

10 The international economy

Case studies

Case study 10.1

- 1 The BBC reported in October 2015 that the latest official figures on the manufacturing sector suggested that it had contracted by 0.8% in August of that year compared with the same month in 2014. In 2015, manufacturing accounted for about 10% of the output of the UK economy, compared to about 33% back in 1970 and 22% in 1995. In 2015, the production industries of mining, quarrying, gas, electricity, water and sewage accounted for another 5%. In contrast to manufacturing, the service sector accounted for 79% in 2015, with construction adding a further 6%. Between 2005 and 2015, manufacturing grew gradually from 2005 to 2008, but then dived after 2008. It recovered from 2010 until the start of 2012 and has been pretty volatile since then.

Foreign investment plays a big role in UK manufacturing. There are lots of things about the UK that make it an attractive destination for foreign companies looking to acquire other businesses or expand overseas.

The BBC argues that the UK is very open to other countries wanting to buy into it. It is within the European Union, which is attractive to US and Asian businesses wanting to reach European customers. The UK has relatively low corporation tax and a flexible labour market, which makes it easier to expand and contract a business as is necessary.

However, a big problem for foreign investors has been the strength of the pound, which makes investing in the UK more expensive for foreign companies and makes their products more expensive to export once they have been made.

There is some evidence of manufacturing output and employment growing when goods are produced at the higher end of the technology spectrum, as these industries are less dependent on competing on cost. Up-market cars produced by companies such as Jaguar and Land Rover provide good examples, though these brands are owned by Tata, an Indian company.

- 2 The recession caused a large drop throughout the world in the demand for imports, and since the growth of trade is such an important part of the globalisation process, this slowed down globalisation. Since the end of the recession, countries have been importing more, of both raw materials and manufactured goods, though the slump in commodity and energy prices in 2014 and 2015 had dented the growth of trade, as had the slowing down in the rate of growth of China's economy.

Case study 10.2

- 1 **Constant returns:** occur when an increase in the level of employment of all the factors of production leads to an exactly proportionate increase in output.

Perfect competition: a market structure in either the economy's goods market or its factor market which exhibits the following six conditions: (i) a very large number of buyers and sellers; (ii) each with perfect information about what is going on in the market; (iii) each able to buy or sell as much as it wants to at the ruling market price determined by the forces of supply and demand in the market as a whole; (iv) but each unable to influence the market price by its own actions; (v) a homogeneous or uniform product being bought and sold; and (vi) an absence of barriers preventing entry into, or exit from, the market in the long run.

Increasing returns: occur when an increase in the level of employment of all the factors of production leads to a more than proportionate increase in output.

Imperfect competition: a market structure in which the conditions of the perfectly competitive market are not satisfied. Forms of imperfect competition include: oligopoly, in which there is only one seller of a product; monopolistic competition, in which there are many sellers producing slightly differentiated products; and monopsony, where there are many sellers but only one buyer.

Second best: If a ‘first best’ or ‘most best’ outcome cannot be achieved — for example, when all the six requirements of perfect competition cannot be met — government policy-makers may decide to settle on a ‘second best’ outcome, such as allowing monopoly to exist but regulating the monopoly. However, the second-best outcome may create new distortions in the market which did not exist beforehand.

- 2 The model of comparative advantage, which provides the main theoretical argument that all countries can benefit through specialisation and trade, assumes that there are constant returns to scale in all industries. In the real world, however, increasing or decreasing returns to scale are both possible and indeed likely. In a world of increasing returns to scale, the more countries specialise in activities in which they initially have an absolute advantage, those that are ‘best’ to start with become even ‘better’. This weakens the case for unlimited free trade based on the principle of comparative advantage, because countries which have not built up economies of scale (which result from increasing returns to scale) are at a competitive disadvantage. Supporters of the ‘infant industry’ and ‘strategic trade’ arguments justify protectionism in developing countries while economies are built up.

With regard to whether imperfect competition weakens the case for unlimited free trade based on the principle of comparative advantage, the evidence is inconclusive. In an in-depth article ‘International Trade Policy with Imperfect Competition’, Richard Pomfret concluded that ‘as a general rule the case for free trade is enhanced rather than diminished by the introduction of scale economies and imperfect competition into the analysis’.

Case study 10.3

- 1 National income statistics are of *some use* in measuring economic development, but their use is indeed limited. The extract in the case study suggests why. The economic activities which generate pollution are included in national income, but the adverse welfare effects of the pollution are not deducted from the national income total. Likewise, the adverse welfare effects resulting from consumption of a demerit good such as tobacco or alcoholic drink are not deducted, though the production value of both goods forms a part of national income. Other indicators of development which are less dependent on ‘raw’ national income figures are used to place a value on economic and social progress. These include the United Nations Human Development Index (HDI). The HDI is constructed by measuring: life expectancy at birth, mean years of schooling and expected years of schooling, and gross national income per head of population, reflecting spending power in terms of US dollars.

Test yourself

Test yourself 10.1

The balance of payments on current account equals the balance of trade in goods and services, plus the primary and secondary income balance, which is £470 million.

Assuming that there is no balancing item, the financial account balance equals the balance of payments on current account (£470 million) minus capital flows and changes in reserves (–£100 million), which is £570 million.

Test yourself 10.2

The change in the exchange rate shows an appreciation of the \$ against the £ (one dollar now buys more pounds), and a devaluation of the £ against the \$ (one pound now buys fewer dollars). A depreciation of the pound makes UK exports cheaper in overseas markets. This increases overseas demand for UK exports, and since exports are a component of aggregate demand, it means that there has been a rise in aggregate demand in the UK. However, the depreciation of the pound's exchange rate increases the prices of imported goods, including raw materials and energy, and this leads to cost-push inflationary pressure. The increase in aggregate demand noted earlier in the answer may also increase demand-pull inflationary pressure. The correct answer is provided by statement B.

Questions

- 1 Globalisation is the process of growing economic integration of the world's economies. As Chapter 10 states, some of the main characteristics of globalisation are: the growth of international trade and the reduction of trade barriers, known as trade liberalisation; greater international mobility of both capital and labour; greater international mobility of labour; a significant increase in the power of international capitalism and multinational corporations; the deindustrialisation of older industrial regions and countries, together with the movement of manufacturing industries to newly industrialising countries (NICs); the movement of internationally mobile service industries to NICs; and a decrease in governmental power to influence decisions made by MNCs to shift economic activity between countries.

Being a developed economy, the UK has enjoyed the fruits of greater trade liberalisation, partly through the growth of export markets, but mostly through the country's residents enjoying a wider range of often cheaper imports. The UK has also benefited from the inward investment of capital in industries such as the manufacture of automobiles. The City of London has also benefited from increased world-wide demand for UK financial services. However, other industries have suffered as investment and jobs have departed to other countries, often China, India and other emerging markets. Two examples are the decline of seaside resorts in the UK and the closure announced in 2015 of much of the British steel industry. The inward migration of labour from other European Union countries is viewed by some as good, but by others as damaging to the UK economy. On the plus side, migrant labour has meant that the UK economy can grow without running into skill shortages that in the past have brought the growth process to a shuddering halt. And migrant workers, being mostly young, help to reduce the effects of an ageing population. Many also argue that migrant workers are prepared to do the jobs which British-born young people are unwilling or unable to do. However, opponents of inward migration claim that concentrated populations of immigrants put a strain on public sector health and education services and depress wages.

Along with most other economists, I believe that for the UK, the advantages of globalisation are greater than the disadvantages, and that globalisation is an inevitable process with which we must live. However, there are some significant disadvantages, both for the UK as a developed economy, and also for countries in the developing world. Examples of the latter include local businesses and brands in developing nations failing to survive as MNCs in developed nations increasingly dominate poorer countries, with local traditions and cultures disappearing.

- 2 Put simply, absolute advantage refers to one country being able to produce particular goods at a lower absolute cost in comparison to other countries. On the other hand, comparative advantage is a condition in which a country produces particular goods at a lower opportunity cost in comparison to other countries.

- 3 A government (or its central bank) can use three different policies to try to cure a persistent deficit caused by an overvalued exchange rate. These are the '3 Ds' of deflation, direct controls, and devaluation or currency depreciation. Deflation, or a reduction in the level of aggregate demand in the economy, reduces a current account deficit because it is mainly expenditure reducing. By contrast, import controls and devaluation are primarily expenditure switching.

Deflation involves using contractionary monetary and/or fiscal policy to reduce the demand for imports. For example, if the marginal propensity to import in the economy is 0.4, reducing aggregate demand by £10 billion should cause spending on imports to fall by £4 billion. This is an expenditure-reducing policy.

Although deflation is primarily an expenditure-reducing policy, it also has an expenditure-switching element. By reducing the rate of domestic price inflation relative to inflation rates in other countries, deflation increases the price competitiveness of exports and reduces that of imports.

However, in modern economies this is usually quite a small effect; the main effect of deflationary policies is to reduce aggregate demand and to depress economic activity in the domestic economy. Output and employment tend to fall rather than the price level. Unfortunately, as well as reducing the demand for imports, deflation affects the domestic economy. Falling demand for domestic output may force firms to seek export orders, so as to use spare production capacity. However, because exports are generally less profitable than domestic sales, a sound and expanding home market may be necessary for a successful export drive.

In summary, when deflating aggregate demand to achieve the external objectives of supporting the exchange rate and reducing a current account deficit, a government sacrifices the domestic economic objectives of full employment and economic growth. For this reason, governments may choose to use expenditure-switching policies of import controls and devaluation, in preference to expenditure-reducing deflation.

The **direct controls** used to reduce a payments deficit are import controls. Embargoes and quotas directly prevent or reduce expenditure on imports, while import duties or tariffs discourage expenditure by raising the price of imports. Import controls do not, however, cure the underlying cause of disequilibrium, namely the uncompetitiveness of a country's goods and services. Indeed, import controls may reduce rather than increase competitiveness. Moreover, because a country essentially gains a 'beggar my neighbour' advantage at the expense of other countries, import controls tend to provoke retaliation.

Ultimately, protectionism reduces specialisation and causes world trade, world output and economic welfare all to fall. Because of this, international organisations such as the EU and the World Trade Organization (WTO) have reduced the freedom of individual countries to impose import controls unilaterally to improve their current accounts. However, the EU uses its common external tariff to provide protection for all its members.

The word **devaluation** is used in a number of different ways. In a strictly narrow sense, a country devalues by reducing the value of a fixed exchange rate or an adjustable peg exchange rate. However, the term is also used in a looser way to describe a downward float or depreciation of a floating exchange rate. The word 'depreciation' can also confuse. Devaluation or a downward float causes an external depreciation of the currency; more units of the currency are needed to buy a unit of another currency. Don't confuse this with an internal depreciation of the currency, occurring when there is inflation within the economy.

'Unavailability' of import controls means that a country must generally choose between deflation and devaluation if it wishes to reduce a current account deficit. As with import controls, devaluation has a mainly expenditure-switching effect. By increasing the price of imports relative to the price of exports, a successful devaluation switches domestic demand

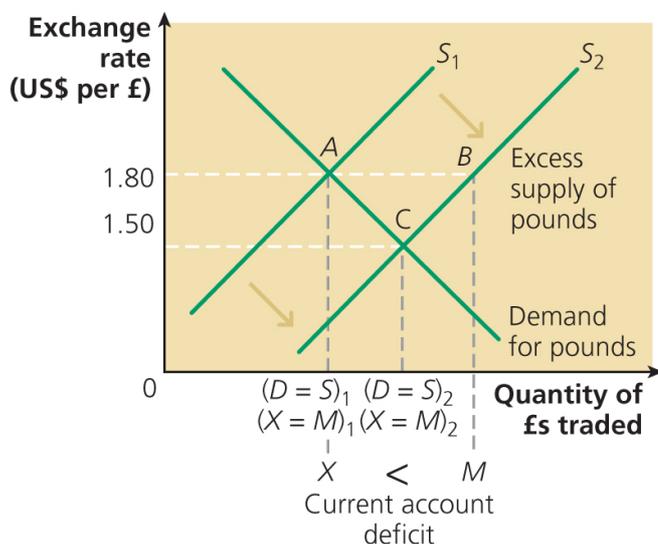
away from imports and towards home-produced goods. Similarly, overseas demand for the country's exports increases in response to the fall in export prices.

- 4 As Chapter 10 argues, deflation, devaluation and import controls may be effective short-term policies for reducing current account deficits. However, it is now increasingly recognised that long-term improvement in trade flows requires appropriate and successful supply-side policies and supply-side reforms undertaken by firms within the economy.

The ability of the UK economy to deliver sustained growth of exports and meet the challenge of imported goods and services depends on making UK exports quality competitive as well as price competitive. A low exchange rate, low interest rates at which British firms can borrow and low domestic inflation all contribute to increased export price competitiveness. However, price competitiveness on its own is not enough. UK goods and services must also be quality competitive. This involves good design and well-made products.

Improved quality competitiveness may only be achievable in the long run if helped by appropriate government supply-side policies together with supply-side reforms undertaken by the private sector. Supply-side policies which promote greater investment in research and development and improved marketing strategies can have powerful long-term effects in improving quality competitiveness. Supply-side reforms, illustrated by an outward shift of the *LRAS* curve, provide the economy with an increased capacity — enabling a reallocation of resources towards exporting. Successful supply-side policies can also improve exports and lead to import substitution, by increasing labour productivity, which in turn is likely to improve the price competitiveness of UK exports.

- 5 Taking the UK's current account and the pound's exchange rate as the context for this answer, exchange rate equilibrium occurs at the market-clearing exchange rate at which the demand for pounds on foreign exchange markets equals the supply of pounds. In the diagram below, this is determined at point *A*. The equilibrium exchange rate is \$1.80 to the pound.



At this exchange rate, the money value of exports (paid in sterling) equals the money value of imports (paid in foreign currencies). And provided we assume that exports and imports are the only items in the current account, the current account is also in balance.

Because we are assuming away any complications introduced by capital flows, exchange rate equilibrium implies balance of payments equilibrium on current account and vice versa.

Given the above simplifying assumption, once the current account of the balance of payments is in equilibrium, there is no pressure for the exchange rate to rise or fall.

Suppose, however, that an improvement in the quality of foreign-produced goods causes UK residents to increase demand for imports, whatever the exchange rate. As a result, the increase in demand for foreign exchange to pay for imports causes the supply curve of the

pound sterling to shift to the right from S_1 to S_2 . In the new situation, the current account of the balance of payments is in deficit by the amount $(X < M)$ in the diagram — as long as the exchange rate stays at \$1.80. At the \$1.80 exchange rate, UK residents supply or sell more pounds than before to pay for imports, but because overseas residents still demand the same quantity of UK goods, the overseas demand for pounds to pay for UK exports remains at its previous level.

At the exchange rate of \$1.80 to the pound, there is now an excess supply of pounds on the foreign exchange market, equal to the distance B minus A . The market mechanism now swings into action to restore equilibrium — both for the exchange rate and for the balance of payments. When the excess holdings of pounds accumulated at the exchange rate of \$1.80 are sold on the foreign exchange market, the pound's exchange rate falls. This increases the price competitiveness of UK exports while making imports less price competitive. The exchange rate falls until a new equilibrium exchange rate is reached at point C , where the exchange rate is \$1.50 to the pound.

The current account of the balance of payments is once again in equilibrium, now at point C , but at $(X = M)_2$ rather than at $(X = M)_1$. This means that at the new equilibrium exchange rate, although they are again equal in size, the money values of exports and imports have both increased.

- 6 Economic growth measures changes in the physical quantity of goods and services that an economy actually produces, or has the potential to produce. But growth does not necessarily improve the economic welfare of all or most of the people living in a country. Economic development is a better indicator of improved human happiness, and the ability to continue to improve happiness, than economic growth. Economic development, which includes the quality and not just the quantity of growth, is measured by a general improvement in living standards that reduces poverty and human suffering; greater access to resources such as food and housing required to satisfy basic human needs; greater access to opportunities for human development, for example through education and training and health care; and environmental sustainability and regeneration, through reducing resource depletion and resource degradation.