from an overseas venture to the country where it is based, typically from a developing country to a developed country (not often the other way around)

TAX AVOIDANCE

Tax avoidance, particularly by powerful MNCs, has attracted the attention of the world's media in recent years. Also, political leaders, particularly in the USA and EU, have accused MNCs, such as Apple and Google, of failing to pay their fair share. However, the MNCs have frequently responded to these accusations by saying that they pay their taxes and have done nothing wrong.

ENVIRONMENTAL DAMAGE

Many environmentalists are suspicious of MNCs because they may cause environmental damage. One reason is because MNCs are heavily involved in the extraction industries such as coal, oil and gold mining. Mining is often destructive.

MOVING PROFITS ABROAD

The profits made by MNCs abroad are often subject to **repatriation**. This means that profits are returned to the country where the MNC is based. As a result, the host country loses out. This suggests that MNCs bring more benefits to developed countries than to less developed countries. This is because the headquarters of most MNCs are based in developed countries.

Chapter 37 – International trade

International trade

OBTAINING GOODS THAT CANNOT BE PRODUCED DOMESTICALLY

Many countries are unable to produce certain goods. This is because they lack the natural resources that enable such production. In 'Getting started', we see that Iceland cannot produce many foodstuffs because it does not have the right climate.

OBTAINING GOODS THAT CAN BE BOUGHT MORE CHEAPLY FROM OVERSEAS

Some countries can produce goods more efficiently than others. This may be because countries have cheaper resources or because they have become experts through specialisation.

SELLING OFF UNWANTED COMMODITIES

Some countries have large amounts of certain commodities. Indeed, in some cases, countries have so much of a resource they could never use it all themselves. In 'Getting started', you learned that Qatar has huge reserves of oil. Most of the oil produced is sold abroad. Qatar consumes just a tiny proportion of its oil output each year.

Advantages of free trade

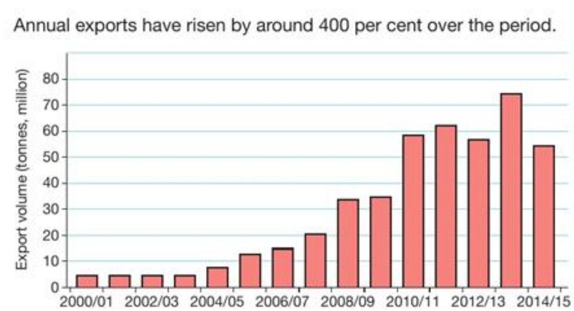
More and more countries encourage free trade. This is where the government allows open access to the markets in its country. The government does not place any restrictions on the amount of goods coming in. At the same time, it encourages firms to sell goods and services abroad. The main advantages to free trade are outlined below.

LOWER PRICES AND INCREASED CHOICE FOR CONSUMERS

One of the main benefits of free trade is that consumers get more choice. If consumers can buy goods more cheaply, their standard of living will improve because they will have greater purchasing power. Another reason why there is increased choice for consumers is because many countries both buy and sell the same products. Although both firms produce confectionery, many of their products have slight differences and consumers welcome the choice they provide.

LOWER INPUT PRICES

Through international trade, countries can obtain essential inputs for its industries at a much lower cost.. Figure 37.4 shows the growth in exports of iron ore from Australia between 2000/01 and 2014/15

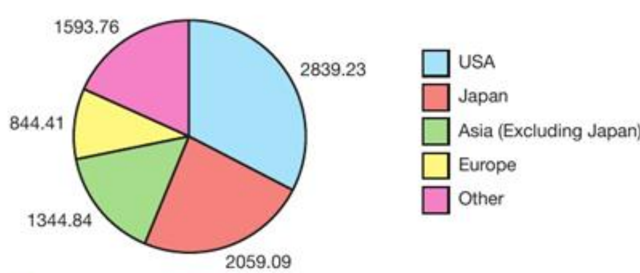


▲ **Figure 37.4** Australia iron exports by volume, 2000/01–14/15

Generally, international trade allows the advantages from specialisation to be extended. If countries specialise in the production of goods in which they are more efficient, the global economy will benefit.

WIDER MARKETS FOR BUSINESSES

If countries are free to specialise and trade, firms will be selling to larger markets. Figure 37.5 shows where Toyota, the Japanese carmaker, sells its cars in global markets. Only about 24 per cent of its output is sold in Japan. Therefore, three-quarters of its cars are sold in other countries around the world.



▲ **Figure 37.5** Toyota sales by region, 2016 (units, 000s)

If a company is able to sell much larger quantities in a wider range of markets, they will be able to exploit economies of scale. This is because their output will be higher than if they were just selling to the domestic market. This will help to lower costs and improve efficiency.

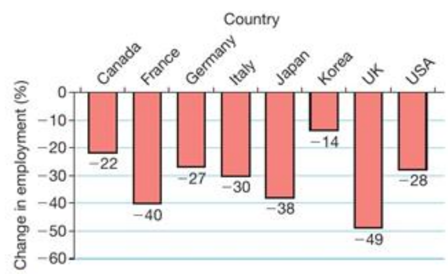
Advantages of free trade

COMPETITION FOR DOMESTIC BUSINESSES

If countries have open economies, it means that imports from anywhere in the world can flow into the economy. If these imports are good in quality and competitively priced, domestic producers might struggle to compete. According to OECD data, the UK and Australia have seen their share of manufacturing drop by around two-thirds since 1971. Germany's share halved, and manufacturing's contribution to GDP fell from 30 per cent in 1980 to 22 per cent today. Not all the decline can be blamed on cheap imports though. Other factors are important, such as the booming growth in the service sector.

UNEMPLOYMENT

One of the main problems with international trade is the threat to employment levels when domestic industries are threatened by cheap imports.



▲ Figure 37.6 Employment in manufacturing: selected countries, 1990–2015

Countries can suffer increases in unemployment when demand patterns change. If a country is too dependent on a narrow range of goods, it will be particularly at risk. If demand or prices fall for these goods, nations will suffer a loss of trade and income.
Primary goods also have low-income elasticity and when the global economy grows, demand for them will not increase at the same pace. Countries need to avoid overspecialization and try to diversify in some way.

Chapter 38 – protectionism

What is protectionism?

Most economists would argue that free trade will benefit the global economy. However, sometimes countries believe that it is in their interests to restrict trade. For example, governments may think it is necessary to protect their domestic producers from overseas competition. They may also give financial help to exporters. This is called **protectionism**. Governments can use several measures to restrict trade. They are called **trade barriers**, and some examples are outlined below.

SUBJECT VOCABULARY

protectionism approach used by governments to protect domestic producers

trade barriers measures designed to restrict imports

Reasons for protectionism

PREVENTING DUMPING

A government may use trade barriers if it feels that an overseas firm is dumping goods. Dumping is where foreign producers sell goods below cost in a domestic market. They may do this to deliberately destroy overseas competitors. In some cases, businesses that dump products are heavily subsidised by their government. Consequently, they have an unfair advantage over foreign rivals. Dumping is unfair competition for domestic producers. If very cheap imports are being sold below cost in a country, domestic producers will find it very difficult to survive in the long term.

PROTECTING EMPLOYMENT

Trade barriers may be used if domestic industries need protection from overseas competitors to save jobs. Unemployment is always unwelcome and a government may be criticised if jobs are being lost because of cheap imports. In a documentary broadcast by Netflix, based on Peter Navarro's book Death by China: Confronting the Dragon, cheap Chinese imports were blamed for the loss of 57 000 American factories and 25 million jobs.

PROTECTING INFANT INDUSTRIES

It is often argued that infant industries need protection. Infant industries are new industries that are yet to become established. Many argue that infant industries should be protected from strong overseas rivals until they can grow, become established and exploit economies of scale. However, it is also argued that this approach may not be successful because governments have a poor record of successfully identifying infant industries with potential.

SUBJECT VOCABULARY

infant industries new industries yet to establish themselves

SUBJECT VOCABULARY

dumping where an overseas firm sells large quantities of a product below cost in the domestic market

TO GAIN TARIFF REVENUE

A government can raise revenue if it imposes tariffs on imports. This money can be spent on government services to improve living standards. It is reckoned that when the UK leaves the EU, if there is no trade deal between the two, the UK government could collect around £12900 million on imports coming in from the EU. However, the EU will also collect around £5200 million from UK exports.

PREVENTING THE ENTRY OF HARMFUL OR UNWANTED GOODS

A government might be justified in using protectionism if it is felt that overseas producers are trying to sell goods that are harmful or unwanted. Administrative barriers might be used to prevent this type of international trade.

REDUCE CURRENT DEFICITS

A country might need to use trade barriers because it has a very large current account deficit. A country has to pay its way in the world and if a current account deficit gets out of control, action may be needed. A government might try to reduce imports and increase exports at the same time to reduce the deficit.

RETALIATION

One motive for imposing trade barriers is to retaliate against dumping. If a foreign business dumps large quantities of goods below cost, a government may feel obliged to retaliate by imposing heavy taxes on those goods when they come into the country. Retaliation may also occur if a country imposes trade barriers on exporters. That country may retaliate by imposing trade barriers on that nation's imports.

Methods of protection

TARIFFS

One way of restricting trade is to make imports more expensive. This will reduce demand for imports and increase demand for goods produced at home. Imports can be made more expensive if the government imposes a special tax on them. Taxes on imports are called **tariffs or customs duties**.

Even though the pace of globalisation is accelerating and an increasing number of countries are opening up their economies to foreign businesses, there are many examples of countries imposing tariffs on imports.

One of the main advantages of tariffs is that in addition to reducing imports to protect domestic industries and improve the current account, they also raise revenue for the government. However, if tariffs are set too high, imports may cease, and government revenue will be zero. Also, consumers will not benefit from tariffs in the short term since they raise prices.

QUOTAS

Another way of reducing imports is to place a physical limit on the amount allowed into the country. This is called a **quota**. By restricting the quantity of imports, domestic producers face less of a threat. They will have more of the market for themselves. However, quotas will raise prices because fewer of the cheaper imports are available. Placing physical limits on the flow of imports means that domestic producers will meet some demand for those goods. This will help to protect employment.

SUBJECT VOCABULARY

embargo official order to stop trade with another country

quota physical limit on the quantity of imports allowed into a country

SUBJECT VOCABULARY

bi-lateral trade agreement trade deal between only two countries

In 2014, Indonesia imposed a quota on wheat-flour imports. The quota was designed to protect domestic producers from further financial losses. The authorities planned to restrict imports of wheat flour to 441 141 tonnes from May until the end of the year.

One of the main advantages of quotas is that they physically limit the supply of imports. Foreign companies cannot easily get round quotas by adjusting prices.

SUBSIDIES

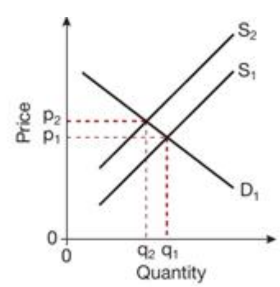
Quotas and tariffs aim to reduce imports. Another approach to protectionism is to give a subsidy to domestic producers. This involves giving financial support, such as grants or tax breaks, to exporters or domestic producers that face fierce competition from imports. If subsidies are given to domestic producers, this will lower prices for consumers because subsidies reduce production costs and increase supply. This forces equilibrium prices down. If subsidies are given to exporters, it makes it easier for domestic businesses to break into foreign markets.

Impact of tariffs, quotas and subsidies of market

The imposition of trade barriers by a government can have an impact on markets. For example, if a government imposes a tariff on imports, the prices of imports will rise. The impact of the different trade barriers on markets is explained below.

TARIFFS AND QUOTAS

Figure 38.1 shows that when the government imposes a tariff, the price rises from p, to p2. As a result, the amount traded in the market falls from q, to 92. These changes are caused by a shift in the supply curve from S, to S2. The effect of the tariff on the supply curve is the same as that of indirect taxes.

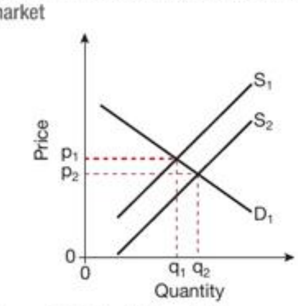


▲ **Figure 38.1** Effect of a tariff or a quota on a market

The effect of a quota in the market is the same as that of a tariff. The supply curve shifts to the left from S, to S2 forcing a price increase from p, to p2. This is also shown in Figure 38.1.

SUBSIDIES

The effect of a subsidy in a market is shown in Figure 38.2. Before a subsidy is granted, the equilibrium price in the market is p1. The effect of a subsidy is to lower production costs, which means that producers will increase supply. This is shown by a shift in the supply curve from S, to S2. The new equilibrium price is P2, which is lower than p1. The amount traded in the market rises from q, to q2. Subsidies will lower prices for consumers.



▲ **Figure 38.2** Effect of a subsidy on a market

Chapter 39 – Trading block

SUBJECT VOCABULARY

trading blocs groups of countries situated in the same region that join together and enjoy trade free of tariffs, quotas and other forms of trade barrier

What is a trading block?

The world is generally divided into several trading blocs. These are groups of countries situated in the same region that join to form a free trade area. It is also common for trading blocs to have a common tariff on imports from non-members. However, not all trading blocs are the same. They may differ in size and nature.

■Preferential trading areas (PTAs): This type of arrangement means that members agree to remove trade barriers on a range of goods and services. However, not all goods and services are covered and some trade restrictions still exist.

■Free trade areas (FTAs): Trade between members of an FTA is completely free of trade barriers. However, members are allowed to impose trade restrictions on non-members.

■Customs unions: These are similar to FTAs but members of a customs union impose a common set of trade barriers on non-members. This means that products imported by one member can be resold and transported to other members in the union.

■Common markets: These operate like customs unions but also allow the free movement of labour and capital between member countries. Common markets will also have the same trading standards and regulations, which makes transactions between members easier.

■Economic unions: These are the most developed type of trade blocs. Economic unions adopt the arrangements of common markets and customs unions but also aim for even more integration.

Impact of trading blocs on member states

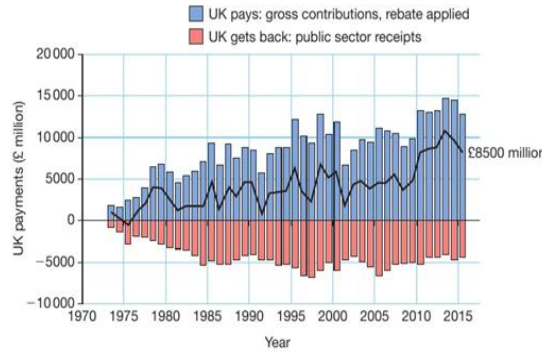
ADVANTAGES

Trading blocs provide many benefits to their members. Belonging to a trading bloc brings much the same benefits as those that result from free trade anywhere. If members of the bloc abolish all trade barriers, goods will be cheaper, and there will be more consumer choice and faster economic growth. Firms will be able to exploit economies of scale because they have access to larger markets and extra competition will improve the quality of goods and encourage innovation.
It is argued that the formation of trading blocs invites FDI. This may be because foreign firms are keen to locate operations within a trading bloc to get access to a larger and barrier-free market. This was the case in Mexico where FDI more than doubled the year after it joined NAFTA.

DISADVANTAGES

Unfortunately, membership of a trade bloc does have some disadvantages. Indeed, in June 2016, the UK voted to leave the EU. The UK voters decided that the disadvantages of belonging to the EU were greater than the advantages. Those in favour of worldwide free trade generally oppose trading blocs. By their nature, trading blocs encourage regional as opposed to global free trade. However, there is no real agreement as to whether regional trade blocs result in less free trade in the world or encourage further globalisation.

Members of a trading bloc may start to standardise trading practices, laws and other customs within their bloc. Some people may not like this because they may be happy with the traditional ways of their own country. Changes in laws and customs may also threaten a nation's culture.



▲ Figure 39.3 UK financial contributions to the EU, 1973–2015

Impact of trading blocs on non-member states

Countries that do not belong to trading blocs will face common trade barriers when selling goods to any member inside the bloc. They will obviously be at a disadvantage and may be forced to find new markets. However, it is still not clear whether non-members will suffer in the long run.

Examples of trading blocs

NAFTA (NORTH AMERICAN FREE TRADE AGREEMENT)

NAFTA is made up of three countries: the USA, Canada and Mexico. It is the biggest trading bloc in the world. In 2017, NAFTA had a population of 450 million and a GDP of over US$20.08 trillion. The three countries have common arrangements relating to trade and investment, labour, financial dealings, intellectual property and environmental issues.

However, despite these benefits, there have been some problems. First, it led to the loss of 500 000-750 000 US jobs, mostly in manufacturing. Some US companies in the automotive, textile, computer and electrical appliance industries relocated to Mexico to exploit cheap labour. Another problem was that job migration reduced or held down wages.

ASEAN (ASSOCIATION OF SOUTHEAST ASIA NATIONS)

ASEAN has ten members from the Southeast Asian region. Some of the largest members include Thailand, Vietnam, Malaysia, Indonesia, the Philippines and Singapore. Its key aims are to:

■accelerate economic growth, social progress and cultural development in the region
■promote regional peace and stability through respect for justice and the rule
of law
■promote cooperation on matters of common interest in the economic, social, cultural, technical, scientific and administrative fields
■help each other in the provision of training and research facilities
■increase cooperation so that regional improvements in agriculture, industry, trade, transport and communication can lift living standards
■promote Southeast Asian studies
■maintain close cooperation with other international and regional organisations.

SACU (SOUTH AFRICAN CUSTOMS UNION)

Formed originally in 1910, SACU is the world's oldest trading bloc. Its members include Botswana, Lesotho, Namibia, Swaziland (the BLNS states) and South Africa. The BNLS states also impose extra duties on agricultural produce. Trade between SACU members is totally free of barriers. Trade between members is also simple and the distances to the markets are short and frequent.

Chapter 40 – The world trade organization and the world trade patterns.

SUBJECT VOCABULARY

World Trade Organization international organisation that promotes free trade by persuading countries to abolish tariffs and other barriers. It polices free trade agreements, settles trade disputes between governments and organises trade negotiations

The world trade organization

The World Trade Organization (WTO), established in 1995, has 164 members and employs over 600 professionals. With a budget of over US$195 million in 2015, it promotes free trade by removing trade barriers and is the sole international agency overseeing trade rules. WTO decisions are final and members can enforce them by punishing violators.

TRADE NEGOTIATIONS

The WTO aims to reduce or eliminate trade barriers through negotiation. It does this by encouraging countries to draw up trading agreements covering matters such as anti-dumping, subsidies and product standards. The WTO aims to bring about trade liberalisation and lays down procedures for settling disputes. The agreements reached between countries may change over time.

IMPLEMENTATION AND MONITORING

The WTO employs various councils and committees to administer and monitor the application of the WTO's rules for trade in goods, services and intellectual property rights. All WTO members must conduct regular reviews of their trade policies and practices. Countries must also submit reports to the WTO as part of the monitoring process.

SETTLING TRADE DISPUTES

Trade disputes between members are not uncommon. The WTO's procedure for resolving trade disputes is vital for enforcing the rules and making sure that trade flows smoothly. Countries bring disputes to the WTO if they think their rights under their agreements have not been preserved.

BUILDING MEMBERSHIP

There are around 20 countries that are yet to join. The WTO helps and encourages new members to join up.

CRITICISMS OF THE WTO

Despite what seems to be the good intentions of the WTO, it does face criticism. This comes mainly from anti-globalisation bodies and environmental groups.

■**It is undemocratic** because the WTO rules are written by and for corporations. The views of consumers, environmentalists, human rights and labour organisations are often ignored.

■It favours the 'rights' of corporations over those of workers. It has also ruled that governments cannot take into account 'non-commercial values', such as human rights when making purchasing decisions.

■It is destroying the environment. For example, the very first WTO panel ruled that a provision of the US Clean Air Act, requiring both domestic and foreign producers to produce cleaner gasoline, was illegal.

■It favours wealthy nations over poorer ones. Many poor countries do not have enough qualified staff to take part in all the negotiations. Some do not have a permanent representative at the WTO. This prevents poor countries from representing their interests.

■It is causing hardship for poorer nations. The World Trade Organization (WTO) opposes market forces controlling agricultural policies, arguing that farmers produce enough food to feed everyone, despite the fact that millions worldwide suffer from food shortages.

WORLD TRADE PATTERNS

INCREASE IN WORLD TRADE

World trade has increased enormously in the last 55 years. Figure 40.1 shows that total world exports have been accelerating rapidly, particularly since 1985. Here are some reasons why this has happened.

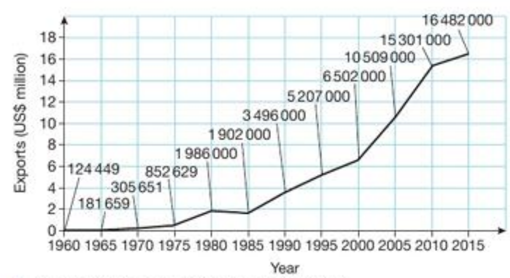
■Better transport and communications: More efficient transport systems mean that goods can be shipped more quickly and cheaply. This reduces the cost of selling goods abroad and therefore makes them more attractive to buy. Developments in ICT, such as the internet, means that buyers and sellers can communicate more easily.

■Relaxing of trade barriers: Since the 1930s, countries have realised that protectionism does not help economic growth. As a result, nations have discussed ways of increasing free trade. At these meetings, national leaders discuss trade matters and sign agreements to reduce tariffs and quotas.

■Development of multinationals: A lot of world trade has been driven by large MNCs. Their aim is to increase sales around the world and produce goods in locations that allow them to minimise their costs. As a result, they have sold an increasing range of goods and services to an increasing number of countries.

■Travel and consumer awareness: Owing to an increase in travel, consumers are more prepared to buy goods from other countries. They welcome greater choice and recognise that imports can satisfy a growing number of needs and wants.

■Trade agreements: Most countries in the world have trade agreements with their neighbours that are designed to encourage free trade. One important feature of these agreements is the formation of a trading bloc.



▲ Figure 40.1 Value of global exports, 1960–2015

TRADE IN DEVELOPED COUNTRIES

Although developing nations are contributing an increasing amount to world trade, it is the developed nations that continue to dominate. Figure 40.2 shows that China, the USA, Germany and Japan were the world's leading exporters and importers of merchandise in 2014.

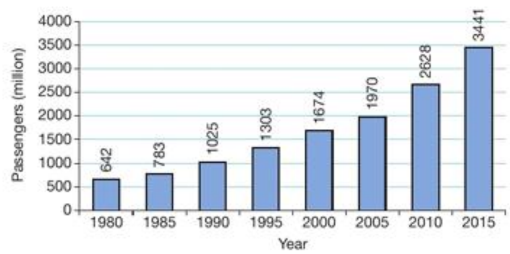
Exporters			Importers		
	US$ million	%		US$ million	%
China	2 343 000	12.4	USA	2 409 000	12.7
USA	1 623 000	8.6	China	1 960 000	10.3
Germany	1 511 000	8	Germany	1 217 000	6.4
Japan	684 000	3.6	Japan	822 000	4.3
Netherlands	672 000	3.6	UK	683 000	3.6
France	583 000	3.1	France	679 000	3.6
Korea	573 000	3	Hong Kong	601 000	3.2
Italy	529 000	2.8	Netherlands	587 000	0.8
Hong Kong	524 000	2.8	Korea	526 000	3.1
UK	507 000	2.7	Canada	475 000	2.8
Australia	240 000	1.3	Australia	238 000	1.2

▲ Figure 40.2 World's leading merchandising traders, 2014

■Loss of trade in manufacturing: Over the last 30 years, there has been a gradual movement of manufacturing from many Western developed countries to Far Eastern countries such as China and South Korea. F

■More air travel: People continue to travel the world in growing numbers. Figure 40.3 shows the scale of the increase. Most of this increase results from developed countries. This may be because of the development of 'budget airlines' offering cheap flights to many new destinations.

Widening of the development gap: Although international trade is rising in developing countries and an increasing number of people are being removed from poverty, trade in the developed countries is also growing. As a result, the gap between the rich and poor nations is widening.



▲ Figure 40.3 Number of passengers carried by air, 1980–2015

TRADE IN DEVELOPING COUNTRIES

Figure 40.4 shows clearly that developing countries have increased their share of world trade between 1995 and 2014. Some examples of recent trends in international trade in developing countries are outlined below.

■An increase in net migration: An increasing number of people are leaving developing countries to find work in developed countries.

■Increased FDI in Africa: Many African nations have benefited from an increasing amount of FDI from China. This has helped to increase international trade in these nations. China is Africa's third largest trade partner, following the USA and France. Total FDI in Africa has risen sharply in the last 20 years. FDI is very important for developing countries.

■Rise in commodity dependence. Many developing countries rely heavily on **commodities** for international trade. Between 1995 and 2013, commodity dependence has increased by 50 per cent. (A country is described as commodity dependent if revenue from the sale of commodities represents at least 60 per cent of total exports.)

■Debt cancellation: Developing countries will benefit from the cancellation of the entire US$40 000 million debt owed by 18 highly indebted poor countries. The money saved may be invested to help these poor nations open up their economies and grow.

■Reduction in barriers: Most WTO members are from developing countries so they will probably welcome trade liberalisation. The potential gains from removing trade barriers are considerable. Developing countries are likely to enjoy improving current balances if more trade barriers can be removed in the future.

SUBJECT VOCABULARY

commodities product that can be sold to make a profit, especially one in its basic form before it has been used or changed in an industrial process. Examples of commodities are farm products and metals

Chapter 41 – Exchange rates and their determination

What is an exchange rate?

Exchange rates are needed because different countries use different currencies. When trading with other countries, payments must usually be made in another currency.

EXAMPLES OF TRANSACTIONS INVOLVING TWO DIFFERENT CURRENCIES

Example 1: How much will it cost a French firm in euros to buy goods from a British firm that cost £400 000 if £1 = €1.10? The cost to the French firm in euros is given by:
£400 000 × 1.1 = €440000

Example 2: How much will it cost a British firm in pounds to buy US$300 000 of goods from a US firm if £1 = US$1.50? The cost in pounds is given by: US$300000 + US$1.50 = £200000

Example 3: How many US dollars will be needed by a British firm buying £55 000 of goods from an US firm if £1 = US$1.50? The cost to the British firm in US dollars is given by:
£55000 x US$1.50 = US$82500

SUBJECT VOCABULARY

exchange rate price of one currency in terms of another

Example 4: How many pounds can a Japanese businessperson buy with JPY 100 000 when visiting London if £1 = JPY 150? The quantity of pounds that can be bought is given by:
JPY 100000 ÷ JPY 150 = £666.67

Factors affecting the demand for a currency

The demand for a particular currency on foreign exchange markets is affected by a number of factors.

INTEREST RATES

Interest rates can affect the flows of money around the world. For example, if interest rates are higher in the UK than in other countries, foreign savers may choose to put their savings in a UK bank. However, before doing this, they will have to buy pounds with their domestic currency. This is because they can only deposit pounds in UK banks. Therefore an increase in interest rates will increase the demand for pounds and cause the exchange rate to rise. A fall in the UK interest rate will have the opposite effect.

CURRENCY SPECULATORS

Speculators are firms, individuals or financial institutions that buy and sell currencies in the hope of making a capital gain (profit). Foreign exchange markets attract speculators because prices of currencies sometimes vary dramatically. This means they buy a particular currency and hope to sell it for a higher price later.

THE DEMAND FOR EXPORTS

Firms that sell goods and services to foreigners expect to be paid in their own currency. Therefore, demand for UK exports also results in a demand for pounds. If demand for UK exports rises, there will also be an increase in the demand for pounds. In Figure 41.4, this will shift the demand for pounds to the right from D, to D2 and increase the exchange rate (or price of the pound) from ER, to ER2. A fall in the demand for exports will have the opposite effect.

Factors affecting the supply for a currency

The factors that affect the supply of a currency on foreign exchange markets are similar to those that affect the demand.

INTEREST RATES IN OTHER COUNTRIES

If interest rates are higher in other countries, savers in the UK may decide to place their money in foreign banks. To do this, they must buy foreign currency. This will increase the flow of pounds into the foreign exchange markets, which will increase supply and reduce the exchange rate. The opposite will happen if overseas interest rates are lower than the UK.

CURRENCY SPECULATORS

Speculators can affect both the supply and demand of a currency. This will increase the supply of pounds in foreign exchange markets and lower the exchange rate.

THE DEMAND FOR IMPORTS

Imported goods and services have to be bought with foreign currency. Therefore, if UK importers buy more foreign goods and services, they will have to buy foreign currency with pounds. The flow of pounds onto the foreign exchange markets provided by importers increases supply.

Outward foreign direct investment (FDI) can also affect the supply of currency. This is because the multinationals will have to pay for the investment in foreign currency. They buy this with pounds and therefore more pounds flow into the market.

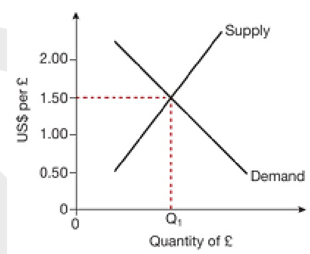
How are exchange rates are determined

Like all prices, market forces determine the price of a currency and if those forces change, the price is also likely to change. Currencies are bought and sold like commodities on a foreign exchange market.

SUBJECT VOCABULARY

foreign exchange market market where foreign currencies can be bought and sold

Figure 41.1 shows the supply and demand for sterling. The price of sterling in this example is given in terms of the US dollar. The equilibrium exchange rate is where supply and demand for pounds is equal.



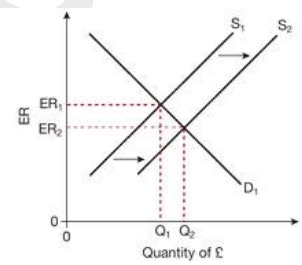
▲ **Figure 41.1** Equilibrium exchange rate

THE EFFECT OF CHANGES IN SUPPLY AND DEMAND ON EXCHANGE RATES

CHANGE IN SUPPLY

If there is a change in the supply or demand for a currency, there is likely to be a change in the exchange rate. The market for currency is no different from any other market.

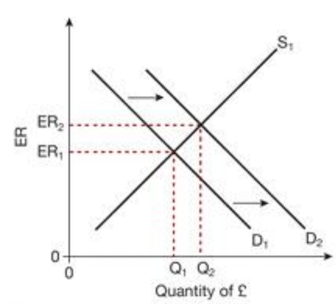
Figure 41.3 shows this. In the diagram, an increase in the supply of pounds resulting from importers buying foreign currency with pounds is shown by a shift from S, to S2. This reduces the exchange rate from ER, to ER2, that is, the value of the pound falls. A fall in demand for imports would have the opposite effect.



▲ **Figure 41.3** Increase in the supply of pounds in the foreign exchange market

CHANGE IN DEMAND

If demand for UK exports rises, there will also be an increase in the demand for pounds. In Figure 41.4, this will shift the demand for pounds to the right from D, to D2. This will increase the exchange rate (or price of the pound) from ER, to ER2. A fall in the demand for exports will have the opposite effect.



▲ **Figure 41.4** Increase in the demand for pounds in the foreign exchange market

Chapter 42 – Impact of changing exchange rate

Why do exchange rate change?

The exchange rate is the price of one currency in terms of another. Like all prices, they can change. This is because market forces determine prices and at any time supply and demand conditions can change. Figure 42.1 shows how the exchange rate between the pound and the euro has changed in the last few years.

▲ Figure 42.1 Pound–euro exchange rate, 2013–17

Appreciation and revaluation

When a nation's currency gets stronger it is said to **appreciate**. This means that a unit of one currency can buy more of another currency. For example, Figure 42.1 shows that the value of the pound against the euro appreciated between the beginning and the middle of 2015. It rose from £1 = €1.28 to £1 = €1.44. This is an appreciation of 12.5 per cent.

However, a government might wish to change the exchange so that it reflects current valuations. If the government raises the exchange rate so that it is stronger, the currency is said to have been **revalued**.

Depreciation and devaluation

When a nation's currency gets weaker, it is said to depreciate. This means that a unit of one currency buys less of another. When the exchange rate is fixed, a government might choose to change the exchange rate so that it is weaker. If this happens, the exchange rate will fall and the currency will be devalued.

Impact of exchange rate appreciation

Changes in the exchange rate can have an impact on the demand for exports and imports. This is because when the exchange rate changes, the prices of exports and imports also change. Look at what happens when the exchange rate rises from £1 = US$1.50 to £1 = US$2.

IMPACT ON EXPORTS

If a UK firm sells goods worth £2 million to a US customer, the dollar price at the original exchange rate is US$3 million (£2 million US$1.50). When the exchange rises, the dollar price of the goods also rises to US$4 million (£2 million x US$2). This means that demand for UK exports is likely to fall because they are now more expensive.

IMPACT ON IMPORTS

If another UK firm buys goods worth US$600 000 from a US supplier, the price in pounds at the original exchange rate is £400 000 (US$600 000 x US$1.50). When the exchange rate rises, the sterling price to the importer falls to £300 000 (US$600 000 x US$2). This means that demand for imports is likely to rise because they are cheaper.

IMPACT ON THE CURRENT ACCOUNT

When the exchange rate appreciates, the impact on the current account is likely to be negative. This is because demand for exports is likely to fall (because they are more expensive) and the demand for imports is likely to rise (because they are cheaper).

SUBJECT VOCABULARY

depreciate (of a currency) where the value of a currency falls owing to market forces – the exchange rate falls as a result

devalued (of a currency) when a government fixes a new lower exchange rate

SUBJECT VOCABULARY

appreciate (of a currency) where the value of a currency rises owing to market forces – the exchange rate increases as a result

revalued (of a currency) when a government fixes a new higher exchange rate

Exchange rates and government policy

A country must balance its current account to pay its way in trading with others. If a country has a persistent current account deficit, the government can help it depreciate by influencing the exchange rate by changing interest rates. Reducing interest rates can lead to a fall in the exchange rate, as seen in the UK's pound's value. However, this policy has its drawbacks.

■ The government might not have complete control over the interest rate. For example, in the UK, the Monetary Policy Committee of the Bank of England sets the interest rate.

■ Reducing interest rates to devalue a currency may conflict with other policies. For example, reducing interest rates when a government is also trying to control inflation is likely to cause more inflation.

■ Devaluation will only work if the demand for exports and imports is responsive to price changes. This is discussed below.

Exchange rate changes and price elasticity

The effectiveness of government exchange rate policy depends on the price elasticity of demand for imports and exports. If interest rates are reduced and the pound value falls, a current account balance deficit can only be reduced if both demand are elastic. Primary goods importers may find it difficult to reduce demand, while non-essential exports like tourism or consumer durables may be more successful.

Revision questions