

Characteristics of money

Money – anything generally accepted in payment of a debt; removes the needs to barter, avoiding the double coincidence of wants

Characteristics of money: acceptable to all, portable, durable, easily divisible, not able to be counterfeited and scarce in supply.

The Four Functions of Money

Medium of exchange – money facilitates transactions between buyer and seller; specialisation and the division of labour requires a means of exchanging goods and services; money promotes this.

Unit of account - a nominal unit of measure used to value/cost/price products, assets, debts, incomes and spending

Store of value – an asset that holds value over time

Standard for deferred payment – the accepted way in each market to settle debt

Money supply definitions

Money supply: the total quantity of money that is available for transactions. It is typically categorised into different monetary aggregates based on liquidity and accessibility.

- **Narrow Money (M1):** M1 represents the most liquid components of the money supply. It includes physical currency (coins and notes) and checking deposits in banks. M1 is used for day-to-day transactions.
- **Broad Money (M2, M3, etc.):** Broader monetary aggregates include M2, M3, and beyond, which incorporate illiquid assets. These aggregates encompass a wider range of savings and time deposits, as well as other near-money substitutes.
- Broad money includes savings accounts, time deposits, and other forms of near-money assets.

Liquidity: highly liquid assets are easy to convert to cash

Types of financial market

Money market: short-term, highly liquid debt securities including instruments like Treasury bills, commercial paper, and certificates of deposit; includes banks, financial institutions, and corporations seeking short-term financing or investments.

Capital market: long-term debt and equity securities, including stocks, bonds, and real estate investments; includes primary (new issue of shares) and secondary (existing bonds/shares are traded)

Foreign exchange market: currencies are bought and sold; facilitates international trade and investment

Types of financial asset

Financial assets are a type of asset that represents a claim to a future cash flow or a stream of payments, such as:

Stocks: Represent ownership in a company and pay dividends to shareholders.

Bonds: A debt instrument that pays interest to the bondholder.

Mutual funds: A pool of investments managed by a fund manager and offers diversification to investors.

Exchange-traded funds (ETFs): Similar to mutual funds but are traded on exchanges like stocks.

Derivatives: Instruments whose value is based on the value of an underlying asset, such as options and futures.

Digital money

Digital money, also known as electronic money or digital currency, refers to a form of currency that exists solely in electronic or digital form. It is increasingly used for transactions and includes, digital wallets, cryptocurrencies, central bank digital currencies and pre-paid cards

Role of financial markets

Financial market: buyers and sellers come together to trade financial assets, such as stocks, bonds, currencies, and derivatives. The main goal of a financial market is to **match buyers and sellers** to efficiently allocate financial capital to its most productive uses helping to increase economic growth.

Key roles:

- To facilitate saving by businesses/households - secure place to store money and earn interest
- To lend to businesses/consumers
- To allocate funds to productive uses; allocate capital to where the rate of return relative to risk is highest
- To facilitate the final exchange of goods/services (e.g contactless payment)
- To provide forward markets to allow economic agents to insure against price instability and hedge against possible risks
- To provide a market for equities, allowing business to raise new capital
- To provide information about the prices of financial assets

Equity v debt

Equity represents ownership in a company, entitling shareholders to a proportional share of profits and voting rights.

- Equity does not need to be repaid and carries higher risk, but potentially higher returns through dividends and capital gains.

Debt involves borrowing money that must be repaid with interest over a specified period.

- Debt holders do not have ownership rights but have a priority claim on assets in case of bankruptcy, making it a lower-risk investment with fixed returns.

Inverse relationship: bonds prices & yields

There is an **inverse relationship between market interest rates and bond prices**. A bond is a loan, repaid when the bond matures; it pays annual interest (the coupon); bonds can be traded after issue

Example: Tutor2u issues a **£1,000 bond** with **£80** annual interest to investors to be repaid in 2028 the date of maturity

- **Yield = $\frac{\text{£80 interest}}{\text{market value of bond}} = 8\%$**
- Interest is paid annually on a set date such as June 1st to bond holders and interest is fixed at £80 per year
- Bonds are traded in the market so the price can and does change
- This changes the implied % yield on a bond e.g **if the price rose to £2,000, then the yield falls to $\frac{\text{£80}}{\text{£2000}} = 4\%$; if the price fell to £500 then the yield rises to**

Commercial & Investment Banks

Commercial banks: provide traditional banking services such as accepting deposits, making loans, and offering checking and savings accounts. They focus on providing financing to consumers and small businesses.

- Banks are licensed deposit-takers providing a range of savings accounts
- They are licensed to lend money and **create money** via new bank loans, overdrafts and mortgages
- Charges a higher interest rate on loans (or other assets) than the rate it pays out on deposits (or other liabilities) to pay the operating expenses of a bank and helps them to make a profit
- Commercial banks are heavily regulated by governments,

Investment banks: Specialise in underwriting securities, M&A advisory, trading, research, and asset management.

- Operate in capital markets.
- They focus on providing financial services to corporations, institutional investors and high-net-worth individuals.
- They are subject to some regulations, often less stringent than commercial banks, often with a focus on securities and financial market operations.
- They are typically investment firms with no physical branches and a focus on providing advice and services.

Functions of a commercial bank

- **Accepting deposits:** commercial banks offer safe and easily accessible deposit accounts, including savings accounts, checking accounts, and fixed deposits.
- **Providing loans:** they extend credit to individuals and businesses for various purposes, such as mortgages, business loans, and personal loans.
- **Payment services:** commercial banks facilitate payment and fund transfer services through checks, electronic funds transfers, and online banking.
- **Safekeeping of valuables:** some commercial banks offer safe deposit boxes for customers to store valuable items securely.
- **Currency exchange:** they provide foreign exchange services to facilitate international trade and travel.

Balance sheet of commercial bank

Assets:

- Cash and Reserves:** funds held in the central bank or as cash on hand
- Loans and Advances:** money lent out to borrowers.
- Investments:** securities held by the bank, such as government bonds or corporate bonds.

Liabilities:

- Deposits:** funds held in customer accounts.
- Borrowings:** funds borrowed from other financial institutions.
- Capital:** the bank's equity, including shares and retained earnings

Money or credit creation by commercial banks

Banks create credit by agreeing loans to businesses and households. When a bank makes a loan, it credits their bank account with a deposit of the size of the loan. At that moment, new money is created. They do not need to attract deposits from savers initially.

Objectives of commercial banks

Liquidity v Profitability:

- Striking the right balance between liquidity and profitability can be challenging. While maintaining high liquidity ensures safety, it may reduce potential profits. Banks must decide how much liquidity to hold.
- Sometimes a central bank will impose minimum liquidity requirements on banks such as a cash/deposits ratio

Profitability v Security:

- Pursuing higher profitability often involves taking on more risk, which can jeopardise the security of customer deposits.
- Balancing these objectives is crucial for long-term sustainability

How the banks create money

Fractional reserve system: banks create credit by using the fractional reserve system, where they are required to hold only a fraction of their deposits as cash / liquid reserves and can lend out the rest.

Money multiplier effect: when banks lend out a portion of the funds deposited with them, these funds are deposited in other banks, creating a chain reaction of lending and increasing the money supply.

Credit creation process: as banks make loans, they effectively create new money in the form of additional deposits. This process multiplies the initial deposit and contributes to economic activity measured by GDP

Limitations on money creation

- Market forces – the profitable lending opportunities to businesses and households can often fluctuate for example at different stages of the cycle
- The risks of lending including default risk from the borrower
- Regulatory policies such as minimum capital reserve requirements as part of regular bank stress tests
- Monetary policy - level of policy interest rates set by the Bank of England influences total demand for loans

Main roles of a central bank

Monetary policy: Central banks set interest rates and control the money supply to influence the economy.

Financial stability: Central banks work to ensure the stability of the financial system by regulating banks and other financial institutions

Managing the currency: Central banks print and issue currency, manage its value, and oversee its distribution.

Lender of last resort: Central banks act as a lender of last resort, providing emergency loans to banks and other financial institutions during times of crisis.

Financial supervision: Central banks supervise the financial system to ensure that financial institutions are operating safely and following regulatory requirements.

Research: Central banks conduct economic research and analysis to inform their policy decisions.

Examples: Bank of England, ECB, the Fed in USA

Lender of last resort

Lender of last resort: role central banks play in times of financial distress. When other financial institutions are unable to provide loans, the central bank steps in to lend money to banks/financial institutions.

- Central banks provide **emergency loans** to financial institutions in times of crisis to prevent their collapse and limit systemic risk.
- They also provide short-term loans to banks at a slightly higher interest rate than the market rate - the **discount window**.
- They **require collateral** from financial institutions as a condition for lending. This helps to mitigate the risk of default.
- Central banks are known as the lender of last resort due to their ability to provide loans in times of crisis, which can help to prevent financial panics/loss of **reputation**

Central Bank = the government's bank

Issuing government bonds: Central banks can issue and sell government bonds on behalf of the government to finance its budget and borrow money.

Managing government debt: Central banks can help governments manage their debt by buying and selling government bonds in the market, helping to stabilize prices and maintain liquidity.

Providing advice: Central banks often provide economic and financial advice to governments, helping them to make informed decisions about fiscal policy and other issues.

Bank base rate

Base rate: main interest rate set by a nation's central bank; the rate of interest charged to commercial banks if they must borrow from the central bank when short of liquidity; market interest rates often take their cue from changes in the Base Interest Rate

Market interest rates: rates for savings, bank overdrafts, mortgages, credit cards, pay day loans etc.

Responsibility for monetary policy

The central bank makes decisions on **base rates & QE** to meet its remit; in the UK the Bank of England has to aim to meet the 2% inflation target in the medium term. **REVIEW: Monetary policy from Year 12!**

Decisions affect the main economic indicators and can affect the exchange rate (higher interest rate leads to appreciation ceteris paribus)

Bank reserve requirements: the central bank can change the amount of money banks must have in reserve to ensure banks have enough liquidity to meet the needs of their customers; the UK does not have these but sets 'stress tests' to check the banks are prepared for a financial shock/crisis

Why regulation is important

Preventing systemic risk: Financial regulation helps to reduce the risk of a major financial crisis by requiring financial institutions to maintain adequate capital and liquidity, and by limiting risky activities.

Protecting consumers: Financial regulation protects consumers from fraud, predatory lending, and other harmful practices.

Ensuring fair competition: Financial regulation promotes fair competition in the financial industry by preventing anticompetitive behaviour and unfair pricing practices.

Promoting financial stability: Financial regulation helps to prevent the kind of market instability that can lead to economic downturns and recessions.

Financial regulation bodies in the UK

The Bank of England

The Prudential Regulation Authority (PRA)

The Financial Policy Committee (FPC)

The Financial Conduct Authority (FCA)

FCA

- **Regulation and supervision:** The FCA is responsible for regulating financial institutions. It sets regulatory rules and standards for these firms, conducts prudential supervision, and ensures that they comply with applicable regulations.
- **Consumer protection:** The FCA ensures that financial products and services are fair, transparent, and not misleading.
- **Market supervision:** The FCA actively monitors financial markets to identify risks and emerging issues

PRA

- **Prudential supervision:** The PRA is responsible for prudential supervision involves assessing and ensuring the financial soundness of financial institutions to prevent financial instability.
- **Setting and enforcing prudential standards:** The PRA enforces standards to ensure that financial firms can withstand economic and financial shocks.

FPC

- **Identifying systemic risks:** The FPC assesses the financial system to identify potential risks that could threaten its stability. .
- **Setting policy tools:** Once systemic risks are identified, the FPC has the authority to recommend or set specific policy tools to address these risks. These tools can include capital requirements for banks, leverage ratios, liquidity requirements, and more.
- **Stress testing:** The FPC conducts stress tests to assess how well the financial system and individual institutions can withstand adverse economic conditions and shocks.

Why commercial banks can fail

Run on the bank – depositors panic and withdraw money leaving the bank with insufficient liquidity to meet all its customers' demands

Credit crunch – bank may be unable to borrow from other banks overnight

Toxic debt - losses from bad debt/loan defaults reduces bank's credit rating; its share price falls

Arguments for and against allowing bank failures

Bank failures

- Encourage market discipline
- Promote competition
- Avoid moral hazard
- Protect taxpayers

Bail-outs help to...

- Prevent systemic risk
- Protect depositors
- Prevent the negative externalities from financial market failure

Liquidity and capital ratios

Liquidity ratios: used to assess a bank's ability to meet its short-term financial obligations and maintain sufficient liquid assets to cover withdrawals and unexpected funding needs

Cash Reserve Ratio (CRR): mandates that banks maintain a certain percentage of their total deposits in the form of cash or deposits with the central bank.

Capital Adequacy Ratio: measures the proportion of a bank's risk-weighted assets (RWA) to its total capital, expressed as a percentage; it ensures that a bank's capital is sufficient relative to its risk exposure.

Market failure in the financial sector: asymmetric information

Asymmetric information: one party in a transaction has more information than the other which can lead to

- **Adverse selection:** occurs when individuals with hidden information about their riskiness (e.g., borrowers with poor credit history) are more likely to seek financial products (e.g., loans), leading to higher default rates for lenders.
- **Moral hazard:** arises when one party, typically after a transaction, has an incentive to behave differently because of incomplete information e.g. borrowers may take on excessive risks if they believe they won't bear the full consequences of their actions.

Market failure in the financial sector: externalities & systemic risk

Externalities: spillover / third-party effects that affect parties not directly involved in a transaction:

- **Negative externalities:** financial institutions may engage in risky practices (e.g., excessive lending) that can lead to **systemic risks** affecting the entire economy e.g. GFC 2008
- **Systemic risk:** widespread failure of financial institutions leading to a domino effect and a widespread economic collapse.
- **Positive externalities:** a well-functioning financial sector can benefit the broader economy by efficiently allocating capital and promoting economic growth.

Market failure in the financial sector: moral hazard

Moral hazard: refers to the risk that one party may take on excessive risks because they believe they are protected from the full consequences of their actions.

- It can arise when banks and financial institutions believe they will be bailed out by the government in the event of a financial crisis.
- This can lead to reckless behaviour and excessive risk-taking.

Market failure: speculation and market bubbles

Speculation: buying assets (e.g. stocks or real estate) with the expectation of profiting from price increases, rather than from the asset's intrinsic value.

Market bubbles: when asset prices rise significantly above their fundamental values due to speculation and irrational exuberance; bubbles often burst, leading to market crashes and financial instability.

Market failure: market rigging

Market rigging: the manipulation of financial markets to gain unfair advantages.

- Examples include insider trading (trading based on non-public, material information), market manipulation (e.g., pump-and-dump schemes), and collusive behaviour among market participants to distort prices.
- Monopoly power is usually assumed to damage consumer and social welfare.
- Market rigging undermines market integrity and can lead to investor losses.

Lack of regulation: inadequate or ineffective regulation of financial markets can lead to excessive risk-taking, fraud, and other forms of misconduct.

Financial crisis

Financial crisis: major shock to financial markets, associated typically with falling asset prices and insolvency amongst debtors which ramifies throughout the financial system, disrupting the market's capacity to allocate financial capital.

Includes currency crisis (sudden collapse of currency), external debt crisis (unable to fund a current account deficit), sovereign debt crisis (government cannot pay interest on their debt), banking crisis (possible run-on banks) and broad financial crisis (combination of others).

Globalisation

Globalisation: The deepening of relationships between countries, reflected in an increasing level of cross-border trade and investment and migration

De-globalisation: a reversal of the process of globalisation

Slower globalisation ('slowbalisation'): slowdown in the speed of globalisation

Characteristics of globalisation

- Increased trade in goods and services (more WTO members, China & India, Russia); higher trade to GDP ratios
- More capital transfers and capital liberalisation (MNCs/TNCs, FDI, foreign ownership of companies etc)
- Global branding
- Greater specialisation and division of global labour force (outsourcing, offshoring....global sourcing and global supply chains)
- Labour migration (within and between countries)
- Shifting balance of economic and financial power from developed world to emerging markets
- De-industrialisation and structural unemployment in developed economies
- Increased global media presence (internet); greater connectivity
- Greater investment spending on infrastructure & innovation; more integrated global supply chains
- Increasing interdependency of economic agents (producers, consumers, governments and enterprises)

Multi or trans-national corporations (MNCs/TNCs)

Multi- or trans- national companies (MNCs or TNCs): companies that operate in more than one country. The head office might be in the USA, but the manufacturing factories in SE Asia, using raw materials from Africa, while final products are sold in markets across the world.

Causes of globalisation

- Containerisation and falling transport, freight and travel costs
- Increasing influence of powerful corporations (MNCs/TNCs)
- Lower trade barriers/trade liberalisation
- Increasing size and number of trading blocs
- More FDI flows between countries
- Greater labour migration and the emergence of a global labour force
- Rapid spread of technologies, manufacturing systems and management techniques (knowledge transfers)
- Faster communication and information flows and the emergence of new markets, especially global media presence
- Improvements in infrastructure
- Geopolitical change
- New emerging markets

Benefits of globalisation

Economies of scale: Globalisation encourages both producers and consumers to reap benefits from **division of labour**; greater productive efficiency

More cost-reducing innovation: more competitive markets reduces the level of monopoly profits and can incentivise businesses to innovate

Lower consumer prices/better quality: greater competition can drive down prices for consumers and may increase range and quality of goods available (increased consumer surplus)

Faster economic growth: leads to higher per capita incomes and reduced extreme poverty in many lower income countries.

Freer movement of labour: helps to relieve skilled labour shortages & diversifies the workforce, promoting knowledge, technology & management practice transfers boosting innovation

Increased awareness: of the long-term global economic challenges from climate change and the impact of wealth & income inequality

Costs of globalisation

Rising inequality: the gains from globalisation are unequal leading to growing political and social tensions when inequality of income and wealth increases; relative poverty may increase

Environmental costs: threats to the global commons including irreversible damage to ecosystems, land degradation, deforestation, loss of bio-diversity and water scarcity

Macroeconomic fragility: in an inter-connected world, external shocks in one region can rapidly spread to other centres (this is known as **systemic risk**)

Trade imbalances: increasing trade imbalances (both surpluses and deficits) lead to protectionist tensions, more import tariffs and quotas and a move towards managed exchange rates – this can then lead to de-globalisation and slower growth

Jobs: Workers may suffer **structural unemployment** from out-sourcing of manufacturing to lower-cost countries and a rise in the share of imports in GDP

Tax avoidance: many large MNCs can find ways of avoiding corporation tax and other taxes; the rich can also avoid tax using tax havens, reducing the tax revenue of governments

Brain drains: a more mobile global workforce means some countries suffer from emigration, losing their most productive workers.

Systemic risk of negative global shocks

A more interconnected world is at greater risk from negative economic shocks such as:

- pandemics
- financial crises,
- currency crises
- natural disasters
- extreme weather
- geo-political shocks
- risks from terrorism,
- commodity price volatility
- unexpected changes in global interest rates

Causes of de-globalisation

Protectionism: measures such as tariffs, quotas, and trade barriers may be used to shield domestic industries from foreign competition.

Economic Shocks: Economic downturns/recessions can lead countries to reduce their reliance on global trade, supply chains and investment.

Changing Trade Agreements: countries might renegotiate or withdraw from trade agreements that were previously promoting globalisation e.g. Brexit

Environmental Concerns: concerns about climate change might lead to prioritisation of local production to reduce the carbon footprint associated with long-distance trade.

Health Crises: global health crises, such as pandemics, disrupt travel, trade, and supply chains.

Economic Nationalism: governments might adopt policies to protect domestic industries and jobs, even if it means reducing international trade

Impact of globalisation on developed countries

Benefits

- Increased access to foreign markets
- Attraction of foreign investment
- Improved productivity and innovation

Costs

- Job displacement/structural unemployment
- Rise in income inequality
- Environmental degradation

Impact of globalisation on developing countries

Benefits

- Increased access to global markets
- Increase in foreign investment
- Increased access to knowledge and technology

Costs

- Economic dependence such as primary product dependency
- Exploitation of labour and issues with emigration
- Environmental degradation

Multinational corporations (MNCs)

Multinational corporations: businesses that base their manufacturing, assembly, research and retail operations in several countries, e.g. Nike, Apple, Vodafone, Netflix, Uber, Amazon, Facebook (Meta) Google and Samsung

How MNCs affect globalisation

- Many MNCs have re-located manufacturing to countries with **relatively lower unit labour costs** in order to increase their supernormal profits and equity returns for shareholders
- Some MNCs are **reshoring** manufacturing as labour costs rise in many emerging countries.
- The pandemic caused some firms to shorten their manufacturing supply chains and 'de-globalise'

Importance of multinational corporations

- Major contributors to FDI, often establishing subsidiaries in foreign countries
- Around two-thirds of global trade is conducted within multinational enterprises or their subsidiaries (WTO data)
- Foreign affiliates of multinational corporations employ around 60 million people worldwide (OECD data)
- In 2019, global trade in intermediate goods accounted for over 50% of total trade. TNCs are at the heart of the creation of global value chains.
- Tax revenue losses from base erosion and profit shifting could be between \$100 billion and \$240 billion annually (OECD data)

Emerging market MNCs

MNCs do not just grow out from developed countries: they have grown out of EM economies e.g. from China: China Mobile, TikTok, Huawei Technologies; from India: Infosys, Tata Group

Global value chains

Global value chain (GVC): the interconnected network of activities involved in the production and delivery of goods and services that are performed by multiple firms, operating in different countries.

- In a GVC, different stages of production, such as design, research and development, manufacturing, marketing, and distribution, are performed by different firms in different countries, with each firm adding value to the final product or service.
- The total trade value of parts and components for smartphones reached nearly \$490 billion in 2019 (WTO)

Benefits of MNC for a country

- **Employment opportunities** created by MNC where they operate, contributing to lower unemployment rates.
- **MNCs bring investment, technology and expertise**, which can stimulate economic growth and development.
- **MNCs can facilitate innovation, knowledge and skills transfer** to local workers, enhancing productivity and competitiveness.
- **MNCs generate tax revenue** for governments through corporate taxes, potentially boosting public finances

Costs of MNC for a country

- MNCs may also displace local businesses, leading to **job losses** in certain sectors or regions.
- Countries hosting MNCs may become **dependent on foreign investment**, risking loss of control over key sectors of the economy.
- MNCs may **exploit cheap labour** in host countries, leading to suppressed wages and poor working conditions for local workers.
- Some MNCs engage in aggressive tax planning strategies to minimize their tax liabilities (**tax avoidance**), which can reduce the tax revenue collected by host countries

Why countries trade

- To increase the availability of resources, goods and services
- To increase choice for consumers/more product differentiation
- To increase efficiency/reduce costs/reduce prices

International specialisation

International specialisation: where countries/regions focus on producing & exporting specific goods or services in which they have a **comparative advantage**, while importing other goods or services that they can acquire more efficiently from trading partners. This specialisation allows countries to allocate their scarce factor resources more **efficiently**, improve overall **productivity**, and hopefully benefit from the **gains of trade across borders**

Absolute advantage

Absolute advantage: a country produces a good at a lower direct costs i.e. if a country using the same factors of production can produce more of a product

	Good X	Good Y
Country A	20	10
Country B	5	15

Together Countries A & B can produce 25 of good X and 25 of good Y *before specialisation*.

- Country A has an absolute advantage in the production of good X, while Country B has an absolute advantage in production of good Y.
- If they specialise where their absolute advantage lies, then A produces 40 of X (but no Y) and B produces 30 of Y (but no X). They have produced 15 more of X and 5 more of Y by specialising. They can trade and potentially share the gains made.

Comparative Advantage

Comparative advantage: when one country can produce a good or service at a **lower opportunity cost** than another country. It considers where a country is **relatively more efficient** or **relatively less inefficient** at producing

	Good X	Good Y
Country A	60	45
Country B	120	60

Before specialisation and trade, the countries can produce 180 of X and 105 of Y. This assumes the labour input and other inputs are initially divided equally between the two countries.

Opportunity cost ratios

In country A, to get 60 more of X means giving up 45 of Y. The opportunity cost of 1X = $45/60$ of Y = 0.75; the opportunity cost of 1Y = $60/45 = 1.34$. In country B, to get 120 more X means giving up 60 of Y. The opportunity cost of 1X = $60/120 = 0.5$; the opportunity cost of 1Y = $120/60 = 2$. Country A has a **lower opportunity cost** than country B in the production of Y (1.34 compared to 2) while country B has a **lower opportunity cost** of production of X (0.5 compared to 0.75). Country A has a **comparative advantage** in Y and country B has a **comparative advantage** in X.

The gains in output after specialisation

	Good X	Good Y
Country A	0	90
Country B	200	20

By specialising in where their comparative advantages lie, their joint output goes up from 180 to 200 of X and from 105 to 110 of Y. They can trade and potentially share these gains.

Mutually beneficial terms of trade

The two countries need to find a **mutually beneficial terms of trade** – in other words, a trade of good X for good Y that benefits both countries. If they trade at **3:2** then both countries can benefit because 3:2 or 1.5X:1Y **lies between the internal opportunity cost ratio** for both countries.

In A, the opportunity cost ratios were 1X:0.75Y and 1Y:1.34X

In B, the opportunity cost ratios were 1X:0.5Y and 1Y:2X

A can now sell 1Y and receive 1.5X in exchange whereas before it received 1.34X

B can now sell 1X and receive 0.67Y in exchange whereas before it received 0.5Y

After trade and specialisation

After both specialisation and trade, both countries are better off than before. Assuming country A exports 43Y to country B and imports 63X from country B

	Good X	Good Y
Country A	63	48
Country B	137	62

Country A has 3X and 3Y more than before

Country B has 17X and 2Y more than before

Both have gained from specialising where comparative advantage lies and then exchanging at a mutually beneficial exchange rate,, even though B has the absolute advantage in the production of both goods.

David Ricardo

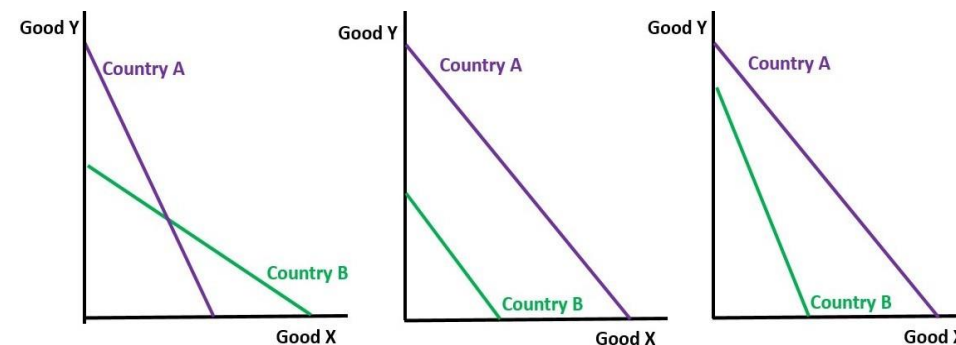
David Ricardo was one of the founding fathers of **classical economics**. He developed the idea of **comparative advantage**. His basic rule: Specialise a country's scarce **factor resources** in goods and services that they are **relatively best at**. This opens **potential gains** from specialisation and trade which leads to improved **economic welfare**

- No transport costs
 - No barriers to trade
 - Homogenous goods
 - No economies of scale
 - No environmental costs
 - Perfect knowledge
 - Factor mobility between uses
 - All resources fully employed and all goods and services sold
- Many of these assumptions do not hold in the real world, so the gains from trade may be less or more than the theory predicts

Competitive Advantage

Competitive advantage: when your country/business has **access to technology or innovations** that allow cheaper and/or more efficient production of goods. This gives a cost advantage and, therefore, a price/quality advantage over competitors. It is a more appropriate trade and specialisation concept when considering **highly differentiated** manufacturing goods, for example.

Using diagrams to show absolute and comparative advantage



A has absolute advantage in Y and B has absolute advantage in X	No gains from trade. Opportunity cost ratios are the same. (Parallel)	A has comparative advantage in X and B has comparative advantage in Y
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Pattern of trade

Pattern of trade: the mix of goods and services that a country and imports and exports in international trade; the range of countries it exports to and imports from

Factors influencing the pattern of trade

- Absolute and comparative advantages
- Factor endowments - the quantity and quality of the resources a country has or has not got
- Trading bloc and trade agreements
- Globalisation, trade liberalisation, protectionism & FDI flows
- Changes in world incomes and growth rates
- Exchange rate movements
- De-industrialisation & the pace of economic development

Geographical pattern of trade

Geographical pattern of trade: how businesses and consumers in other countries trade with businesses and consumers in a country

Intra-regional trade: trade between countries in the same region

Gravity theory of trade: countries tend to trade most with other nations in closest proximity

Commodity pattern of trade

Commodity pattern of trade: the type of products (goods and services) traded internationally. It shows if a country has a dependence on primary v manufactured v service exports. As a nation develops **complexity** and **capabilities**, they become capable of supplying and exporting a broader range of products

The EU's pattern of trade and the USA & China

The EU trading bloc is a customs union and a single market which encourages a high degree of intra-regional trade. 20 countries also share a currency, the Euro. Many countries have either of both China and the USA as a major trading partner because of their economic size.

The UK's pattern of trade**Geographical**

- Despite Brexit, 46 per cent of UK exports go to the European Union and 53 per cent of UK imports come from the European Union
- 3.6 per cent of UK exports go to China and 13% of UK imports come from China
- USA is largest single export market for UK with Germany 2nd
- Germany is biggest source of imports (12%), USA on 11% and Netherlands on 7.3%. (2023 data)

Commodity

- The UK trades most in petroleum products; road vehicles; pharmaceutical products; industrial machinery; business services; financial services (including insurance); telecommunications; cultural and creative services.

Pattern of trade and primary product dependency

Primary product dependency: where a country's economy heavily relies on the export of raw materials or primary products, such as agricultural goods, minerals, or energy resources.

Export earnings fluctuate with global commodity prices and demand leading to economic instability and hindering economic development.

Examples include oil-exporting countries, agricultural exporters e.g. Cote d'Ivoire & cocoa and mineral-dependent countries e.g. Zambia & copper

Emerging markets and trade patterns

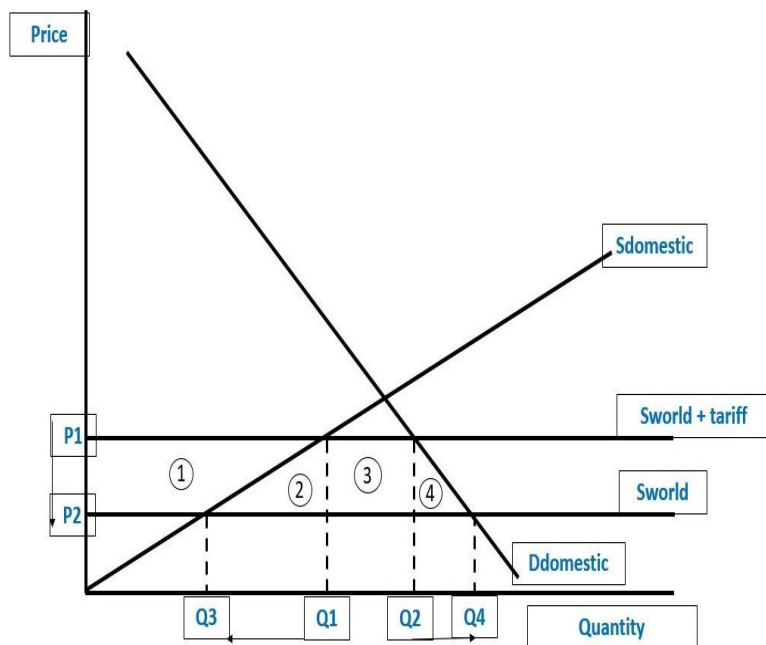
Emerging Market: an economy that cannot yet be classified as 'developed' and is investing heavily in its productive capacity.

- Many EMs have followed a path of industrialisation built on rising domestic and inward investment increasing their export capacity and also their demand for primary commodities, affecting trade patterns

Types of restrictions on trade

- Tariff:** tax on imports (ad valorem or specific)
- Quota:** physical limit on the quantity of imports allowed
- Subsidy:** payments by the government to reduce the costs of producers, increases supply and reduces the price
- Non-tariff barrier (NTB):** barriers such as import quotas, tough environmental and product standard rules, trade embargoes and export subsidies
- Rules of Origin:** rules of the national source of the traded goods e.g. a minimum % for locally-sourced components

Impact of a tariff on a market



Before the tariff, price is P2; domestic demand is Q2 and domestic supply is Q3; imports are Q3Q4. After imposing the tariff; new price is P1, domestic demand is Q1 and domestic supply is Q1: Q1Q2 of good is imported. Consumer surplus falls by area 1+2+3+4; producer surplus rises by area 1; government tariff revenue rises by area 3: **net welfare loss** of areas 2+4.

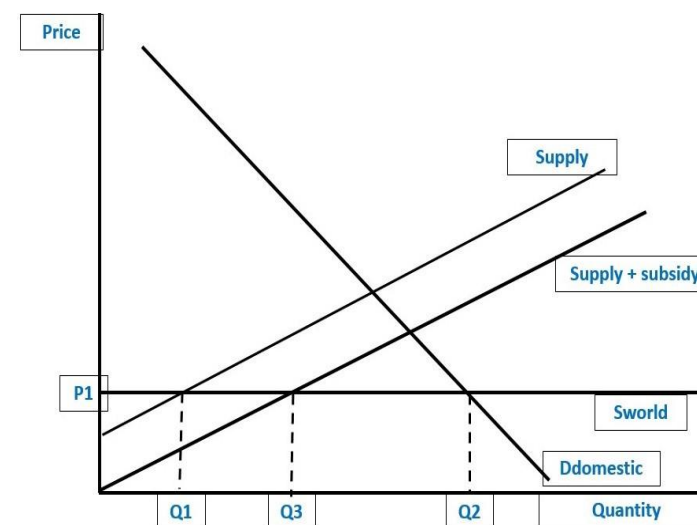
NTBs

- Intellectual property laws** such as patents and copyright protection
- Technical barriers to trade** including labelling rules and stringent sanitary standards. This raises product compliance costs for exporters
- Preferential state procurement policies** – where government favour local producers when finalising contracts for state spending projects
- Domestic subsidies** – aid for businesses facing financial problems –for example, subsidies for car manufacturers or loss-making airlines.
- Financial protectionism** – when a government instructs state-owned banks to give priority/cheaper loans to domestic businesses
- Managed exchange rates** – government intervention in currency markets to change the relative prices of imports and exports

Tariffs v quotas

The impact of a quota is similar to a tariff; restricting supply of imports increases the market price. A quota that raises the price by the equivalent amount as the tariff has the same welfare effects as a tariff except there is no gain in government tax revenue (areas 2+3+4 = net welfare loss)

Impact of subsidy on imports



Before the subsidy, imports are Q1Q2. Subsidy shifts domestic supply to right. Imports fall to Q2Q3. At the subsidised price, more domestic suppliers can compete with the world producers.

Causes of protectionism

Protecting domestic industries: trade restrictions can shield domestic industries from foreign competition, preventing job losses and maintaining national self-sufficiency in critical sectors.

National security: trade restrictions may be used to safeguard national security interests; export of certain technologies or goods could be restricted to prevent them from falling into the wrong hands.

Diversify: an economy that is too dependent on one product.

Infant industry argument: governments may protect emerging or "infant" industries until they can compete internationally; tend to be temporary trade barriers, like subsidies or tariffs, providing domestic industries time to grow

Sunset industry argument: use tariffs to slow the decline of older sectors and limit risks of structural unemployment.

Anti-dumping measures: duties are imposed when foreign companies sell products below their production cost in the domestic market, harming domestic producers protecting local industries from unfair competition.

Environmental and health concerns: restrictions prevent the import of products that do not meet domestic environmental, health, safety and quality standards.

Balance of payments improvement: trade restrictions can be used to improve a country's balance of payments by reducing imports through tariffs or quotas can help reduce trade deficits that use up foreign currency reserves

Raise tax revenues: this is especially important for many developing countries who have a limited domestic tax base).

Benefits of protectionism

- Domestic industries become **more competitive** with better products for consumers
- Protects domestic industries and helps them grow; may **create jobs**
- Can **protect jobs**, prevent structural unemployment
- Governments can gain some **tax revenue** from tariffs
- Can be used to **improve the current account balance** on the Balance of Payments
- Can **protect citizens** from dangerous products, protect national security and help promote self-sufficiency in strategic industries

Problems with protectionism

Higher prices for consumers: protectionist policies often lead to higher prices for imported goods due to tariffs or quotas.

Less choice for consumers: trade restrictions can limit or prevent some goods being imported

Lower living standards: living standards may fall as the availability and affordability of goods decreases; many protectionist measures reduce welfare

Over-reliance on protection: can lead to inefficiencies in supply, reducing competitiveness in the long term.

Danger of retaliation/trade war: protectionist policies may strain diplomatic relations and lead to retaliation by trading partners.

Increase in income inequality: if trade restrictions benefit specific industries or groups while imposing costs on others; they may also affect global income distribution by limiting opportunities for developing countries to export

Shadow markets: incentives to by-pass controls

Issues with free trade

Job losses: free trade can lead to job losses in industries where other countries have a comparative advantage; when cheaper imports flood the market, this can lead to layoffs and unemployment.

Wage suppression: free trade can lead to downward pressure on wages, as companies might move production to countries with lower labour costs.

Income inequality: free trade can exacerbate income inequality within countries;

Trade barriers and inequality

- Protectionism tends to benefit high-income earners and harm low-income earners because of higher prices are regressive
- Job losses caused by trade barriers also disproportionately affects low-income workers, though jobs for some could be protected.
- Trade barriers can lead to less competition in certain sectors, allowing companies to have more pricing power; higher profits could be shared with workers via higher real wages.

Trading blocs

Trading bloc: regional economic groupings/**regional trade agreements**

RTAs i.e. groups of countries that trade more freely amongst themselves but may set barriers against non-members

Bilateral trade agreement: trade agreement between two countries

Multilateral trade agreement: trade agreements between many countries or between a trading bloc and another country/trading bloc

Types of trading blocs

Preferential Trading Area (PTA) such as trade agreements between the EU and the less developed countries

Free trade area/agreement (FTA): free trade between members; tariffs and quotas removed;

Customs union: free trade between members and a common external tariff (CET) on non-members

Single (common) market: free trade and common policies on product regulation, and freedom of movement of the factors of production (capital and labour) and of enterprises and services. The physical (borders), technical (standards) and fiscal (taxes) barriers are removed to allow free movement among the member states – **creates a 'level playing field' for trade by removing NTBs**, which is particularly useful for services trade

Monetary union: members of the bloc share a common currency, central bank and interest rate e.g. Eurozone

Free trade areas and rules of origin

A **free-trade area** eliminates tariffs, import quotas, and preferences on most (if not all) goods and services traded between them.

Examples: ASEAN, USMCA, EFTA, ACFTA

- Each member can set its own tariff on imports from outside the FTA
- FTA may be undermined by **re-exporting** so this is prevented by imposing tariffs on re-exports and enforce a '**country of origin rule**' (i.e. a certain % of goods traded must originate from a member state to qualify for tariff-free internal trade)
- **Rules of Origin:** negotiating and establishing the rules of origin is complex and adds to the costs of firms that trade

Free trade between members and the common external tariff (CET) cause:

Trade creation: removal of tariffs between members increases trade between businesses within the bloc; more gains from specialisation and trade; greater exploitation of the bloc's countries' comparative advantages

Trade diversion: the CET means trade may pivot away from the global lowest-cost producers to the lowest cost producer within the bloc; trade is diverted from outside to inside the bloc

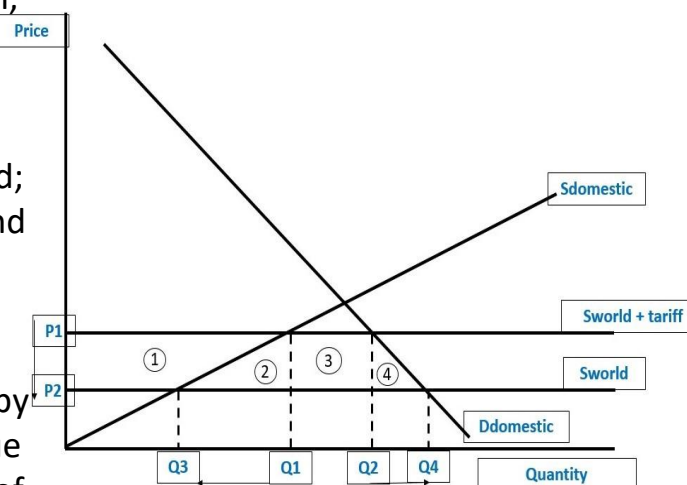
Examples: the EU, Turkey & the EU

Trade creation diagram

Before joining the customs union, price is P_1 ; domestic demand is Q_2 and domestic supply is Q_1 ; Q_1Q_2 of good is imported.

After joining the tariff is removed; new price is P_2 , domestic demand is Q_4 and domestic supply is Q_3 ; imports increase to Q_3Q_4 .

Consumer surplus rises by area $1+2+3+4$; producer surplus falls by area 1; government tariff revenue falls by area 3: **net welfare gain** of areas $2+4$.



Single or common market

Common/single market has free movement of goods, services, capital and labour and a common set of rules on standards reducing both tariff and **non-tariff barriers to trade**

Example: the EU single market

Brexit: the UK left both the EU customs union and single market and negotiated an FTA with the EU called the Trade and Cooperation Agreement

Brief History

UK joined the European Economic Community in 1973 when it was a customs union. The EU evolved and become more integrated with the establishment of the EU's Single Market (1993 onwards) and the Eurozone (1999 onwards). It also enlarged, for example, many Eastern European countries joined in the 1990s. In 2016 the UK held the Brexit referendum and the UK voted narrowly to leave the EU. In 2020 the UK officially left the EU.

Benefits of EU membership for UK 1973-2020

Access to the Single Market: the free movement of goods, services, capital, and labour facilitated trade and investment flows between the UK and other EU member states, boosting economic growth.

Foreign Direct Investment (FDI): increase in UK's access to FDI from other EU countries, as well as from outside the EU, contributing to job creation, technological advancement, and overall economic development.

Trade Agreements: the UK benefited from the trade agreements negotiated collectively by EU member states with other countries and regions, providing enhanced market access for British goods and services.

Regulatory Alignment: EU membership entailed adherence to common standards and regulations, which reduced non-tariff barriers to trade and compliance costs for UK businesses, particularly in sectors heavily integrated with the EU market.

Regional Development Funds: The UK received funding from various EU programs aimed at promoting regional development, infrastructure projects, and research and innovation initiatives in less economically developed areas.

Access to immigrant labour: EU immigrants filled skills gaps and contributed positively to the public finances

Membership Fees: the UK made significant net financial contributions to the EU budget. These contributions were a source of contention, particularly among those advocating for Brexit.

Loss of Sovereignty: EU membership necessitated the acceptance of supranational laws and regulations, limiting the UK's ability to make independent policy decisions in areas such as trade, agriculture, and competition policy.

Immigration and Freedom of Movement: Many citizens of member states came to live and work in the UK, leading to concerns about increased immigration levels and pressure on public services, infrastructure, and wages.

Trade Restrictions: Membership in the EU's Single Market also meant compliance with common external tariffs and trade policies, which could limit the UK's ability to negotiate independent trade deals with non-EU countries.

Regulatory Burden: While regulatory alignment with the EU facilitated trade, some businesses viewed EU regulations as burdensome and overly bureaucratic, potentially stifling innovation and competitiveness

Brexit

The benefits and costs above can largely be reversed for the pros & cons of Brexit. **2016-2020:** Uncertainty about the type of Brexit the UK would choose and what type of trade agreement the UK would make with the EU created economic uncertainty deterring business investment. **2020:** The UK agreed the TCA with the EU – a free trade agreement. Research estimates the UK economy is about 4-5% smaller than it would have been. Tax revenue is estimated to be about £40bn less per year. Many SMEs are finding it costly to adhere to UK & EU sets of standards after leaving the EU's SEM and some alignment with the EU is creeping back in..

Trading blocs: advantages

- Increased Trade:** RTAs lead to increased trade among member countries, boosting economic growth. More trade creation & gains from trade
- Efficiency Gains:** by reducing trade barriers, resources are allocated more efficiently; more dynamic efficiency and tech transfer
- Economies of Scale:** larger markets allow for economies of scale, reducing production costs.
- Political Cooperation:** RTAs can promote political cooperation and peace among member countries; pooled sovereignty can increase global influence

Trading blocs: disadvantages

- Trade Diversion:** RTAs can lead to trade diversion, where members start trading more with each other but less with non-members.
- Complexity:** compliance with different rules and regulations within the RTA can be complex and expensive for businesses; may be some diseconomies of scale
- Exclusion:** non-member countries can face trade disadvantages, potentially causing international tensions.
- Inequality:** may benefit more efficient states at expense of weaker ones
- Loss of Sovereignty:** deeper integration may require members to cede some sovereignty in trade policy.

Factors influencing the potential success of a trading bloc

- Economic size of the bloc
- Number of members in the bloc
- How integrated the bloc is
- The flexibility and willingness to change over time as global economic balance of power alters
- The unity of purpose within the member states
- The strengths and weakness of the economies of members
- How evenly the benefits of membership are spread across the members

The key functions of the WTO are:

- Negotiation:** facilitating trade negotiations among member countries to reduce trade barriers.
- Dispute Settlement:** resolving trade disputes through a rules-based system
- Monitoring:** monitoring trade policies and practices of member countries to ensure they comply with WTO rules.
- Technical Assistance:** providing technical assistance to developing countries to help them participate in global trade.

Possible conflict between trading blocs and the WTO

- Trade Discrimination:** RTAs may discriminate against non-members, potentially violating WTO's most-favoured-nation principle.
- Trade Diversion:** if RTAs lead to trade diversion, they can be seen as contrary to the WTO's goal of reducing trade barriers globally.
- Inconsistent Rules:** conflicting rules between RTAs and WTO agreements can create legal and practical challenges.
- Preferential Treatment:** WTO rules generally favour non-discrimination, while RTAs provide preferential treatment to member countries.
- Dispute Resolution:** disputes can arise when WTO and RTA rules conflict, requiring resolution mechanisms to reconcile differences.

Challenges faced by the WTO

- Multilateral Negotiations Gridlock:** there have been numerous disagreements among member countries on various issues such as **farm subsidies** and special treatment for developing countries.
- Rise of Bilateral and Regional Agreements:** done outside the framework of the WTO, leading to a complex web of overlapping trade rules and regulations.
- Diverging Development Goals:** developing and developed countries have differing priorities and expectations from the WTO.
- Digital Trade and E-Commerce:** the rapid growth of digital trade and e-commerce presents challenges for the WTO, as existing trade rules and agreements may not adequately cover these areas.

Balance of Payments

A country's **balance of payments** account records all the flows of money between the residents of that country and the rest of the world. It has three key parts:

- Current account
- Capital account
- Financial account

Export (X) = a UK produced good or service sold overseas resulting in an **INFLOW** of income to the UK; it is a CREDIT or positive on the UK current account on the balance of payments; an injection into the circular flow

Import (M) = an overseas produced good or service purchased by UK citizens resulting in an **OUTFLOW** of income from the UK; it is a DEBIT or negative on the UK current a/c on the BoP; a withdrawal from the circular flow

Net exports = $X - M$

Trade balance

- If the value of X exceeds the value of M, there is a **trade surplus** (net injection, boost AD)
- If the value of M exceeds the value of X, there is a **trade deficit** (net withdrawal, reduces AD)
- If the value of M equals the value of X, there is **an equilibrium in trade or balance in trade**

Current account on the Balance of Payments

Current Account: The current account records the transactions related to a country's trade in goods, services, primary and secondary income

Trade Balance: The balance of trade accounts for the difference between the value of a country's exports and imports of goods

Services balance: The balance in trade for services, such as tourism, financial services, transportation, and consulting.

Primary Income: Income includes net flows of earnings from investments, such as dividends, interest, and profits,

Secondary income: Net transfers of money or goods between countries, such as foreign aid, remittances from expatriates, and gifts.

The **capital account:**

- Records financial transactions that involve the **acquisition or disposal of non-financial assets**, such as real estate, patents, and copyrights, between a country and the rest of the world.
- It also includes **capital transfers**, which involve the transfer of assets for specific purposes, like debt forgiveness.

Financial account on the Balance of Payments

The **financial account:**

- Records transactions related to **financial assets and liabilities**, including foreign direct investment (FDI), portfolio investment, banking flows (such as hot money) and changes in foreign exchange reserves.
- It details how a country's residents and entities interact with foreign assets and liabilities.

The balance of payments always balances

As a set of accounts all debits must be matched with credits.

- Any deficit on the current account will be offset by a surplus on the capital & financial accounts.
- ***A 'balancing item' ensures any discrepancy between current account, capital account and financial account is solved.***

Current account deficit v budget deficit

BE CAREFUL NOT TO CONFUSE THESE DEFICIT TERMS!

Current account deficit: when the value of exports is less than the value of imports in goods, services, primary and secondary income; a net withdrawal from the circular flow ($X < M$); AD shifts left, ceteris paribus, slowing growth.

Budget deficit: when the government spends more than it receives in tax revenue; a net injection into the circular flow ($G > T$); AD shifts right, ceteris paribus, encouraging growth

Current account deficit

Current account deficit: The value of exports of goods and services, investment incomes and transfer inflows is lower than spending on imported goods and services, investment income outflow and outward transfers.

- A net outflow of income from a country's circular flow ($X < M$)
- A current account deficit can be a sign of economic weakness, as it means that the country is relying on borrowing from abroad to finance its consumption.
- However, a current account deficit can also be the result of strong economic growth or investment in importing new capital goods.

Financing a current account deficit

To finance a current account deficit, a country needs to:

- Attract inflows of FDI, portfolio investments, hot money, savings which may need higher interest rates or better rates of return
- Use up foreign currency reserves
- Sell assets/property to foreign investors
- Find ways to increase its international competitiveness

Causes of a current account deficit

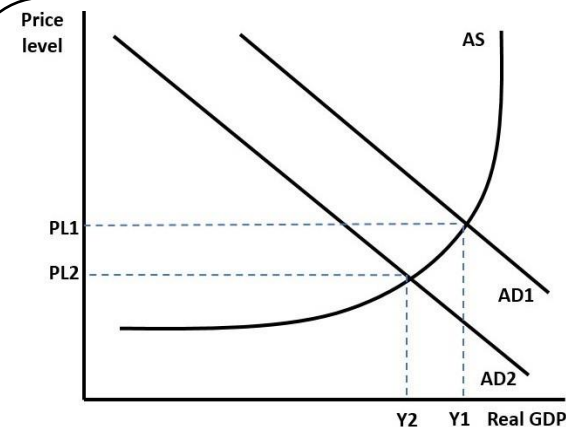
Cyclical causes of current account deficit: when an economy is booming, rising real incomes boost consumer spending increasing demand for imports, causing a wider trade deficit; and vice versa in an economic downturn

Structural causes of current account deficit: arise from supply-side weaknesses such as relatively low capital investment, low productivity & research and businesses not operating at the cutting edge of innovation

Short run causes (often cyclical): fall in value of exports, a boom in consumer spending or a broader economic boom (more imports); an appreciation of the exchange rate (less price competitive as exports prices rise and import prices fall)

Causes of a current account deficit

Long term causes (often structural): low rates of capital investment which limits the overall productive capacity and cost competitiveness of key export industries; relatively high cost & price inflation contrasted with trade partners; weaknesses in non-price competition such as branding & innovation; long-term decline of previously dominant export sectors such as deindustrialisation in manufacturing, decline in extractive sectors, loss of comparative advantage

Consequences of a current account deficit

- Fall in AD since $(X - M)$ is negative – leading to fall in real output (Y_1 to Y_2), slower GDP growth
- Drag on GDP growth might then lead to weaker investment & jobs
- Possible negative multiplier effect
- Large external deficit likely to lead to a depreciating exchange rate

Does a current account deficit matter?

It depends on:

- its size relative to GDP
- its persistence
- what has caused it
- how easy it is to finance it

Current account surplus

- Net injection into economy
- Positive export multiplier effects
- Trade surplus allows net exporting of capital
- Trade surplus enables additions to foreign currency reserves.
- Inflationary if there is no spare capacity
- Creates trade deficits elsewhere in world which may need correcting, more protectionism
- Pressure on currency to appreciate
- If surplus is due to high saving/low consumption, SoL may not be as high as it could be

Reducing a current account deficit

Correcting a deficit may require:

- Deflationary policies to reduce AD and spending on imports
- Depreciation/devaluation of the currency: to restore price competitiveness
- Direct controls: on imports via tariffs, quotas etc.
- Supply-side improvements: to improve both price and non-price competitiveness

Expenditure-switching policies

Expenditure-switching policies: policies designed to **change the relative prices of exports and imports.**

- An exchange rate depreciation can improve the price competitiveness of exports and make imports more expensive when priced in a domestic currency
- A tariff can make imported goods relatively more expensive than domestic ones.
- Lower relative inflation makes exports more competitive relative to imports

Expenditure-reducing policies

Expenditure-reducing policies: contractionary monetary and fiscal policies designed to **lower real incomes and aggregate demand** and thereby cut the demand for imports.

- Higher direct taxes
- Cuts in real government spending on welfare
- Cuts in real government spending on public services
- An increase in interest rates to lower demand for credit and increase saving

These deflationary policies might conflict with other macroeconomic objectives such as maintaining low unemployment and ensuring a steady rate of economic growth.

Supply-side policies

- Infrastructure projects in improving transport networks, telecoms to increase supply-side capacity and productive efficiency
- Incentives to promote enterprise/start-ups/new export businesses
- Privatisation/deregulation to increase productivity & efficiency
- Investment in education to improve a country's human capital
- Protecting property rights to drive a faster rate of innovation/ideas
- Tax incentives to attract foreign direct investment from companies who subsequently export goods and services

Effectiveness of different policies

Depends on the root causes of the current account deficit

- If consumer boom caused it, then deflationary policies may work well
- If it is a structural deficit, then supply-side policies work better
- If it is a lack of price competitiveness, a depreciation may work well

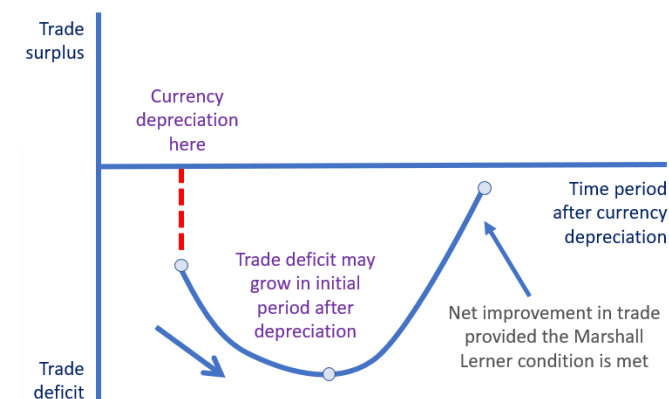
Will a depreciation/devaluation improve the trade deficit?

A depreciation reduce export prices and increase import prices; this could increase net export demand and the trade deficit improves.

BUT the response to these relative price changes depends on the PED for X and PED for M. According to the **Marshall-Lerner condition**, the absolute value of the sum of the PED for X + PED for M must be greater than or equal to 1 for a depreciation to improve the current account.

J-curve effect

In the short run, PEDs are low, trade deficit worsens; but over time the PEDs rise and the Marshall-Lerner condition is met. The J-curve shows the time lag between a depreciation or devaluation and an improvement in the trade balance.



Causes of current account surplus

- Strong competitive advantage
- Persistent excess of savings over investment (savings glut)
- High global prices for an exported commodity
- High levels of net investment inflows
- Cyclical: a recession leading to fewer imports

Effects of a current account surplus

- Allows a country to run deficit on the financial account of the balance of payments
- Surplus foreign currency can be used to fund investment in assets located overseas.
- Some current account surplus countries have large sovereign wealth funds which can be used to invest in assets at home or overseas.
- Stronger exchange rate since high export sales leads to an increase in demand for a nation's currency
- May cause inflation (higher AD; exporting firms competing for resources bidding up costs; inflow of liquidity into banking system)

Policies to correct a trade surplus: reflation (boost AD, reduce S), revaluation of currency (Marshall-Lerner condition must hold; may be an inverse J-curve effect, remove barriers to trade to increase imports)

Importance of the Balance of Payments

- Trade imbalances can lead to economic instability or reflect it
- Persistent deficits can constrain economic growth and encourage more protectionism
- Current account deficits can cause a currency depreciation, affecting import prices, inflation, and investor confidence.
- A surplus can provide a source of savings and investment
- A deficit may indicate that a country is borrowing heavily to finance its consumption, which can be unsustainable in the long term

Trade imbalance: when a country has a current account deficit or surplus that is greater than 3% of its GDP

Main causes of global trade imbalances

- Differences in savings and investment
- Exchange rates – may be over- or under-valued
- Differences in productivity and competitiveness
- Government protectionist policies (e.g. tariffs, export subsidies)
- Structural factors (e.g. demographics, resource endowments)
- Global supply chains
- Net capital flows (can affect exchange rates)
- Cyclical factors (e.g. boom sucks in more imports)

Consequences of global trade imbalances

- Deficit countries run up large external debts and are reliant on foreign capital. This risks political opposition to domestic assets being bought by overseas MNCs
- Deficit countries might decide to switch towards using protectionist policies promoting the rise of economic nationalism
- Surplus countries are saving more than they spend, thereby depressing global aggregate demand and growth
- Surplus nations might be under-consuming (thus affecting living standards) and allocating domestic scarce resources to exporting overseas
- Deficit countries may use deflationary policies to correct the deficit, slowing growth

Global trade imbalances can lead to increased economic volatility, heightened protectionism, and potential disruptions to global economic stability, hindering sustainable economic growth and cooperation among nations.

Exchange rate

Exchange rate: the price of a currency in terms of another. It is determined by demand and supply in FOREX markets

Bilateral exchange rate: one currency in terms of one other currency. eg £1 = \$1.05

Multilateral exchange rate: one currency in terms of a group of other currencies e.g. *effective or trade-weighted index = a weighted average exchange rate expressed as an index (Base year =100)*

Real effective exchange rate is adjusted for relative inflation rates

Factors influencing the demand for a currency

Demand for a currency is **an inflow of money into an economy**. Demand for currency is derived from the need to have currency to buy exports, inwards investment, etc.

- Buying **exports** of goods and services
- Overseas **portfolio inflows** into property, shares and bonds
- **Hot money** flowing into a country's banking system
- Inflows of **foreign direct investment (FDI)**
- **Speculative buying** of a currency by market traders

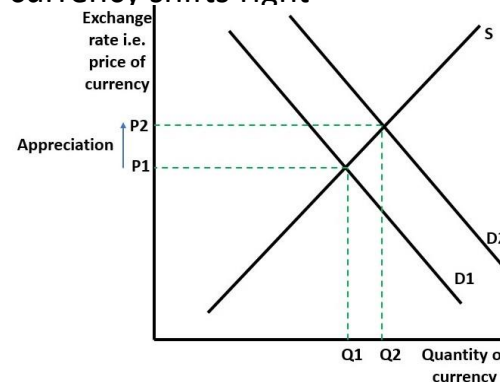
Factors influencing the supply of a currency

Supply of a currency is an **outflow of money into an economy**. The supply of a currency is determined by domestic demand for imported goods and services from abroad, outwards investment etc. Economic agents sell their currency to get the currency they need for these international transactions

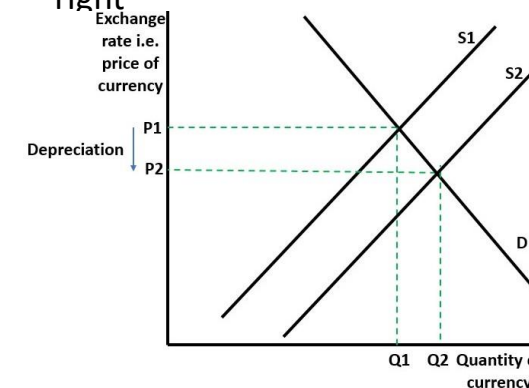
- Domestic spending on **imported goods and services**
- **Outflow of portfolio flows** in property, shares and bonds
- **Hot money** flowing out of a country's banking system
- **Outflows** of foreign direct investment (FDI)
- **Speculative selling** of a currency by market traders

Equilibrium exchange rate: the rate which **equates demand and supply** for a particular currency against another currency. Changes in the equilibrium exchange rate happen when there are **changes in currency demand and supply**

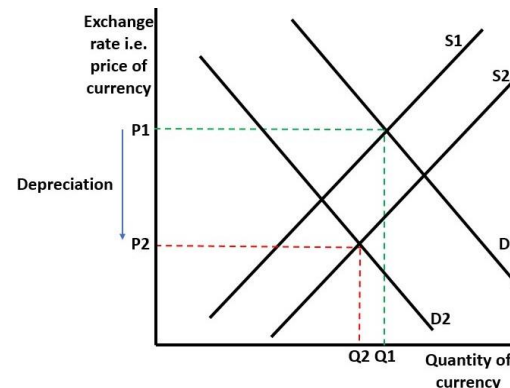
Impact of an increase in exports or inward investment – demand for currency shifts right



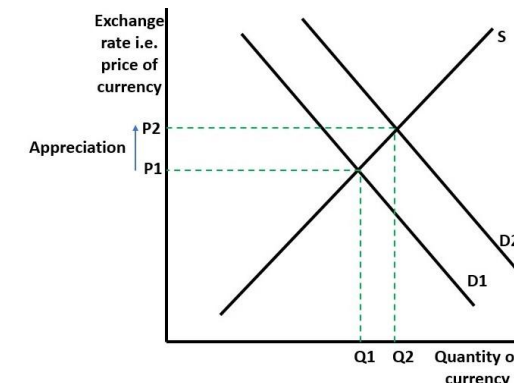
Impact of an increase in imports or outward investment – supply shifts right



Impact of a fall in interest rates – demand shifts left and supply shifts right (double shift)



Impact of speculation – if currency is appreciating, speculators may buy in = demand shifts right



Types of exchange rate systems

- Freely floating
- Managed floating
- Semi-fixed (adjustable/crawling peg)
- Fully fixed (hard peg) Currency board (hard peg)

Freely floating exchange rate

- Currency value is set **purely by demand and supply** of the currency i.e. market forces.
- Currency can either **appreciate** (rise) or **depreciate** (fall)
- **No intervention by central bank**
- There is no target for the exchange rate
- The external value of currency is **not an explicit target of monetary policy**; interest rates are not set to influence the value of the currency)

Managed floating exchange rate

- Central bank gives freedom for market exchange rates on a day-to-day basis, supply and demand factors drive the currency's value
- Central bank may **intervene** occasionally
 - Buying to support a currency (selling their FX reserves or selling to weaken a currency (adding to their FX reserves)
- Currency becomes a key target of domestic monetary policy
- Higher exchange rate to control inflationary pressures
- "Managed depreciation" to improve competitiveness & trade balance

Fixed exchange rate

- Central bank pegs the currency value to one or more currencies
- The central bank must hold enough foreign exchange reserves to intervene in currency markets when needed to maintain the fixed currency peg
- Pegged rate becomes the official rate
- There might be unofficial trades in shadow currency markets
- Adjustable peg: occasional realignments may be needed (must be officially sanctioned with the agreement of the IMF) leading to either a devaluation or revaluation

- A currency board: country's domestic currency is fully backed by a foreign reserve currency or specific foreign asset, typically held in a **fixed** exchange rate relationship.
- Domestic currency is issued only when there are corresponding foreign currency reserves to back it up, and the currency in circulation is **fully convertible** into the foreign reserve currency at the established fixed exchange rate.
- The currency board **must hold foreign currency reserves** equal to the total amount of domestic currency in circulation.

Exchange rate terms

- Depreciation** (currency falls in value in a floating system) v **devaluation** (currency's value is deliberately reduced in a fixed system)
- Appreciation** (value rises in a floating system) v **revaluation** (currency increased in a fixed system)

Advantages of floating exchange rate systems

- **Independent Monetary Policy:** Interest rates and QE decisions can be used to influence domestic economy, not constrained by exchange rate considerations.
- **Shock Absorption:** Free-floating exchange rates allow countries to absorb external economic shocks more effectively to help rebalance the economy.
- **Reduced Speculative Attacks:** Since exchange rates are determined by market forces, speculative attacks on a currency are less likely
- **Automatic 'correction' of trade imbalance:** If a country is running a large trade deficit, its currency's depreciation can over time make its exports more price competitive and imports more expensive, leading to a narrowing of the deficit.
- **Currency reserves:** The central bank does not need to hold large foreign currency reserves because there is no specific currency target, financial capital can flow freely across countries seeking the best returns

Disadvantages of floating exchange rate system

Exchange Rate Volatility: this causes uncertainty for businesses reducing international trade and investment.

Currency Risk: Volatility introduces currency risk for businesses and investors.

Inflation Pass-Through: Exchange rate fluctuations can lead to changes in import prices, which can impact domestic inflation.

Loss of Exchange Rate as a Policy Tool: While countries gain monetary policy autonomy, they lose the ability to manage the exchange rate as a deliberate policy tool.

Advantages of fixed exchange rate systems

Price Stability: A fixed system provides price stability helping control inflation; provides a predictable environment for businesses and consumers.

Reduced Exchange Rate Risk: Fixed exchange rates eliminate the currency risk associated with fluctuating exchange rates.

Discipline on Monetary Policy: constrains a country's central bank from pursuing an independent monetary policy. This can prevent excessive money supply growth and associated inflationary pressures.

Foreign Investment: A stable exchange rate can attract foreign investment, because there is less risk associated with currency fluctuations.

Disadvantages of fixed exchange rate system

Lack of Flexibility: a fully fixed system cannot respond to external economic shocks. Interest rate may be needed to keep exchange rate fixed rather than affect domestic economic indicators

Balance of Payments Issues: Persistent imbalances can lead to pressures on the currency peg.

Speculative Attacks: Fixed exchange rate systems can be vulnerable to speculative attacks if investors believe that the currency is overvalued or if there are concerns about the country's ability to maintain the peg.

Dependence on Reserves: To maintain a fixed exchange rate, a country needs to have sufficient foreign exchange reserves.

EXTENSION: Terms of Trade

The **terms of trade** measures the rate of exchange of one product for another when two countries trade.

Terms of Trade Index (ToT) = $100 \times \text{Average export price index} / \text{Average import price index}$

If a country can buy more imports with a given quantity of exports, its terms of trade have **IMPROVED**. If the ToT index falls, this is said to be a **DETERIORATION** as fewer imports can be bought for every export sold.

The terms of trade fluctuate in line with changes in export and import prices. The exchange rate and the rate of inflation can both influence the direction of any change in the terms of trade:

- A depreciation will cause a **DETERIORATION** in the ToT
- An appreciation will cause an **IMPROVEMENT** in the ToT

EXTENSION: Changes in the terms of trade

Standard of living: improvement in ToT makes imported food, medicines, etc; a long term decline in the ToT would reduce the standard of living

Technology and capital goods: improvement in ToT makes imports of technology/capital more affordable; but a deterioration in the ToT has the reverse effect

Prebisch-Singer Hypothesis: ToT are likely to deteriorate over time for primary product producers because there is a low YED for primary goods, while productivity in production rises; implications for developing countries that are primary product dependent if it holds.

Price competitiveness: Deterioration in ToT may not be a concern if it is caused by a depreciation that increases international price competitiveness

International competitiveness

International competitiveness: sustained ability to sell goods and services profitably at competitive prices in a foreign country

International price competitiveness: producing goods/services at lower price than international competitors

International non-price competitiveness: producing goods/services that are better quality, better designed, have faster delivery, better after-sales service...than international competitors

Measures of international competitiveness

Relative unit labour costs: ULCs are the labour cost per unit of output; a measure that takes into account the costs of employing workers and their productivity

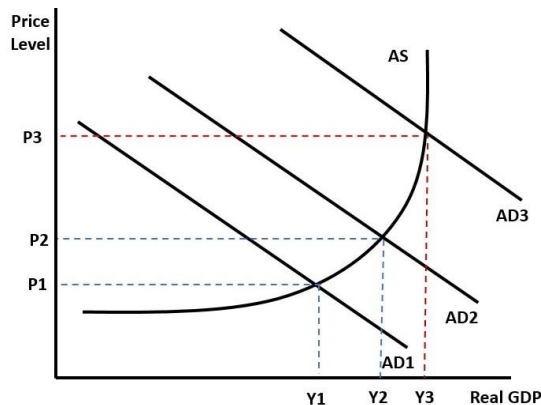
Relative export prices: if a country's exports become cheaper relative to its competitors, it becomes more price competitive

The global competitiveness index: an indicator that takes into account a whole range of factors that influence both price and non-price competitiveness

Benefits of international competitiveness

- Stronger trade performance (trade surplus/smaller deficit)
- Export-led growth (multiplier effect) increasing real incomes; higher standard of living
- Lower unemployment
- Increase in FDI

Diagram shows export-led rise in AD from AD1 to AD2 with export multiplier effect AD2 to AD3; real GDP increases from Y1 to Y3, but there may be some demand-pull inflation

**Being internationally uncompetitive**

- Larger trade deficit constraining economic growth and lowering the standard of living
- Economic decline/stagnation as industries cannot compete effectively: more structural unemployment as uncompetitive industries may shed jobs
- Income inequality may grow as a lack of competitiveness can exacerbate income inequality because some industries decline while others thrive.

A lack of international competitiveness can cause a wider trade deficit, increasing unemployment with negative multiplier effect and slower economic growth

Strategies to improve international competitiveness

- Stable macroeconomic environment
- Competitive exchange rate
- Low & stable inflation
- Strong financial & legal institutions
- Competitive tax environment
- Investment in human capital; more education & training; better healthcare
- Inward migration of skilled workers
- Improvement in management to boost worker productivity
- Increased research and development (R&D) and innovations
- Market competition to raise productivity
- Support enterprise; make it easier to start up a business; reduce business red tape
- Investment in critical infrastructure (transport, energy, communication networks)
- Balanced growth across economy's regions
- Use of supply-side policies to increase productivity, incentives and competition

Growth v Development

Economic growth: increase in the value of total output of goods and services produced by an economy over time

Economic development: improvement in the overall standard of living and quality of life of the population; it involves both an increase in the quantity and quality of those goods and services.; it also includes social and environmental progress; increases the freedom & opportunities of individuals.

So, economic growth is a necessary but not sufficient condition for economic development. *While growth can help increase incomes, development also encapsulates cultural and human values, e.g. self-esteem not just material well-being*

Measures of development**The UN's Human Development Index (HDI)**

- Health – life expectancy at birth
- Education – mean years of schooling and expected years of schooling
- Living standards – GNI per capita at PPP

Each dimension is measured on a scale from 0 to 1, with 1 being the highest achievement. The HDI combines these values by taking the geometric mean of the three. Each is given the same importance

HDI Values

- Very high for HDI of 0.80 and above
- High from 0.70 to 0.799
- Medium from 0.550 to 0.699
- Low below 0.550

Is the HDI a good measure of development?

HDI is holistic, simple, useful for policy guidance, good for global comparisons

But it does not cover all elements of development progress, the data may not always be accurate, giving equal weighting to each element may fail to allow for a country's development priorities, hides regional, income and educational inequalities;

Other measures of development

Gini Coefficient: Measures income inequality within a country, indicating the distribution of income and wealth

Gender Inequality Index: Evaluates gender disparities in health, education, and economic participation

Multidimensional Poverty Index (MPI): Considers factors such as health, education, and living standards to assess poverty and deprivation in multiple dimensions e.g. child mortality, access to water & cooking fuel, sanitation etc.

Environmental Sustainability Indicators: Evaluates a country's impact on the environment e.g carbon emissions, natural resource depletion, and pollution.

Human Poverty Index (HPI): Focuses on severe deprivation in health, education, and standard of living, emphasizing the most disadvantaged populations.

Social Progress Index (SPI): Measures various aspects of well-being, including basic human needs, foundations of well-being, and opportunity.

Sustainable development goals (SDGs)

- | | |
|---|---|
| 1. No Poverty | 10. Reduced Inequality |
| 2. Zero Hunger | 11. Sustainable Cities & Communities |
| 3. Good Health & Well-being | 12. Responsible Consumption & Production |
| 4. Quality Education | 13. Climate Action |
| 5. Gender Equality. | 14. Life Below Water |
| 6. Clean Water & Sanitation | 15. Life on Land |
| 7. Affordable & Clean Energy | 16. Peace, Justice, & Strong Institutions |
| 8. Decent Work & Economic Growth | 17. Partnerships for the Goals |
| 9. Industry, Innovation, & Infrastructure | |

The SDGs are designed to be universally applicable and are meant to be achieved by 2030. They serve as a framework for governments, organisations, businesses, and individuals to work collectively toward a more sustainable, equitable, and prosperous future for people and the planet.

Main characteristics of less developed countries

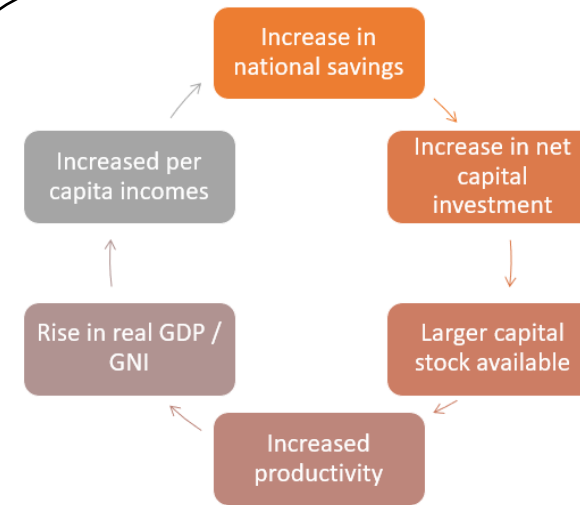
- Low per capita income
- High levels of poverty and inequality
- Limited infrastructure for transportation, communication, and electricity networks, for example
- Limited human capital - a less educated/skilled workforce, with lower levels of literacy and numeracy
- Dependence on primary commodities: rely on exporting primary commodities, such as agricultural products or natural resources, rather than manufactured goods

Primary product dependency & the 'resource curse'

- **Primary product dependency:** when a country has a high dependence on extracting & then exporting primary commodities, making it vulnerable to volatile global prices and terms of trade
- **Export-commodity-dependent country:** when more than 60 per cent of its total merchandise exports are composed of primary commodities.
- **Prebisch-Singer Hypothesis (PSH):** over the long run, real prices of primary commodities such as coffee decline relative to prices of manufactured goods such as cars because primary products have a lower income elasticity of demand.
- **Resource curse/Dutch disease/Petrocurrency effect:** a natural resource/natural gas/oil find attracts inward investment causing the currency to appreciate and making other industries such as manufacturing less internationally price competitive

Savings-Investment Gap

Savings gap: in low-income countries, extreme poverty and weak financial markets makes it hard to generate enough savings to fund capital investment projects that could boost development



The Harrod-Domar model stresses the importance of savings and investment. The rate of economic growth depends on:

- Level of national saving (S)
- Productivity of investment (capital-output ratio)

Rate of growth of GDP = savings ratio / capital output ratio

The model suggests that a higher savings ratio leads to an increased rate of investment (in a closed economy), thereby helping to building the capital stock of a country as a result, increasing output through a rise in productive capacity (LRAS)

Volatile commodity prices

Volatile commodity prices can cause uncertainty; it is unpredictable for a commodity producer what will happen to export earnings and the terms of trade over time; uncertainty also deters investment.

When prices fall unexpectedly:

Fall in export earnings
Trade deficit
Fall in revenue/profits for producers
Loss of government revenue
Unemployment
Depreciation of currency

When prices rise unexpectedly:

Rise in export earnings
Economic growth
Inflation pressure
Trade surplus
Appreciation of currency
Income inequality
Increase in government revenue

Human capital gap

Human capital: the knowledge, skills, experiences, and abilities possessed by individuals in a population that can be used to produce economic value.

Human capital gap: the difference between the skills, knowledge, health, and other attributes of a workforce and the level required to support sustainable economic growth and development

Problems with human capital gaps:

- Hinders labour productivity growth
- Reduces innovation and technological progress
- Holds back increases in entrepreneurship
- Can deter foreign investment
- Reduces economic resilience to shocks

Infrastructure gaps

Infrastructure gap: when the available infrastructure resources / investments do not fully meet those infrastructural needs adequately
Infrastructure projects are important and add to both AD and LRAS in an economy, often with high multiplier effects

Problems with infrastructure gaps:

- Higher costs for businesses – this causes higher prices – therefore hitting real incomes for consumers
- Lower geographical mobility of labour causing higher structural unemployment
- Less attractive to FDI (slower economic growth in the long run)
- Economy more vulnerable to effects of climate change especially risks from natural disasters
- Impact on human development – including having access to safe and reliable water and sanitation services
- Can damage export competitiveness
- Can contribute to ender inequalities

Weak institutions: when the legal, financial and political institutions are not well-established

Problems with weak institutions: more difficult to establish property rights; harder to access to credit & finance – may have to use informal financial sector; less say in how the economy is run - may not have a democratic vote

Corruption: the abuse of public office for private gain – it can include, bribery of public officials when contracts are negotiated, bribery at customs facilities, money laundering, misappropriation of aid flows; illegal tax evasion

Problems with corruption: deters foreign investment by increasing the cost/risk of doing business; more allocative inefficiency - public resources are diverted for private gain; political lobbying can sway government decisions; more persistent income & wealth inequality and reduced progress cutting extreme poverty; loss of trust - a breakdown of social capital; poorer human development outcomes because less tax revenue is collected

Absence of property rights

Property rights: need to be clearly defined e.g. identifying and titling land rights, protection of intellectual property, preventing illegal poaching, having the right to start & own a business, enables use of digital identity programmes; helps prevent the Tragedy of the Commons

Failing to establish property rights deters entrepreneurship, R&D and innovation, reduces investment that may boost agricultural productivity, limits wage growth that could lead to greater tax revenue for development projects, allows deforestation and other depletion and degradation of natural resources

Other development barriers

Demographic issues, capital flight, foreign currency gaps, high levels of external debt; country is land-locked with bad neighbours; conflict/civil war; poor governance/political unrest; the geography of the country; too reliant on natural resource

Market-based policies

- **Trade liberalisation** – remove some of the tariff and non-tariff barriers to trade more openly **REVIEW: topics of free trade, protectionism, tariff model.... for advantages/disadvantages**
- **Promotion of FDI** - attract resource-seeking, efficiency-seeking and/or market-seeking FDI by cutting corporate taxes, making country more attractive to business, reducing business risks.. to boost AD and LRAS, with multiplier) **REVIEW: topic of investment**
- **Removal of government subsidies** to increase incentives to innovate **REVIEW: Topic of subsidies**
- **Floating exchange rate systems** to allow currency to find its market value; may depreciate or appreciate depending on whether it was over or undervalued in its fix; frees up use of interest rates to benefit the domestic economy **REVIEW: Topics of exchange rate systems and effects of a depreciation or appreciation**
- **Microfinance schemes** provide extremely poor people with small loans (microcredit) to help them engage in productive activities or to grow their tiny businesses. They can help the poor increase their income, build businesses and reduces vulnerability to external shocks via microinsurance.
- **Privatisation** – **REVIEW: topic of privatisation**

Interventionist strategies

- **Development of human capital** - investment in education; skills development programmes; healthcare initiatives; adult education course: entrepreneurial support; gender equality policies; infrastructural improvements – more schools, easy access to education **REVIEW: Supply-side policies**
- **Protectionism** – infant industry protection; export subsidies to promote trade, anti-dumping, diversification, less primary product dependent **REVIEW: topics of free trade, protectionism, tariff model**

Interventionist strategies

- **Managed exchange rates** – to increase stability/certainty helping to increase investment and inflation control **REVIEW: Topics of exchange rate systems and effects of a depreciation or appreciation**
- **Infrastructure development** – public sector investment can crowd in private investment; improves labour mobility, efficiency of supply chains, productivity, information between buyers and sellers... **REVIEW: Supply-side policies**
- **Promoting joint ventures with global companies** – helps knowledge, technology & skill transfers by offering tax advantages/breaks and streamlining opportunities for businesses **REVIEW Economies of scale**
- Buffer stock schemes – help reduce commodity price volatility but often a case of government failure **REVIEW Minimum and maximum prices**

Other development strategies

- Industrialisation – the Lewis model – move underemployed rural workers into urban manufacturing to increase productivity growth
- Development of tourism – injects income in from abroad
- Development of primary industries – diversify to a range of primary products
- Fairtrade schemes
- Aid – humanitarian/emergency/financial - may need paying back
- Debt relief – or debt forgiveness; frees up tax revenue from debt interest costs

Role of aid and trade

- **Aid** provides immediate relief and support to countries facing economic challenges, helping to address urgent needs such as healthcare, education, and infrastructure development but can lead to more debt
- **Trade** facilitates long-term sustainable growth by fostering the exchange of goods and services, encouraging specialisation, and promoting investments, thereby stimulating economic development and improving living standards over time.

Public spending

Public spending: spending by the government to influence AD

Current spending: government consumption G = spending on the say-today costs of running public services e.g. wages of teachers, energy bills for hospitals; directly affects AD; does not include transfer payments

Transfer payment: payment made or income received in which no goods or services are being paid for, such as a benefit payment or pension

Capital spending: government investment in the economy's infrastructure e.g. building hospitals & housing, new roads/railways

Factors in the changing size & composition of public spending

Demographics – ageing populations increase the demand for healthcare

Rising incomes – public services typically have a high YED so if real incomes grow there is an increase demand for public services

Expectations – as technology improves, expectations of better health/education/infrastructure/wifi increase

Times of crisis – people expect the government to bail out banks or support businesses and jobs in a pandemic, help households with energy bills in a cost-of-living crisis etc

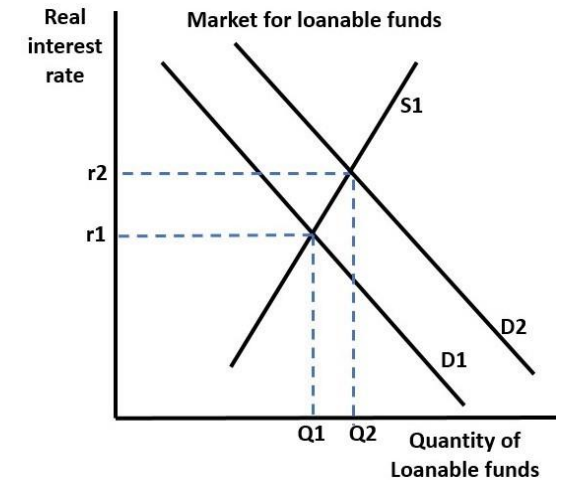
Advantages of higher public spending as % of GDP

- Adds to AD increasing short run growth
- Helps economy recovery from recession (with fiscal multiplier effects)
- If government invests can add to AS and long run growth
- Can 'crowd in' private sector investment if government improves transport/communications/energy networks which increase private sector's efficiency;
- Government spending on healthcare and education can also increase labour productivity in the long run
- Can help reduce income inequality and poverty
- Can help reach net zero environmental targets

Disadvantages of higher public spending

Resource crowding out: when the economy is operating at full capacity and the growth of the public sector causes a shortage of resources in the private sector

Financial crowding out: expansion of the state sector financed by increased government borrowing can cause an increase in demand for loanable funds ($D1$ to $D2$) which pushes up interest rates ($r1$ to $r2$) and crowds out private sector investment



Disadvantages of higher public spending

- Government sector is not profit-motivated, so an increasing role for the state could reduce productivity growth and economic growth
- Rising national debt – successive budget deficits increase the size of the national debt which increases the debt servicing costs (debt interest) so less is available to spend on public services
- May mean higher taxes and/or more austerity required in future
- Restricts freedom of choice – 'nanny state' - anti-free market philosophy that private sector allocated resources more efficiently
- Less government spending can ease demand-pull inflation pressures

Impact of government spending on inequality

- Spending on welfare benefits can help reduce poverty and inequality; caps on welfare have the opposite effect
- Low-income households tend to benefit disproportionately from public spending on housing, healthcare and education

Taxation

Direct tax: a tax on income/wealth e.g. income tax, employee NICs, corporation tax, capital gains tax

Indirect tax: a tax on spending e.g. VAT, excise duties

Progressive tax: a tax that takes a higher proportion of income from those on higher incomes

Proportional tax: a tax that takes the same proportion of income whatever the level of income

Regressive tax: a tax that takes a lower proportion of income from those on higher incomes

Changes in direct taxes

- Reduction in income tax and NICs – increases real disposable incomes, increases consumption, AD rises, short run economic growth, but there may be demand-pull inflation; could suck in imports causing a deterioration in the current account balance
- Lower direct taxes can increase incentives to work, save and invest
- Lower direct taxes may attract more immigration and help fill skills gaps
- Lower corporation tax increases the retained profits of businesses which could be re-invested; higher investment adds to AD with multiplier effect and LRAS.
- Lower direct taxes may encourage more entrepreneurship, R&D and innovation; increase dynamic efficiency
- Lower direct taxes could attract more FDI (less corporation tax)
- Lower direct taxes, which are usually progressive, could increase income and wealth inequality
- Lower direct taxes could reduce government revenue depending on the impact on the supply-side of the economy; higher budget deficit, National Debt could rise

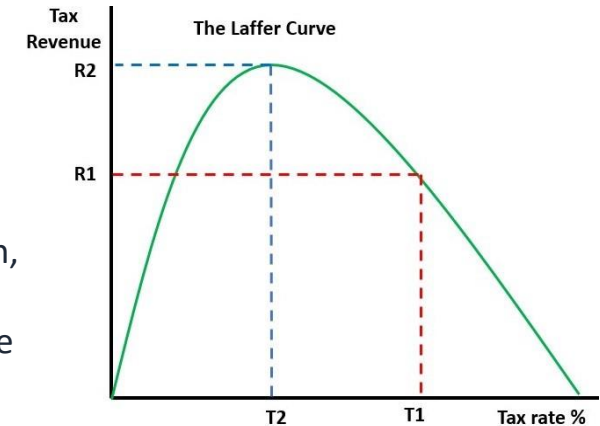
NB: Analysis can be reversed for increases in direct taxes

Changes in indirect taxes

- Reducing VAT could encourage increased spending if cost savings are passed on to consumers; could boost confidence
- Reducing excise duties on tobacco, alcohol etc. Could increase consumption of goods that have negative consumption externalities; net welfare loss
- Reducing regressive taxes would reduce income inequality
- Reducing import tariffs can boost the gains from trade but exposes businesses to more competition from abroad
- Lower indirect taxes can reduce cost-push inflation
- Lower indirect taxes can reduce shadow market activity & bootlegging
- Reducing indirect taxes may reduce government revenue and weaken public finances
- *NB: Analysis can be reversed for increases in indirect taxes*

Laffer curve

Laffer Curve: the relationship between tax rates and government revenue. At very high tax rates, people are disincentivised to work/save/invest, there may be more tax avoidance/evasion/ possible brain drain, so a cut in the tax rate (T1 to T2) could generate economic growth and increase tax revenue (R1 to R2)

**Tax burden**

Tax burden: the total tax revenues (direct and indirect) as a percentage of GDP.

- Rising tax burden increases government revenue, helps reduce government borrowing, redistributes income/wealth (if progressive taxes are higher), allows more investment in public goods and helps address externalities
- However, it also may constrain growth, reduce disposable incomes, increase tax avoidance/evasion, reduce competitiveness and curb incentives to work

Fiscal policy

Automatic stabilisers: automatic fiscal changes as the economy moves through stages of the business cycle e.g. the fall in tax revenues during a recession or an increase in state welfare benefits when unemployment is rising; help smooth the trade cycle

Discretionary fiscal policy: fiscal policy decisions determined by government macroeconomic priorities

Counter-cyclical fiscal policy: Keynes argued fiscal policy should be expansionary in recession and contractionary in a boom.

Fiscal (budget) deficit v National Debt

Budget deficit or fiscal deficit: the annual amount the government borrows to make up the gap between its income (mostly tax revenue) and its spending. A net injection into the circular flow $G > T$; it is a flow

National debt (public sector net debt): a stock of the total accumulation of budget deficits (government borrowing) that is still to be repaid

Cyclical fiscal deficit: government borrowing related to the trade cycle – in a recession government spending rises and tax revenues fall; should go when economy returns to trend growth rate

Structural fiscal deficit: government borrowing that remains when economy is at full capacity; tax and welfare reform may be needed

Government borrowing v household borrowing

Govt finances not like a household's or an individual business's finances because:

- Government decisions are big enough to influence whole economy
- Fiscal policy can, and should, be used counter-cyclically
- Governments do not 'die' so any debts can be paid off in future
- Government can borrow to invest; interest is then paid by those benefiting from the investment in future – this can be considered intergenerationally much fairer than borrowing for current spending)

Financing government borrowing

- If government revenue is less than government spending, it has to borrow to make up the difference
- Government issues bonds/Treasury bills = IOUs
- It has to pay interest on its debt (debt servicing costs)
- Interest on bonds is called the bond yield
- The yield on the bond varies inversely with the price of bonds
- Some bonds are index-linked (just over 25% in UK) and the interest increases payable with inflation

Fiscal rules

Fiscal rules: restrictions on fiscal policy set by the government to constrain its own decisions on spending and taxes

UK government's main fiscal rules are:

- National Debt should be on course to fall as a % of GDP in five years' time
 - Public sector borrowing should not exceed 3% of GDP in five years' time
 - Some types of welfare spending should stay below a pre-specified cap
- The Eurozone's fiscal rules allow countries with excessive borrowing to reduce their debt on average by 1% per year if it is above 90% of gross domestic product (GDP), and by 0.5% per year on average if the debt pile is between 60% and 90% of GDP

Factors influencing the size of the budget deficit and size of the National Debt

Budget deficit factors:

- State of the economy (cyclically part higher in recession, more spent supporting incomes & jobs, less tax revenue as more unemployed, less consumer spending, lower profits)
- State of the housing market (affects stamp duty revenues)
- Political priorities
- Unplanned events (Economic shocks, global pandemic..)

National Debt factors:

- Size and persistence of budget deficit (which adds to the National Debt)
- Government policy choices on tax and public spending