INTERNATIONAL TRADE

SPECIALISATION AT NATIONAL LEVEL:

The basis for specialisation at national level are:

- **Superior resource allocation**
- **Cheaper production methods.**

ADVANTAGES EXIST TO CONSUMERS/FIRMS AND ECONOMY:

OVERALL BENEFITS:

- **Specialisation helps to make a better use of available resources[factor endowments]**
- **It leads to an increase in the output**
- **Leads to higher standards of living**
- **Country can take the advantage of a lower opportunity cost ratio in production**
- **There is an increased efficiency.**

BENEFITS TO CONSUMERS AS A RESULT OF SPECIALISATION:

- **The cost of production may get lowered and this benefit may be passed on to the consumers in the form of lower prices.**
- **Lower prices give consumers a greater real purchasing power.**
- **They get standard products whose specifications are met.**
- **A higher output enables consumers to enjoy more goods and services and hence they have a higher standard of living.**
- **The consumers get good quality products . This is because firms develop the necessary techniques and skills to develop the specialised product.**

BENEFITS TO FIRMS AS A RESULT OF SPECIALISATION:

Following are the benefits to firms as a result of specialisation:

- **Specialisation improves skills of workers, saves time and leads to invention of new technology , increase productivity and raises the quality, thereby decreasing the average cost of production .**
- **It decreases the prices and thus increases the demand , enabling advantage to be taken of economies of scale , thereby increasing profits.**

BENEFITS TO A COUNTRY AS A RESULT OF SPECIALISATION:

- **Specialisation generates economies of scale , enabling a country to be more internationally price competitive**
- **It improves productivity /efficiency by producing what the country is best at .**
- **It increases GDP by making better use of scarce resources, allowing a country to export more .**
- **It increases the purchasing power of consumers , who through trade can purchase goods and services from the most efficient producers**

DISADVANTAGES EXIST FOR CONSUMERS/FIRMS AND ECONOMY:

The following are the potential disadvantages at the international level:

- **A country can be vulnerable if it has to rely on imports to meet its needs for instance, there may be a decline in the supply of a food product due to bad weather in the country from which it is sourced .**
- **Less efficient industries will collapse leading to an increase in unemployment .**
- **A country can be vulnerable to changes in world economic conditions and may be harmed by a world recession**
- **A country can be vulnerable to volatility in exchange rate movements, e.g. exports may be reduced by a rise in the exchange rate.**

DISADVANTAGES OF SPECIALISATION TO FIRMS:

The following are the potential disadvantages to firms :

- **Firms may become dependent on other countries for obtaining raw material and for selling their finished goods. Events in the countries , such as imposing taxes on imports and restricting export of raw materials etc. can adversely affect the firms.**
- **A fall in demand could result from a change in the tastes, substitute product may be developed**

DISADVANTAGES OF SPECIALISATION TO CONSUMERS:

- **If people are buying products that have not been made in the home country, it is quite possible that the health and safety standards might not be met by the country producing the product.**
- **A shortage of the product may result in case of an occurrence of a natural disaster or in case of change in government policies etc.**

APPLICATION BASED QUESTIONS:

[You need to explain the bulleted points. We have given you the basic points only]

EXPLAIN WHY COUNTRIES SPECISLISAE IN PRODUCING DIFFERENT GOODS AND SERVICES [6]

The following are some of the reasons why countries specialise in producing different goods and services:

- Countries concentrate on producing those products that their resources are best at making
- This comes about because of the different factor endowments all over the world.
- Specialisation will involve a better use of resources internationally
- This will lead to greater efficiency of production; this should lower the costs of production
- Absolute advantage-A country will produce a product if it can produce it using fewer resources than other countries.
- Countries will tend to focus on labour-intensive production if they have an abundance of labour, e.g. China, and capital-intensive production if there is a shortage of labour, e.g. Singapore.

2.EXPLAIN WHY MAY NOT CHOOSE TO SPECIALISE [5]

- There may be increasing costs of production from diseconomies of scale.
- High transport costs may not make it worthwhile to specialise
- There may be exhaustion of resources
- They may want to avoid risk of relying on a few products.

3. (a) EXPLAIN WHY SPECIALISATION IS AN IMPORTANT ASPECT OF INTERNATIONAL TRADE. [5]

Specialisation is an important aspect of international trade because:

- **The countries have different factor endowments**
- **Countries should specialise in producing the products they are best at making or those which make the best use of these endowments**
- **The benefits from economies of scale can be obtained, so costs and prices can be lower.**
- **The world output will increase because of the greater efficiency of production and hence the standards of living will rise**

GLOBALISATION-FREE TRADE AND PROTECTION

GLOBALISATION: It is a process by which the world is becoming increasingly interconnected through trade and other links.

REASONS FOR GREATER INTERCONNECTION BETWEEN COUNTRIES:

- Reduced transport costs
- Improvements in communication
- Removal of some trade restrictions

CONSEQUENCES OF GLOBALISATION:

POSITIVE:

- Greater range of products can be purchased at lost costs
- Firms may also shift some of their production in the most efficient locations.

NEGATIVE:

- A recession in one economy may adversely affect the other.
- Government policy is constrained due to globalisation. For instance. It might not be able to increase certain taxes, fearing that MNC's might relocate to other countries.
- Workers might lose their jobs due to breakdown of barriers between national markets

FREE TRADE:

Explain what is meant by free trade. [4]

- international trade which is not restricted by import controls , such as tariffs, quotas or other methods of trade protection
- It allows world output to be increased when each country specialises in producing the goods and services they are best at producing/with the lowest opportunity cost
- It is encouraged by organisations such the World Trade Organisation
- It can increase standards of living

THE BENEFITS OF FREE TRADE

EXPLAIN THREE POTENTIAL BENEFITS OF FREE TRADE: [6]

- Countries can specialise in what they do most efficiently
- It provides for a more efficient allocation of resources
- The world output of goods and services increases , raising standards of living
- Consumers gain from a greater choice , they can benefit from consumption of goods not produced in their country/variations in products .
- The consumers can gain from lower prices due to greater competition
- The firms can have greater choice of raw materials , this will lower costs of production and improve the quality of products made.

PROTECTIONISM:

DEFINE PROTECTIONISM:[2]-BOARD QUESTION

Protectionism is the deliberate attempt to limit imports or promote exports / make foreign products less competitive and have trade restrictions

METHODS OF PROTECTION:

- Tariffs - tax on imports that would increase the price of imports (1).
- Quotas - limit on the volume of imported goods allowed into the country
- Subsidies-to reduce the costs of domestic firms / reduce the price of domestic goods and services
- Embargoes - total restriction / ban on imported goods
- Exchange controls - limit on the amount of foreign currency that can be purchased
- Regulations -making it difficult to import

{EXPLAIN ANY TWO METHODS OF TRADE PROTECTION [4]}-BOARD QUESTION

REASONS FOR PROTECTION

EXPLAIN TWO REASONS WHY A GIVERNMENT MIGHT INTRODUCE TRADE PROTECTION [6]

Following are the reasons why a government might introduce trade protection:

- to protect an infant industry
- to prevent dumping
- to protect a declining industry
- to raise revenue through tariffs
- to overcome a balance of payments deficit.
- Raising employment and improving trade position.
- Protect an industry from low wage competition
- Protect industries from other forms of unfair foreign competition such as subsidies by their government etc.

CONSEQUENCES OF PROTECTION

- Protecting infant industries may make them more dependent on the protection and these might lose out on becoming more efficient , in case an opportunity arises.
- Owners of the declining industries, who receive protection, might oppose government's decision withdraw protection.
- Restricting imports, especially of raw materials may increase a firms cost of production.
- Lower choice for products
- Higher price of products
- Inefficiency

APPLICATION BASED QUESTIONS:

[You need to explain the bulleted points. We have given you the basic points only]

1.ANALYSE HOW FREE TRADE CAN REDUCE A FIRM'S COST OF PRODUCTION [6]

The following are some of the reasons why countries specialise in producing different goods and services:

- It can allow a country to specialise in what it's best at and thus use resources more efficiently
- no tariffs charged on exports/imports
- increased competition may force firms to reduce costs and increase productivity.
- A larger market and hence firms may be more able to take advantage of economies of scale .example, more sources of raw materials/capital goods and hence lower price or better quality

2.EXPLAIN HOW TWO METHODS OF TRADE PROTECTION MAY REDUCE IMPORTS [4]

1 mark each for each of two methods identified:
1 mark each for each of two explanations given:

- tariffs – tax on imports will raise price of imports which may reduce demand
- quotas – a limit on imports will restrict quantity of imports that can be purchased
- embargo – a ban on imports will reduce quantity imported to zero
- exchange control – a limit on availability of foreign currency will make it difficult to get the currency to buy imports
- VER – agreements between governments to restrict exports to each other
- quality standards – making it difficult / expensive to achieve requirements
- subsidies – given to domestic producers to make them internationally competitive
- expensive paperwork – increase the costs of exporting to the country

3.**DISTINGUISH BETWEEN QUOTAS AND EXCHANGE CONTROLS AS METHODS OF TRADE PROTECTION[4]**

	Quotas	Exchange controls
1	It is a restriction/limit on the imports of goods into a country	It is an exchange control is where a government limits access to foreign currency which makes it more difficult to buy imports from abroad .

FOREIGN EXCHANGE RATES

FOREIGN EXCHANGE RATES:

- It is the price of one currency in terms of another currency or currencies

FIXED EXCHANGE RATE:

- It is an exchange rate whose value is set at a particular level in terms of another currency or currencies.

FLOATING EXCHANGE RATE:

- It is an exchange rate that can change frequently, as it is determined by market forces.

APPRECIATION:

- It is a rise in the value of a floating exchange rate.

DERECIATION:

- It is a fall in the value of a floating exchange rate.

DEVALUATION:

- A fall in the value (of a (fixed) exchange rate
- Fall in value of currency (relative to another

CAUSES OF EXCHANGE RATE FLUCTUATIONS:

- Change in the export revenue and import expenditure, direct foreign investment, the sale and purchase of financial assets between the country and other countries, speculation and central bank action
- An increase in the current account surplus would increase the value of the currency.
- An increase in the investment in a country can lead to a rise in the value of currency.
- A government can buy and sell the currency to raise the exchange rate.
- The value of currency can be increased if government introduces measures to increase exports and reduce imports.
- Raising of the interest rates by central banks also raises the value of the currency.

DESCRIBE THE DIFFERENCES BETWEEN A FIXED AND A FLOATING EXCHANGE RATE. [4]

	FLOATING INTEREST RATE	FIXED INTEREST RATE
1	The value is determined by the market forces of demand and supply	a fixed exchange rate is maintained by the government/central bank (1)
2	the value can change frequently due to changes in demand and supply , e.g. speculation/rate of inflation etc.	• it is maintained through intervention in the foreign exchange market, buying or selling the currency/changes in the interest rate to maintain a particular value
3	There is no need for a government/central bank to maintain a particular exchange rate	

DISCUSS WHETHER A FLOATING EXCHANGE RATE IS PREFERRED TO A FIXED EXCHANGE RATE SYSTEM: [6]

Discussion should include a comparison and explanation of the following points.

Advantages of a floating exchange rate system: • the rate will be determined continually through market forces, so the government doesn't have to intervene • there is no need to hold large amounts of reserves • government is not committed to maintaining a particular external value of the currency and so can focus on other objectives	Advantages of a fixed exchange rate system: • less volatility in the exchange rate so less instability • makes planning/forecasting easier and so less uncertainty • could encourage investment/trade, having a positive effect on the economy • avoids speculative movements in exchange rate
Disadvantages of a floating exchange rate system: • it can fluctuate a great deal and this volatility can make it very difficult for firms to plan ahead • there can be speculative pressures on the currency	Disadvantages of a fixed exchange rate system: • requires government to hold large reserves • if the rate cannot be maintained, there will be a dramatic change in value through a devaluation

CONSEQUENCES OF A CHANGE IN THE EXCHANGE RATE:

1. **EFFECT OF A CHANGE IN THE EXCHANGE RATE ON IMPORT AND EXPORT PRICES**
   - A rise in the country's exchange rate would raise the price of its exports and lower the price of its imports
2. **EFFECT OF A CHANGE IN THE EXCHANGE RATE ON THE MACROECONOMY:**
   - A change in the exchange rates affects the economic growth, employment and inflation.
   - A fall in the exchange rate will result from lowering the export prices and raising import prices . This is likely to increase the demand for domestic products. This rise in the aggregate demand can increase output and employment of the economy, if it is not operating at its full capacity initially.
   - A rise in the inflation will be caused due to a reduction in the pressure on domestic firms to keep price-rise to a minimum, in-order to remain competitive

3. EFFECT OF A RISE IN THE VALUE OF THE EXCHANGE RATE ON AN ECONOMY:

- It will make exports more expensive and therefore less competitive
- This could lead to a reduction in the demand for exports and therefore possible job losses (the effect will be determined by PED)
- It will make imports less expensive and therefore more competitive
- This could lead to an increased demand for imports (again depending on PED) which could put some domestic firms out of business
- Although it would make the price of imported raw materials/component parts cheaper (not just finished goods) which could help domestic firms to keep down prices

THE ADVANTAGES AND DISADVANTAGES OF FLOATING AND FIXED FOREIGN EXCHANGE RATES:

ADVANTAGES AND DISADVANTAGES OF A FIXED EXCHANGE RATE.

POSSIBLE ADVANTAGES:

- There is a greater degree of certainty and stability .
- This can encourage investment and trade
- There is likely to be less speculation • can set rate low to increase exports/improve current account
- Can set rate high to reduce inflation.

POSSIBLE DISADVANTAGES:

- The governments need to maintain sufficient reserves to intervene in the market
- The agreed exchange rate might not be appropriate. It might be too high and it might make exports uncompetitive, too low and expensive imports cause inflation
- The policies taken to maintain a particular exchange rate may not be in the best interests of the wider economy.

ADVANTAGES AND DISADVANTAGES OF A FLOATING EXCHANGE RATE.

POSSIBLE ADVANTAGES:

- The exchange rate automatically adjusts so that demand equals supply.
- This can automatically eliminate deficits or surpluses in balance of payments .
- There is no need for the central bank to maintain reserves
- Domestic policies can be pursued more easily, e.g. changing interest rates.

POSSIBLE DISADVANTAGES:

- It can cause instability which could discourage investment and trade
- The exchange rate can be very volatile .
- Speculation on future exchange rate movements can be destabilising.

INTERNATIONAL COMPETITIVENESS:

A country may become internationally competitive if:

- It provides goods and services desired by consumers at a price acceptable to them. .
- A fall in the country's exchange rate and inflation may make it internationally competitive as their products will attract more customers in their home country as well as abroad.

INDICATORS OF A COUNTRY BECOMING INTERNATIONALLY COMPETITIVE:

- It will have a stable economic growth rate
- It will have a reasonable share of world trade
- It will have high level of investment and expenditure on research and development
- It will have good quality education
- It will have a well-developed infrastructure.

APPLICATION BASED QUESTIONS:

[You need to explain the bulleted points. We have given you the basic points only]

1.DISCUSS WHY SOME COUNTRIES HAVE FIXED EXCHANGE RATES WHILE OTHERS HAVE FLOATING EXCHANGE RATES.

Reasons why some countries have fixed exchange rates:

A lower exchange rate will reduce the price of exports raise the price of Imports. Net exports may rise / exports may rise / imports may fall. The current account of the balance of payments may improve , total (aggregate) demand may increase , real GDP may increase economic growth and employment may rise

Reasons why some countries have floating exchange rates:

- Higher import prices may not reduce spending on imports if demand for imports is inelastic , export revenue may not rise if demand for exports is inelastic . Import restrictions imposed on other countries may make it difficult to sell more exports
- Higher import prices may cause inflation. Imported raw material costs may rise causing cost-push inflation ,imported finished products may not be replaced by domestic products .A rise in net exports may cause demand –pull inflation .
- Domestic citizens may be able to purchase fewer imports (1) lower living standards
- If the country is in debt , it may increase the cost of repaying the debt .
- If the country is operating at full employment , it may not be possible to produce more exports / substitutes for imports .
- Demand for the country's exports may be low, if quality is poor /incomes abroad are falling.
- If the fall is used as a way to capture markets abroad / protect domestic industries there may be retaliation .

2 WHAT DETERMINES THE VALUE OF A CURRENCY IN A FLOATING EXCHANGE RATE SYSTEM? [3] [You need to explain your choices]

(a) Up to 3 marks for an explanation in terms of:

- influence of changes in demand
- influence of changes in supply
- payments for exports and imports
- capital movements
- changes in interest rates
- speculation
- expectations about future currency movements
- lack of government intervention.

3. ANALYSE HOW A COUNTRY'S CURRENT ACCOUNT DEFICIT MIGHT BE REDUCED IF ITS FIRMS BECOME INTERNATIONALLY COMPETITIVE. [6]

Coherent analysis which might include:

Being internationally competitive e.g. high productivity, low inflation, low exchange rates increases production , reduces cost of production , decreases price of exports , increases quality of exports , increases demand for exports , increases value of exports / net exports .Imports relatively more expensive / other countries products more expensive ,lower relative quality of imports ,decreases imports .

CURRENT ACCOUNT OF BALANCE OF PAYMENTS

BALANCE OF PAYMENTS:

- The balance of payments (BOP), also known as the balance of international payments, is a statement of all transactions made between entities in one country and the rest of the world over a defined period, such as a quarter or a year.
- It summarizes all transactions that a country's individuals, companies, and government bodies complete with individuals, companies, and government bodies outside the country.

STRUCTURE [COMPONENTS] OF THE CURRENT ACCOUNT:

- **visible trade account –[Trade in goods]** the difference between the export revenue and import spending on physical goods, e.g. cars, washing machines
- **invisible trade account –[Trade in services]** measures the difference between export revenue from and import spending on services, e.g. banking, insurance and tourism
- **Primary income [Income]–** e.g. interest, profit and dividends flowing in and out of the country
- **Secondary income[Current transfers]** – e.g. grants for overseas aid.

CURRENT ACCOUNT DEFICIT:

- The combined value of the debit items in the four sections of the current account of the balance of payments is greater than the combined value of the credit items in the four sections of the current account.

CAUSES OF CURRENT ACCOUNT DEFICIT:

- A High exchange rate would mean high export prices and low import prices
- Inflation makes domestic products less price competitive.
- low productivity of labour will raise wage costs/high prices of domestic products
- high costs of production e.g. raw material cost/results in high prices of domestic products
- Low quality reduces demand for exports and raises demand for imports
- Low incomes abroad may result in low demand for exports
- High incomes at home may lead to high demand for imports
- Protectionism abroad e.g. tariffs make it difficult to export
- Absence of protectionism at home may result in e.g. dumping.

CURRENT ACCOUNT SURPLUS:

- Credit items on exports, income and current transfers exceed debit items on imports, income and current transfers. A current account surplus is a positive current account balance, indicating that a nation is a net lender to the rest of the world.
- Revenue from the export of goods and services exceeds expenditure on the import of goods and services.

CONSEQUENCES OF CURRENT ACCOUNT DEFICIT:

- if a country is spending more on imports than on exports, this will result in money leaving a country making the country less well-off
- output and employment are lower than they would otherwise be because too few exports are being demanded and too many imported goods are entering the country
- the deficit will put downward pressure on a country's exchange rate , leading to a depreciation of its value/fall in internal inflation
- if one country has a deficit, it means that another country will have a surplus

CAUSES OF SURPLUS IN THE CURRENT ACCOUNT BALANCE OF PAYMENTS:

A surplus in visible balance :

- depreciation/devaluation of exchange rate would make exports cheaper and imports dearer, this would contribute to a surplus if PED was elastic
- A country's exported goods have a reputation for quality/reliability , other countries rate of economic growth is higher , inflation rate is lower – making goods relatively cheaper ,higher productivity, reducing prices and/or raising quality of goods.

A surplus in invisible balance :

- A country is very good in particular services, e.g. banking or insurance .
- Shipping services can bring in a lot of money
- Tourist expenditure by people visiting a country

A surplus in income:

- A net positive investment income , e.g. money from dividends, would contribute to a surplus
- Current transfers , e.g. net surplus from gifts, charitable donations and payments from one government to another , workers' remittances.

CONSEQUENCES OF CURRENT ACCOUNT SURPLUS:

- The country's aggregate demand increases. Hence the real GDP and employment may increase.
- Higher aggregate demand will cause demand-pull inflation.
- If an economy is operating close to its full capacity, it means that the country is consuming fewer products than what it is producing.
- If a country is operating a floating exchange rate, an increase in a current account surplus may result in an appreciation in the exchange rate, because the demands for the economy's currency will exceed its supply.

POLICIES TO ACHIEVE BALANCE OF PAYMENTS STABILITY:

MEASURES TO CORRECT CURRENT ACCOUNT DEFICIT:

- Implement policy measures to reduce imports and increase exports to reduce current account deficit. This can be done by imposing import restrictions, subsidising exports and reducing country's foreign exchange rate.
- Implement policy measures to reduce imports and increase exports by introducing measures to lower the country's consumer-spending by increasing income tax, raising interest rates and increasing the rates of indirect taxes. All this would give domestic firms greater incentive to export as they might find it hard to sell in their home country.
- Supply-side policy measures help to reduce long-run current account deficit. Example; Education and training lowers the average cost of production and improves the quality of goods that are produced. Supply-side policies have the potential to raise the international competitiveness over a long period of time. It also may help to avoid the disadvantages of other measures such as (retaliation) import restrictions, inflation (lower foreign exchange rate) and higher unemployment(an increase in the income tax)

MEASURES TO CORRECT CURRENT ACCOUNT SURPLUS:

- It would revalue a fixed exchange rate
- Or encourage the appreciation of a floating exchange rate.
- Encourage households and firms to purchase more imports by making use of expansionary fiscal policy and monetary policy.

APPLICATION BASED QUESTIONS:

[You need to explain the bulleted points. We have given you the basic points only]

DISCUSS WHETHER OR NOT A REDUCTION IN A COUNTRY'S TRADE PROTECTION WILL REDUCE ITS CURRENT ACCOUNT SURPLUS.

Why it might:

- lower tariffs will reduce price of imports
- removal of quotas may result in more imports being purchased
- removal of a ban/embargo will permit imports of the product to enter the country
- import expenditure may rise
- higher import expenditure may reduce the gap between export revenue and import expenditure

Why it might not:

- foreign firms may not have the capacity to supply more products
- demand for imports may be price inelastic
- the quality of imports may have fallen
- other countries may also reduce their trade restrictions
- the exchange rate may fall, raising exports and reducing imports
- export revenue may rise to match the higher import expenditure
- may have large surplus on invisibles

2. **(A) EXPLAIN TWO CONSEQUENCES OF A CURRENT ACCOUNT DEFICIT. [4]-BOARD QUESTION [4]**

- if a country is spending more on imports than on exports, this will result in money leaving a country making the country less well-off
- output and employment are lower than they would otherwise be because too few exports are being demanded and too many imported goods are entering the country
- the deficit will put downward pressure on a country's exchange rate , leading to a depreciation of its value/fall in internal inflation

- if one country has a deficit, it means that another country will have a surplus