IB Economics SL

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4. The Global Economy

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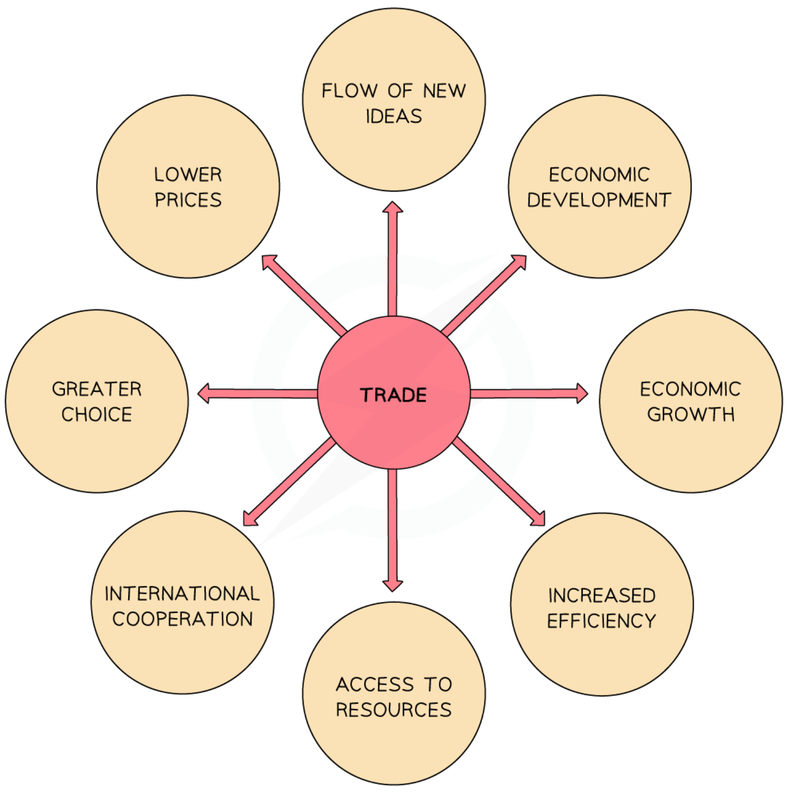
4.1 Benefits of International Trade

4.1.1 The Advantages of Free Trade

The Benefits of International Trade

- International trade refers to the **exchange of goods and services** between countries
- International trade involves the exchange of goods/service through exports and imports
- **International trade** is 'free' when there is no government intervention (quotas, taxes etc.) to reduce or limit trade



The benefits of free trade

- **Greater choice:** with access to a wider variety of goods/services, the standard of living improves
- **Lower prices:** with international competition prices fall giving households the ability to buy more
- **International cooperation:** required for trade helps countries to build better relationships which leads to lower levels of hostilities
- **Flow of new ideas:** innovative ideas and technology can be shared between countries
- **Access to resources:** output can increase and costs of production can fall with increased access to raw materials

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- **Increased efficiency:** international competition allows the most efficient firms to emerge and this improves the use of global resources
- **Economic growth:** exports are a key component of the gross domestic product of many countries and an increase in exports can lead to economic growth
- **Economic development:** Increased output leads to lower levels of unemployment which leads to higher incomes and a higher standard of living

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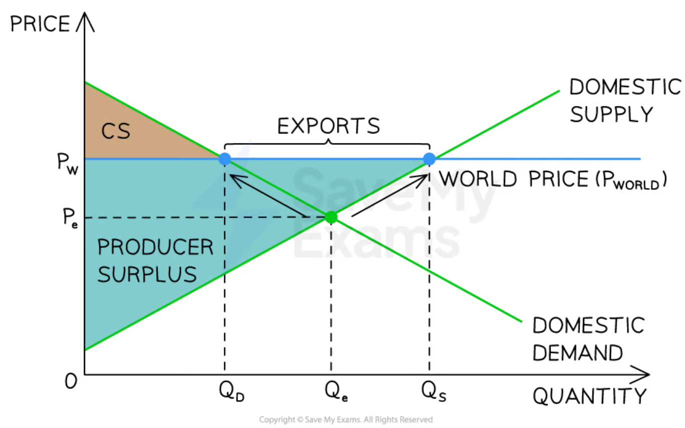
Diagrammatic Illustration of the Benefits of Free Trade

- The **benefits of free trade** are best understood when analysing markets in which:
  - The world price for a good/service is above the domestic price thus allowing for exports
  - The world price for a good/service is below the domestic price thus encouraging imports

1. World price is above the domestic price



When the world price (W_P) is above the domestic equilibrium price (P_E), a country's firms are able to export the excess supply

Diagram Analysis

- The **domestic equilibrium** in the market for rice in Vietnam is at P_eQ_e
- The world price of rice is higher at P_w
- Vietnamese rice producers are **incentivised by the higher prices** to produce a higher level of output and domestic supply increases from Q_e to Q_s
- Vietnamese consumers now have to pay the world price for rice (P_w) and the domestic demand contracts from Q_e to Q_d
- The **excess domestic supply** (Q_s- Q_d) is now **available for export**

2. World price is below the domestic price

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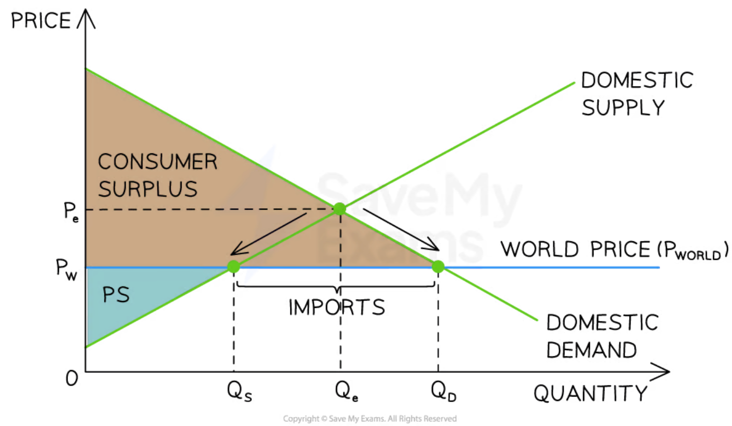

When the world price (P_w) is below the domestic equilibrium price (P_e), households and firms are incentivised to increase their imports

Diagram Analysis

- The **domestic equilibrium** in the market for bananas in Sri Lanka is at P_eQ_e
- The world price of bananas is lower at P_w
- Some of Sri Lanka's firms cannot compete with the **lower prices** and domestic supply contracts from Q_e to Q_s
- Sri Lanka consumers benefit from the lower world price (P_w) and the domestic demand extends from Q_e to Q_d
- The **excess domestic demand** (Q_d- Q_s) is now **met through imports**

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4.2 Types of Trade Protection

4.2.1 Tariffs

An Introduction to Protectionism

- Free trade aims to maximise global output through **national specialisation**
- However, there are numerous **reasons** why countries would seek to **limit free trade** in order to protect themselves from certain outcomes
- This is called protectionism and may take the form of import tariffs, export subsidies, the use of quotas or embargoes

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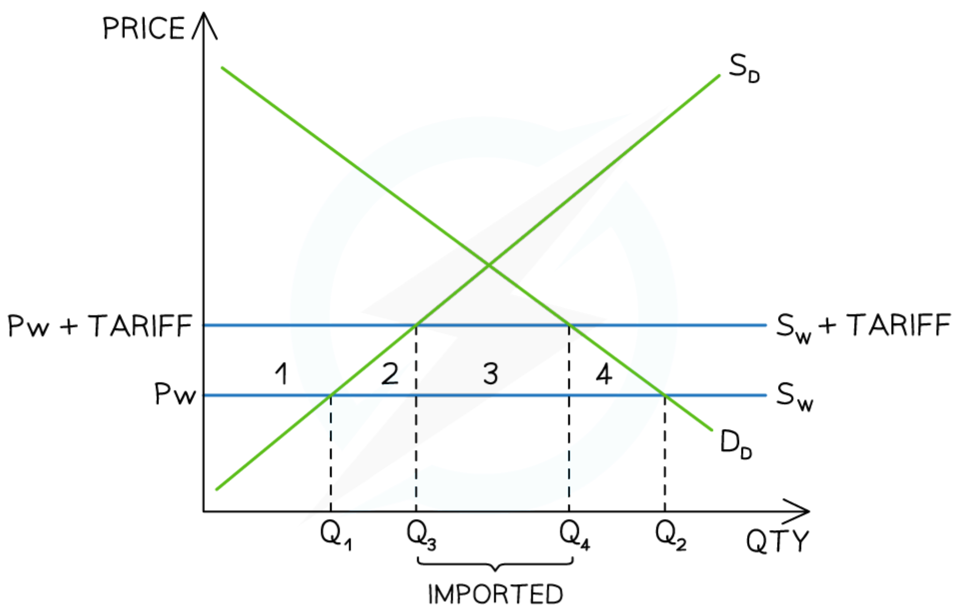
An Explanation of Tariffs

- The most commonly used forms of **trade protectionism** include tariffs, subsidies, quotas and administrative barriers

- **A tariff is a tax on imported goods/services (customs duty)**
  - The tax raises the selling price of the good/service within the country

- The higher price allows more **inefficient domestic firms** to increase their production and market share
  - More efficient global competitors reduce their output due to the tariff
  - With increased domestic output, **employment** may increase



A tariff raises the price of the world supply from P_W to P_{W+} Tariff. This reduces the quantity of imports from Q_1Q_2 to Q_3Q_4

Diagram Analysis

- **World supply (S_W)** is considered to be infinite and this supply curve is included with the domestic demand (D_D) and supply (S_D) curves

- The **pre-tariff** market equilibrium is seen at P_wQ_2
  - Domestic firms supply up to Q_1 at a price of P_w
  - Foreign firms supply the difference equal to Q_1Q_2 at a price of P_w (imports)

- **After the tariff** is imposed, the world price increases from P_w to P_w+ tariff

- The **new market equilibrium** is seen at P_w+tariff and Q_4
  - Following the law of demand, the **quantity demanded contracts** from Q_2 to Q_4

- Following the law of supply, the **quantity supplied** by domestic firms **extends** from Q_1 to Q_3
- The level of **imports is reduced** from Q_1Q_2 to Q_3Q_4

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An Evaluation of Tariffs

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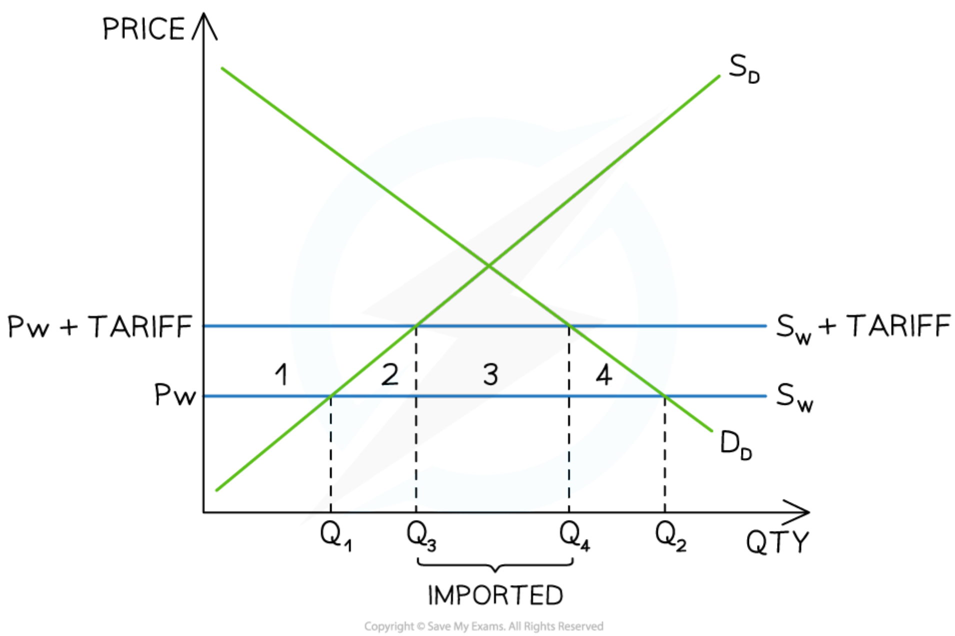
- The best way to consider the **impact of a tariff** on stakeholders is to explain it using a diagram



A tariff impacts domestic producers, consumers, foreign producers and the government

The Impact of Quotas on Stakeholders

Stakeholder	Explanation of Impact
Domestic Producers	• **Before the tariff** domestic producers produced output equal to $0Q_1$ and their revenue was equal to P_w x Q_1 • **After the tariff** was imposed domestic producers produced $0Q_3$ and their revenue was equal to P_w+tariff x Q_3 • Domestic producer surplus has increased by area 1
Foreign Producers	• **Before the tariff** foreign producers sold output equal to Q_1Q_2 and their revenue was equal to P_w x (Q_2 - Q_1) • **After the tariff** was imposed foreign producers sold output equal to Q_3Q_4 and their revenue was equal to P_w x (Q_4 - Q_3) • Foreign producer surplus has decreased by the areas underneath 2 and 4

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Domestic Consumers	• **Before the tariff** domestic consumers consumed Q_2 products at a price of P_w • **After the tariff** domestic consumers consumed **fewer products** (Q_4) at a **higher price** of P_w+tariff • Domestic consumer surplus has decreased by areas 1,2 3 and 4 • Some consumers have been priced out of the market (contraction of quantity demanded from $Q_2 \rightarrow Q_4$
The Government	• **After the tariff** is imposed the government receives **tax revenue** equal to ((P_w+tariff) - P_w) x (Q_4-Q_3) ◦ This is equal to area 3
Downstream Producers	• Other producers who rely on the imported product as a **raw material** in their own production process, now have to pay more for it as prices are higher • This increases their **costs of production** • They may have to reduce output which could impact **unemployment levels** and government tax receipts in their industry
Society (welfare loss)	• **Less efficient** domestic firms are now producing at the expense of more efficient foreign producers - there is a welfare loss equal to area 2 • Consumers are frustrated with the higher prices and there is no longer allocative efficiency - there is a welfare loss equal to area 2 • The net welfare loss is equal to areas 2 and 4

Exam Tip

Tariffs are one of the most frequently examined sub-topics in Paper 2. When evaluating their use, consider how many jobs are protected (or created) in the industry that is targeted by the tariff as opposed to jobs which may be lost in multiple downstream industries due to higher prices.

For example, a tariff on solar panel imports protects a few firms who manufacture solar panels. However, the higher prices can cause a significant fall in the quantity demanded leading to the possible loss of thousands of jobs for installation experts.

4.2.2 Quotas

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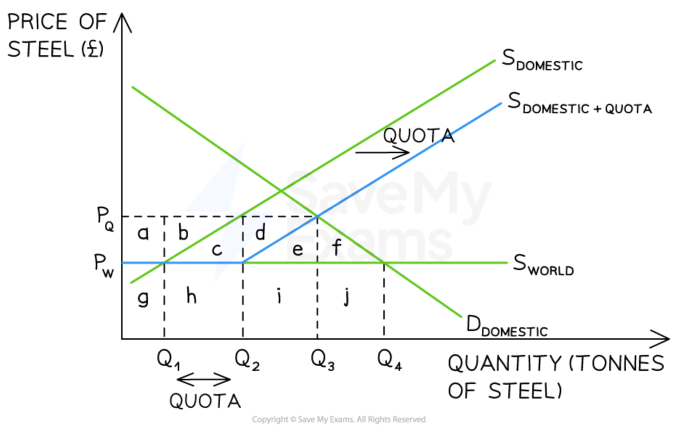
An Explanation of Quotas

- **A quota is a physical limit on imports** e.g. in June 2022 the UK extended its quota on **steel imports** for a further two years in order to protect employment in the domestic steel industry

- This limit is usually set **below the free market** level of imports
  - As cheaper imports are limited, a quota **raises the market price**
  - As cheaper imports are limited a quota **may create shortages**

- Some domestic firms benefit as they are able to **supply more** due to the lower level of imports
  - This may increase the level of employment for domestic firms



A quota on steel imports reduces the equilibrium quantity from Q_4 → Q_3 and raises the market price from P_w → P_q

Diagram Analysis

- The initial **market equilibrium** is at P_wQ_4
  - Domestic firms supply up to Q_1 and **Q_4-Q_1 is imported**

- To support the domestic steel industry, the UK government **limits the amount of imports** by instituting a quota
  - The **domestic supply curve (S_d)** shifts to the right by the size of the quota (Q_2-Q_1)
  - Where this curve crosses the domestic demand curve (D_d) it forms the **new market equilibrium at P_qQ_3**
  - The quota has raised prices and reduced total output from Q4→Q_3
  - Domestic producers supply up to Q1 **PLUS** Q_3-Q_2
  - Foreign producers supply Q_2-Q_1 (the quota)

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- Once governments **announce the quota level,** the market automatically prices in the reduced output
  - This means that each unit of output is sold at the quota price (P_q)
  - Both domestic producers and foreign producers receive a higher price for their steel

Exam Tip

One of the main reasons that the quota diagram is confusing is because it appears that domestic producers supply up to Q_1, then take a holiday while the imports flood in until Q_2 is reached, after which they continue to supply up until Q_3. This is not how it works in reality.

1. The government announces the quota for the next 12 months
2. The market factors in the reduced supply and a new market price is established
3. Even while domestic firms are selling their products, importers continue to import the foreign product for as long as there i any quota allowance left
4. The government keeps track of the level of imports and once the quota level is reached, they will not allow any more imports of that product to enter the country

An Evaluation of Quotas

- Quotas can be beneficial in that they are a **less confrontational method of protectionism** than tariffs as there is less of a penalty for trading partners

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The Impact of Quotas on Stakeholders

Stakeholder	Explanation of Impact
Domestic Producers	• Before the quota, the domestic revenue was area **g** • After the quota, domestic revenue is greater covering areas **a+g+d+e+i**
Foreign Producers	• Before the quota, foreign producer revenue was area **h+i+j** • After the quota, foreign producer revenue is less covering areas **b+c+h** • Under the quota, they receive a **higher price** for all units sold at P_q but they sell fewer products
Domestic Consumers	• Consumers pay a **higher price (P_q)** than previously (P_w) which reduces their disposable income • Some consumers leave the market as they cannot afford the higher price **(contraction from $Q_4 \rightarrow Q_3$)**
The Government	• They gain some favour with the industry they are protecting • This policy **may create jobs** in the industry being protected and reduce the level of unemployment benefits required • The government **does not receive tax revenue** as they do when using a tariff
Downstream Producers	• Other producers who rely on the imported product as a **raw material** in their own production process, now have to pay more for it as prices are higher • This increases their **costs of production** • They may have to reduce output which could impact **unemployment levels** and government tax receipts in their industry
Efficiency	• **Global efficiency** has worsened as less efficient domestic producers are producing at the expense of more efficient foreign producers **(area e+f)**

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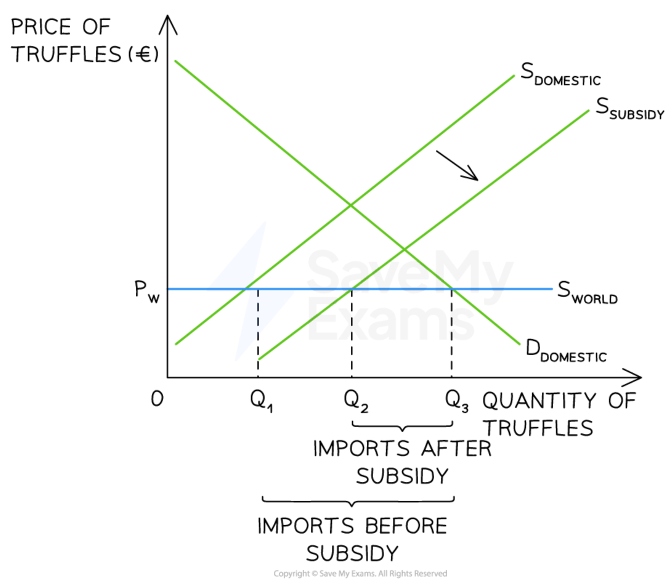
4.2.3 Export Subsidies

An Explanation of Export Subsidies

- Both subsidies and export subsidies lower the cost of production for **domestic firms**
  - They can increase output and **lower prices**
  - With lower prices their goods/services are **more competitive** internationally
  - If firms are able to meet all of the domestic demand (D_d) then the excess supply may be exported
  - Otherwise, the level of **imports will decrease**
  - The increased output may result in **increased domestic employment**

- Following the 2nd World War, the **European Union** subsidised food production and this has continued ever since
  - Once food security had been established within Europe, countries were able to start **exporting the excess supply** that subsidies generate



European Union subsidies for truffle producers shift the domestic supply curve to the right which decreases the level of truffle imports required from Q_1Q_3 to Q_2Q_3

Diagram Analysis

- The domestic market for truffles in the EU was initially in **equilibrium at P_wQ_3**
  - Domestic firms supplied up to Q_1, while Q_2-Q_1 was imported into the EU

- The implementation of the subsidy **lowered firms costs of production**, shifting the domestic supply curve from S_d to $S_{d+subsidy}$
  - Domestic firms increase output and market share from $Q_1 \rightarrow Q_3$
  - Imports reduce from $Q_1Q_3 \rightarrow Q_2Q_3$

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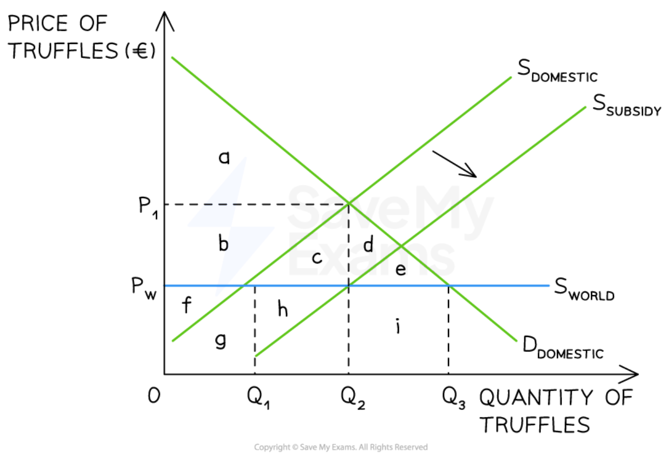
An Evaluation of Subsidies

- An evaluation of the **effectiveness of the use of subsidies** as a form of protectionism is best done by considering the impact on all of the relevant stakeholders



The effect on different stakeholders can be considered by analysing each area of the international subsidy diagram

- The stakeholders affected are domestic and foreign producers, consumers, government, and society (welfare)

An Evaluation of the use of Subsidies to Protect Domestic Firms

Stakeholder	Explanation
Domestic Producers	• Decreases costs of production • Increases output from $Q_1 \rightarrow Q_2$ • Revenue before subsidy was **f+g** • Revenue after subsidy is **b+c+f+g+h** • Increases **international competitiveness**
Foreign Producers	• Makes it harder for them to compete with domestic firms • Their exports reduce from $Q_3-Q_1 \rightarrow Q_3-Q_2$ • **Revenue** for foreign firms before the subsidy was **h+i** • Revenue after the subsidy is only **i**
Consumers	• Consumers already benefitted from the lower world price and receive no further benefit

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Government	• This costs the government the amount of the subsidy - **area b+c** • There is an opportunity cost associated with every subsidy provided
Society (Welfare)	• There is a **welfare loss (area c)** as more inefficient domestic producers are now producing at the expense of more efficient global producers

Exam Tip

When evaluating the use of subsidies in essay responses, it is worthwhile considering both the length of time that the subsidy has been in place, along with the size of the subsidy.

If the subsidy is large and has been in place for a long time, the industry is likely to be a global monopoly such as the USA cotton industry. Their price is effectively the world price.

This is one reason why the WTO aims to limit export subsidies. They put small-scale farmers in developing nations out of business, often decimating the industry and thus increasing unemployment. Compared to fifty years ago, very few African countries now produce cotton. This is entirely down to the size and longevity of the subsidies in the USA.

4.2.4 Administrative Barriers

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An Explanation of Administrative Barriers

- There are many strategies that can be used to **create barriers to trade** using less obvious methods than tariffs, quotas and subsidies
    - **Health and safety regulations** e.g. in 2017 the EU put a new health regulation in place regarding the permitted level of *aflotoxins* in nuts. *Aflotoxin* levels are naturally higher in southern hemisphere countries and it effectively blocked the import of southern hemisphere nuts
    - **Product specifications** e.g. Canada specified that all jam imported into Canada needed to be in a certain size of the jar. Many countries do not usually manufacture jars in the required size
    - **Environmental regulations** e.g. in November 2021 new regulations were put in place in the EU and the USA to limit the amount of imports of 'dirty steel' - predominantly this is steel produced using coal-fired power stations which are prevalent in China
    - **Product labelling** can be expensive for firms to apply and may limit their desire to sell into certain markets
    - **Inefficient administrative systems** e.g. many border crossings in Africa still require physical paper copies to be submitted at each crossing with some companies claiming they have to provide in excess of 10,000 documents for a single journey

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4.3 Arguments For & Against Trade Protection

4.3.1 Arguments For & Against Trade Protection

Arguments for Trade Protection

- Despite the benefits that free trade offers, there are many good arguments which would support the use of protectionism in certain instances

Arguments for Protectionism

Reason	Explanation
Infant industries	• To protect **new firms** that would be unlikely to succeed at start-ups due to the level of global competition. Once established support is removed
Sunset industries	• Similar to above, but at the other end of the life cycle, these firms are on their way out and the government chooses to support them to help **limit the economic damage** that would occur if they closed abruptly
Strategic industries	• Industries such as energy, defence and agriculture are essential to **self-sufficiency** and security. Being reliant on other countries for these creates vulnerabilities for a nation
Dumping	• Dumping is anti-competitive and can harm a country's industries
Employment	• When firms outsource production to other countries or certain industries are experiencing structural unemployment governments will step in to protect jobs
Current Account deficit	• When **imports > exports** the amount of money leaving the country to support foreign firms is greater than that entering to support domestic firms. Protectionism aims to correct this **imbalance**

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Labour/environmental regulations	• Many countries offer **cheap labour and low-cost production** due to poor environmental regulations. Protectionism can help apply **pressure** to bring about change in these countries

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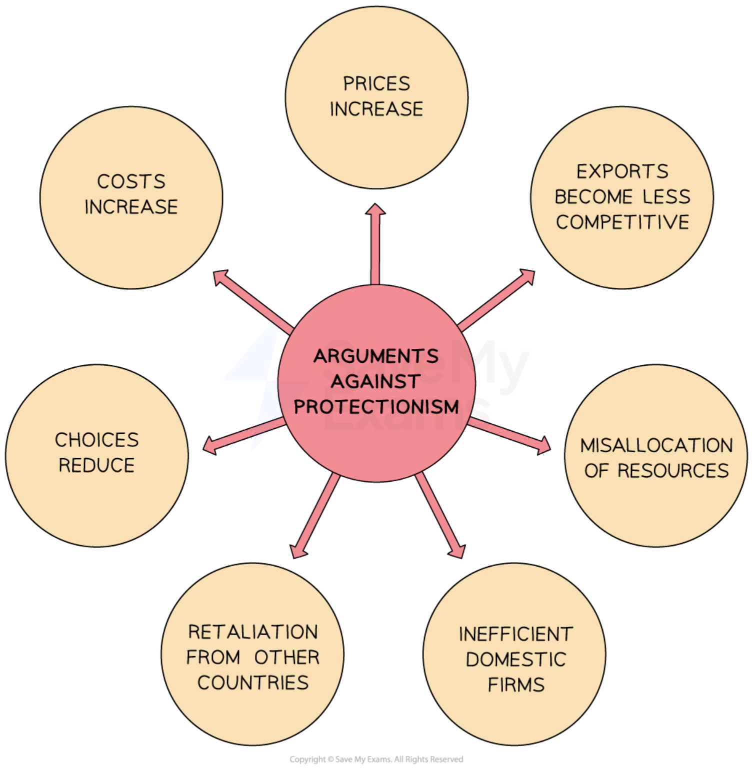
Arguments Against Trade Protection

- The arguments against trade protection are evident from the impact that each form of protection has on the stakeholders. These can be summarised in the diagram below



Seven common arguments against protectionism

1. **Reduced choice**
   Protectionism reduces both the quantity and variety of goods/services available to customers
2. **Increased prices**
   Protectionism either reduces the supply of goods/services which leads to higher prices - or in the case of tariffs, directly leads to higher prices
3. **Increased costs**
   Manufacturers who rely on imported raw materials face higher costs of production. If protectionism is widespread it may generate inflation in the economy and/or lead to a loss of employment
4. **Retaliation**
   Foreign producers are hurt by protectionism and it is common for their governments to retaliate with their own measures which further harm free trade
5. **Reduction in export competitiveness**
   Protectionism reduces the need to be efficient or to innovate. Over time this leads to higher prices and worse quality products which will reduce export sales
6. **Resource misallocation**
   Global welfare is reduced as protectionism shifts production away from more efficient

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foreign producers to less efficient domestic producers

7. **Domestic inefficiency increases**
   With a reduced level of competition, domestic firms will be less productively efficient and will spend less on research, development and innovation

An Evaluation of free Trade Versus Protectionism

- Trade liberalisation has helped to generate significant economic growth and economic development

- As an economy moves towards free trade, structural unemployment often develops as certain industries move abroad
  - Without an **intentional government program** to retrain these workers, they often fall through the cracks and their quality of life reduces significantly
  - It has been argued that structural unemployment is at the **heart of nationalism** as angry workers seek to expel foreigners and get their jobs back
  - Voters are able to influence the **political agenda** and protectionism goes through periods of immense popularity

- **More economically developed countries (MEDCs)** have the funds available to provide significant export subsidies to their firms
  - The aim is usually not to protect these firms but to help them gain a global monopoly
  - As monopolies develop they gain more revenue and **generate more tax revenue** which may go back to their government (often it goes to off-shore bank accounts)

- **Less economically developed countries (LEDCs)** are often pushed into free trade agreements by MEDCs with a focus on resource extraction
  - MEDCs frequently place tariffs on the **import of manufactured goods** with added value from LEDCs
  - This prevents LEDCs from **generating higher profits** e.g. cocoa beans are exported from Ghana to the USA at low prices and without any import tariffs, however, there is a high tariff on the import of Ghanaian chocolate to the USA

- This argument is not as simple as free trade is better. **The context** of the trade and the nature of the trading partners ultimately decides whether a path of free trade or protectionism would serve a nation better
  - There is no doubt free trade generates **higher output and income**, but the distribution of this income may be vastly unfair

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4.4 Economic Integration

4.4.1 Understanding Economic Integration

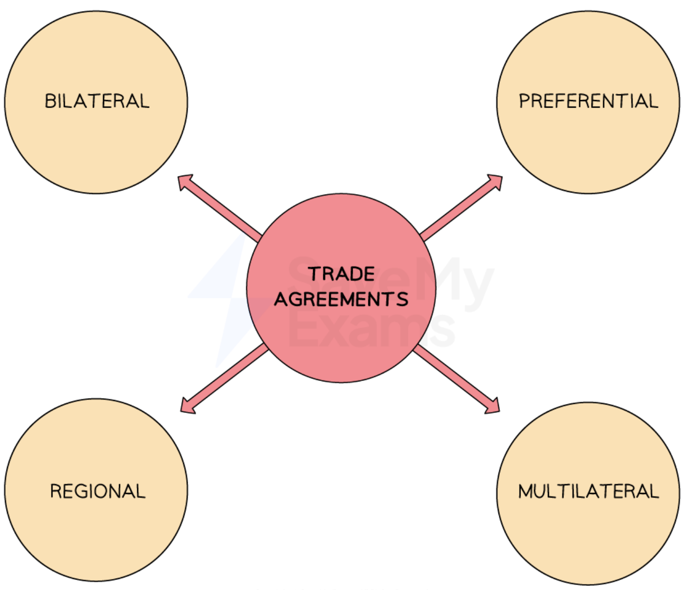
Economic Integration

- **Economic integration** occurs as countries reduce trading barriers between themselves and become more interdependent

- There are several ways in which **economic integration can deepen**

1. Through the development of trade agreements
2. Through the creation of trading blocs
3. Through the formation of a monetary union

1. Trade agreements



There are 4 common types of trade agreements

- **A preferential trade agreement (PTA)** is an agreement between two or more countries providing preferential (better)
terms and conditions of trade to member countries
    - **E.g. Vietnam** has preferential tariff rates with Australia

- **A bilateral trade agreement** is a preferential trade agreement between two countries and aims to reduce or eliminate barriers to trade
    - **E.g. Vietnam** signed a bilateral trade agreement with Korea in 2015

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- **A regional trade agreement (RTA)** is a preferential trade agreement usually between more than two countries in the same geographical region
  - **E.g. Armenia** created an agreement with the EU in 2019 to create the EU-Armenia RTA

- **A multilateral trade agreement** is a legally binding preferential trade agreement between more than two countries or trading blocs and is usually negotiated and overseen by the World Trade Organisation (WTO)
  - **E.g. The East African Community** was created in 2005 between seven African countries

2. Trading Blocs

- There are generally three types of trading blocs - Free Trade Areas (FTAs), Customs Unions, and Common Markets
  - Each successive bloc has a higher level of integration

3. Monetary Unions

- Monetary Unions often develop once there is integration at a Common Market level
- Nations in the Common Market may desire the creation of a common central bank and convergence of monetary policy

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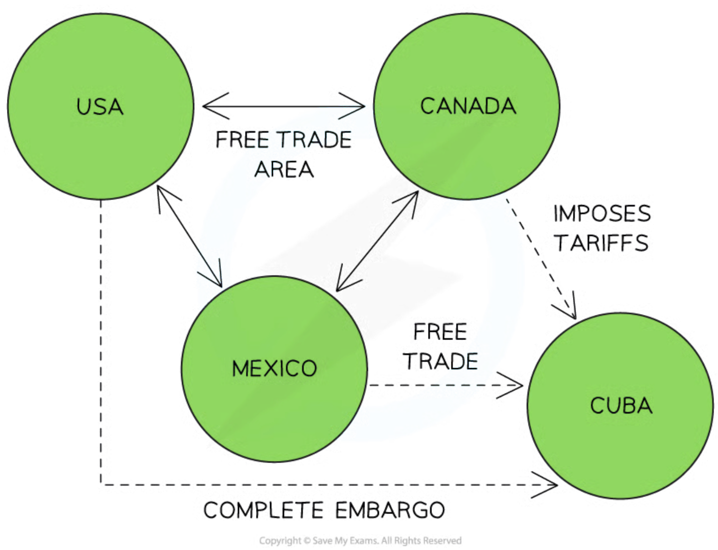
4.4.2 Types of Trading Blocs

1. Free Trade Areas (FTAs)

- A **trading bloc** is a group of countries who come together and **agree to reduce or eliminate any barriers to trade** that exist between them
- There are different levels of economic integration ranging from relatively low integration in a **bilateral agreement** to high integration in a **monetary union** e.g. the Eurozone
- Globally, there were more than 420 regional trade agreements in effect in 2022
- Each subsequent type of trading bloc has **increased levels** of economic integration

- A **free trade area** is a bloc in which countries agree to **abolish trade restrictions between themselves** but maintain their **own restrictions** with other countries e.g Canada–United States–Mexico Agreement (CUSMA)



Mexico, Canada and the USA have a free trade agreement but can deal individually with Cuba as they see fit

- In the diagram above, Mexico, Canada and the USA have **reduced/eliminated many trade restrictions** between themselves
  - The USA **refuses to trade** with Cuba and has placed a complete ban on all exports/imports to Cuba
  - Canada trades with Cuba but imposes **tariffs on all imports**
  - Mexico **trades freely** with Cuba

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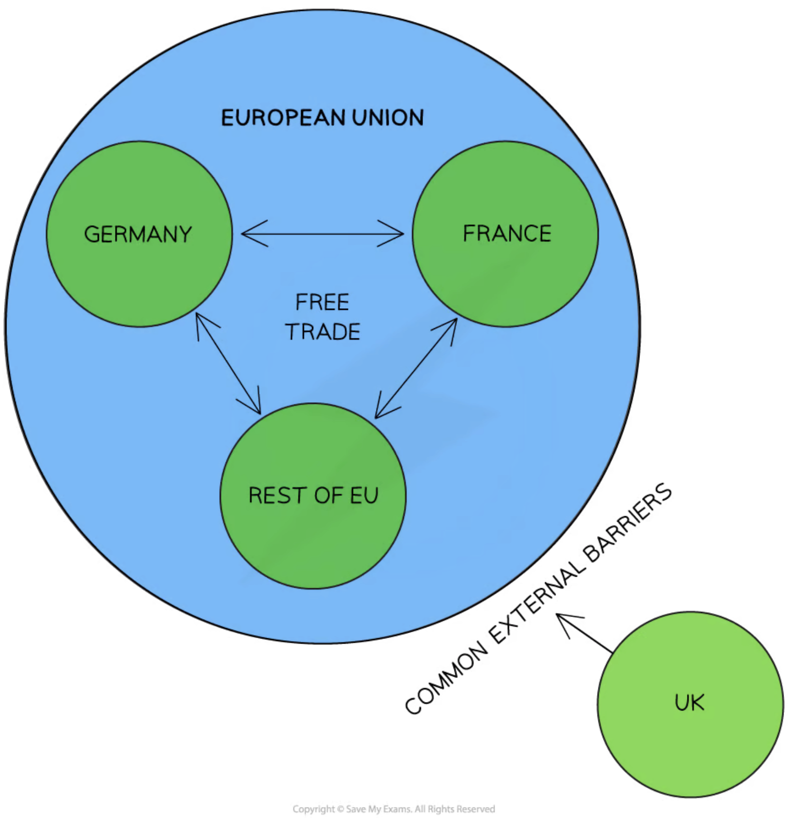
2. Customs Unions

- A **customs union** is an agreement between countries in which all goods/services produced by members are **traded tariff free**. Additionally, countries agree on **common tariff rates on imports** from all external (third-party) countries



Countries within the European Union trade freely between themselves and have common barriers with all third-party countries e.g. UK

- In the diagram above, countries in the **European Union** have **eliminated all tariff barriers** between themselves but impose **common tariff barriers** on third party countries such as the UK or China

3. Common Markets

- Similarly, to a customs union, goods/services are traded tariff-free in **common markets**
- Additionally, the four factors of production flow freely between member countries
    - The goal is to improve the **allocation of resources** between the common market members and lower the costs of production
    - The **European Union** is a customs union and a common market

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4. Monetary Union

- A **monetary union** takes integration a step further. Members enjoy all of the benefits of a customs union and common market, but then also establish a **common central bank** which issues a **common currency** and controls the monetary policy of member countries
  - Prior to Brexit, the UK was a member of the **European Customs Union** and common market **but never joined the Eurozone**
  - At the start of 2023, 20 of the 27 countries in the EU are also members of the Eurozone

Advantages and Disadvantages of Trading Blocs

Advantages	Disadvantages
• Greater access to markets offer the potential for economies of scale • With freedom of labour, there are **greater employment opportunities** • Membership in a trading bloc may allow for stronger **bargaining power** in new multilateral negotiations • **Greater political stability** and cooperation between the countries within the bloc due to the increased interdependence	• **Loss of sovereignty** as nations increasingly give up their autonomy, perhaps most visible when joining a monetary union (nations lose the ability to set their own monetary policy) • **Multilateral trading negotiations** become more challenging as countries within a trading bloc have to maintain the existing bloc rules when dealing with third-party countries • Trade diversion can distort the efficient allocation of resources

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4.4.3 The World Trade Organisation (WTO)

The role of the WTO

- The World Trade Organisation (WTO) was established in 1995 to **promote free trade**
  - They believe free trade is the best way to raise living standards, create jobs and improve people's lives

- **Trade liberalisation** is the process of rolling back the barriers to free trade e.g. removing tariffs

- The WTO has two main roles in liberalising trade

1. It brings countries together at conferences and encourages them to reduce or eliminate **protectionist trade barriers** between themselves e.g. The Doha Round conferences
2. It acts as an **adjudicating body** in trade disputes. Member countries can file a complaint if they believe a trading partner has violated a trade agreement. The WTO will then run a hearing and make a judgement

The Objectives and Functions of the WTO

Objectives of the WTO	Functions of the WTO
• Improving people's lives • Promotion of fair competition • Protecting the environment	• Trade negotiations • Implementation and monitoring of trade agreements • Dispute settlement • Building trade capacity between nations • Outreach to governments and influential organisations on behalf of member countries

Exam Tip

WTO judgements are **not legally binding.** Members voluntarily submit to them (or not). A judgement in favour of a trade dispute does allow the aggrieved nation to put protectionist measures in place with the WTO's approval. The hope is that these measures will then force the nation committing the violation to back down and resolve the trade issue.

When evaluating the effectiveness of trade agreements, it is worth noting that larger economies tend to selectively choose which rulings of the WTO to abide by. Smaller (usually developing) economies tend not to have that luxury.

Factors Affecting the Influence of the WTO

YOUR NOTES
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- In March 2022 there were 320 **regional trade agreements** globally
- While these are **beneficial to the members** in the agreement (as they strengthen ties and create more trade between them), they also create **conflicts** with the stated aim of the WTO - to liberalise trade
  - Regional agreements often **shift trade** from a non-member who is more efficient in producing certain goods/services, to a member country who is less efficient (trade diversion)
  - Regional trade members then often institute common **trade barriers** on non-members which is the opposite of trade liberalisation (protectionism)

Two key Factors Which Continue to Undermine the Influence of the WTO

Difficulties in reaching agreement on services and primary products	Unequal bargaining power of members

• **MEDCs continue to subsidise** many firms producing primary products which allows them to dominate global markets
  ◦ LEDCs do not have the tax revenue to do the same for their firms and so they are unable to compete
• Firms from **LEDCs are frequently blocked** from offering services (which generate higher profit and income) in MEDCs
  ◦ This prevents free trade in services
	• Firms and individuals from MEDCs tend to be **better networked** and will unashamedly work their connections so as to gain better trading conditions
	• Larger, wealthier countries will also **pressurise WTO negotiations** in order to secure the outcome they want
	• It is much harder for LEDCs to gain preferential terms in trade negotiations due to this **power imbalance**

YOUR NOTES
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4.5 Exchange Rates

4.5.1 Types of Exchange Rate Systems

Foreign Exchange Rates

- An **exchange rate** is the price of one currency in terms of another e.g. £1 = €1.18
  - International currencies are essentially **products** that can be bought & sold on the **foreign exchange market** (forex)

- The Central Bank of a country controls the **exchange rate system** that is used in determining the value of a nation's currency

- Three of the main **exchange rate systems** are
  - A floating exchange rate
  - A fixed exchange rate
  - A managed exchange rate

YOUR NOTES
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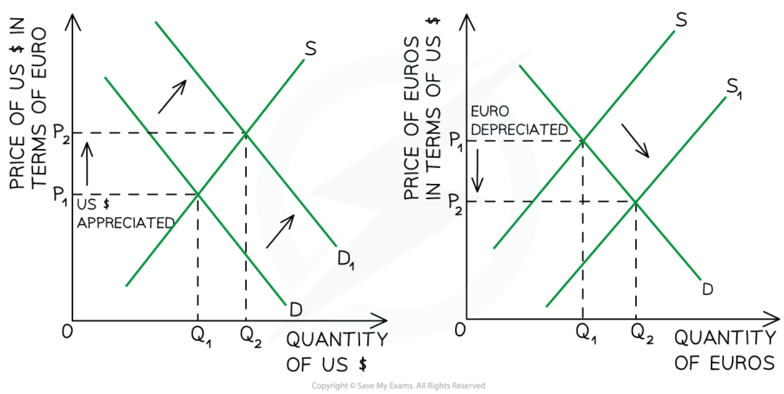
1. A Floating Exchange Rate System

- Different currencies can be bought and sold, just like any other product
- The forces of **demand and supply** determine the rate at which one currency exchanges for another
- As with any market, if there is **excess demand** for the currency on the forex market, then prices rise (the currency **appreciates**)
- If there is an **excess supply** of the currency on the forex market, then prices fall (the currency **depreciates**)



The relationship between the US$ and the Euro shows that as Europeans demand the $ it appreciates but by supplying their own currency it depreciates

Diagram Analysis

- The Euro/US$ market is shown by **two market diagrams** - one for the USD market on the left and one for the Euro market on the right
- The initial **exchange rate equilibrium** is found at P_1Q_1 in both markets
- When Europeans visit the USA, they demand US$ and supply Euros
    - The **increased demand for the US$** shifts the demand curve to the right which results in the value of the $ appreciating from $P_1 \rightarrow P_2$ in the USD market and a new market equilibrium forms at P_2Q_2
    - The **increased supply of the Euro** shifts the supply curve to the right which results in the value of the Euro depreciating from $P_1 \rightarrow P_2$ and a new market equilibrium forms at P_2Q_2

Floating Exchange Rate Calculations

- As the value of a currency appreciates or depreciates, the value of any international transaction changes
- These changes can be significant for firms during times of exchange rate volatility

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Worked Example

Marsha is a currency trader who buys and sells currency in order to make a profit. Currently, she is holding €200,000 and expects that the Pound will appreciate against the € in the next few months.

At present £1 = €1.10

1. Marsha exchanges her Euros for Pounds. Calculate the quantity of Pounds she will receive for €200,000 [1]

2. The Pound depreciates against the Euro by 10%. Fearing further depreciation, Marsha changes her Pounds back to Euros. Calculate the loss she has made. [3]

Step 1: Calculate the quantity of Pounds received for €200,000

$$\frac{200,000}{1.1} = £181,818.18$$

(1 mark for the correct answer)

Step 2: Calculate the new exchange rate

£1= (€1.10 x 0.9) = €0.99

(1 mark for the correct answer)

Step 3: Use the above value to calculate the new amount of Euros

£181,818.18 x 0.99 = £179,999,9982

Step 4: Round to two decimal places

£180,000

(2 marks for the correct answer rounded to 2 decimal places)

Step 5: Calculate the loss

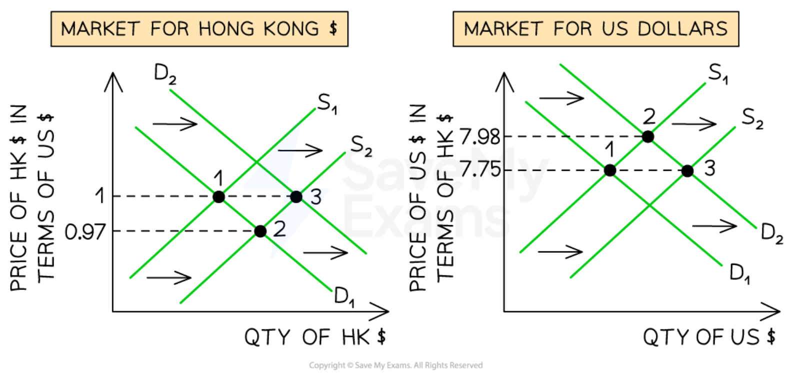
£200,000 - £180,000 = £20,000 loss

(1 mark for the correct answer)

2. A Fixed Exchange Rate System

YOUR NOTES

- A system in which the country's **Central Bank intervenes** in the currency market to **fix (peg) the exchange rate** in relation to another currency e.g US$
  - When they want their currency to appreciate, they buy it on forex markets using their foreign reserves, thus increasing its demand
  - When they want their currency to depreciate, they sell it on forex markets, thus increasing its supply
- Sometimes the peg is at **parity** e.g. 1 Brunei Dollar = 1 Singapore Dollar
- Often the peg is not at parity e.g. Hong Kong has pegged its currency to the US$ at a rate of HK$ 7.75 = US$ 1
- A **revaluation** occurs if the Central Bank decides to change the peg and increase the strength of its currency
- A **devaluation** occurs if the Central Bank decides to change the peg and decrease the strength of its currency



The Hong Kong Monetary Authority intervenes to maintain the exchange rate of HK$ 7.75 = US$ 1

Diagram Analysis

- The HK$/US$ market is shown by **two market diagrams** - one for the HK$ market on the left and one for the US$ market on the right
- The initial **exchange rate equilibrium** is found at ***HK$ 7.75 = US$ 1*** *– represented by point 1*
- When Hong Kong firms import goods from the USA, they demand US$ to pay for them and supply HK$
- This impacts the market for each currency - the US$ appreciates and the HK$ depreciates
- To maintain the fixed exchange rate at ***HK$ 7.75 = US$ 1***, the Hong Kong Monetary Authority intervenes in the forex market by **using US$ from its foreign reserves to buy HK$**

Left Diagram – HK$

- The **increased supply of the HK$** shifts the supply curve to the right which results in the value of the HK$ depreciating from (HK$7.75 = $1) → (HK$7.75 = $0.97) and a new market equilibrium forms at point 2

YOUR NOTES
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- The Monetary Authority intervenes by buying HK$ which shifts the demand curve right from $D_1 \rightarrow D_2$
- The HK$ has now been moved **back to its target value** of K$ 7.75 = US$ 1 - point 3

Right Diagram - US$

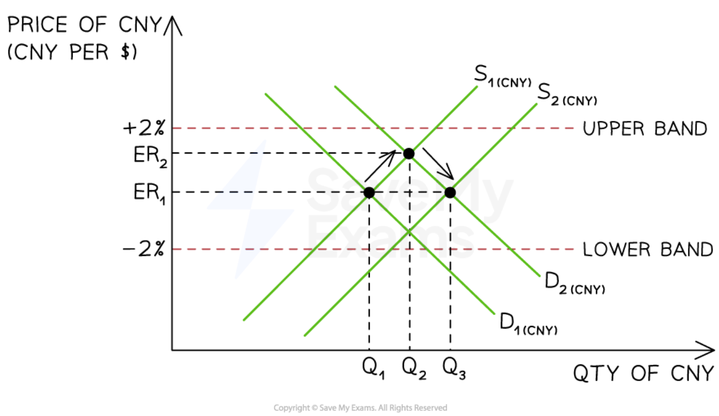
- The **increased demand for the US$** shifts the demand curve to the right which results in the value of the US$ appreciating from ($1 = HK$7.75) → ($1 = HK$7.98) and a **new market equilibrium** forms at point 2
- The Monetary Authority intervenes by buying HK$ using UD$ which increases their supply shifting the supply curve right from $S_1 \rightarrow S_2$
- The HK$ has now been **moved back to its target value** of K$ 7.75 = US$ 1 - point 3

3. A Managed Exchange Rate System

YOUR NOTES

- The exchange rate is allowed to **fluctuate within a specified band** around a desired valuation. If it goes outside of this band then the Central Bank will intervene to bring it back within the band
  - When they want their currency to **appreciate to back within the band**, they buy it on forex markets using their foreign reserves, thus increasing its demand
  - When they want their currency to **depreciate back into the band**, they sell it on forex markets, thus increasing its supply

- Currently, almost all currencies are **managed currencies**
  - The width of the band varies from country to country
  - These bands are not published as it would help currency speculators to know when **currency reversals** would be initiated by the Central bank and they would seek to profit from that knowledge



The Peoples Bank of China intervenes to maintain the exchange rate within a specified band of trading and is in the region of 2% around a value of 1US$ = 6.75 CNY

Diagram Analysis

- China has not released their currency bands, however, the value seems to fluctuate up to 2% ***around a value of 1US$ = 6.75 CNY***
- The initial market equilibrium is found at ER_1 Q_1

Action to correct currency appreciation

- **Increased demand** for the Chinese Yuan leads to a rightward shift of demand $D_1 \rightarrow D_2$ leading to an **appreciation** from $ER_1 \rightarrow ER_2$
- The currency is approaching the upper band so the Peoples Bank of China intervenes by selling their own currency (and buying foreign reserves)
  - This increases the **supply of the Yuan** causing a rightward shift from $S_1 \rightarrow S_2$
  - A new equilibrium is established at ER_1Q_3, well within the band

YOUR NOTES
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Action to correct currency depreciation

- **Increased supply** of the Chinese Yuan on world markets leads to a rightward shift of supply from $S_1 \rightarrow S_2$ leading to a **depreciation** from ER_1 towards the bottom currency band
- The currency is approaching the bottom band so the Peoples Bank of China intervenes by buying their own currency (and selling foreign reserves)
  - This increases the **demand of the Yuan** causing a rightward shift from $D_1 \rightarrow D_2$
  - A new equilibrium is established at ER_1Q_3, well within the band

4.5.2 Causes & Consequences of Exchange Rate Fluctuations

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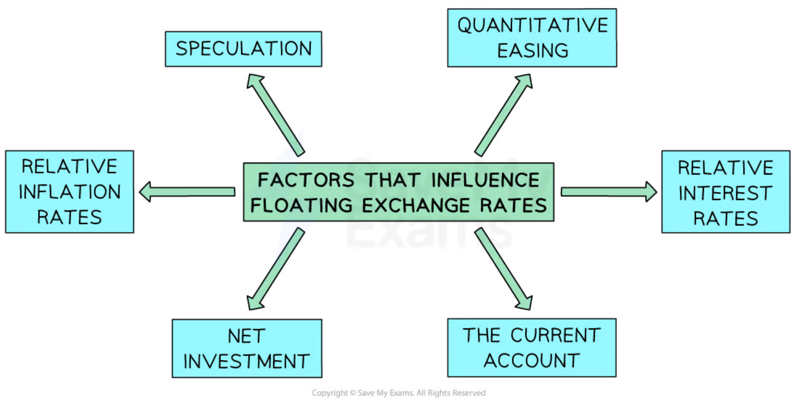
Causes of Exchange Rate Fluctuations

- Numerous factors influence floating exchange rates, resulting in an appreciation or depreciation of a currency



Factors influencing floating exchange rates

1. **Relative** interest rates**:** influence the flow of hot money between countries. If the UK increases its interest rate, then demand for £'s by foreign investors increases and the £ appreciates. If the UK decreases its interest rate, then the supply of £'s increases as investors sell their £'s in favour of other currencies and the £ depreciates

2. **Relative** inflation rates**:** as inflation in the UK rises **relative** to other countries, its exports become more expensive so there is **less demand** for UK products by foreigners, which means there is less demand for £s and so the **£ depreciates**

3. **Net** foreign direct investment (FDI): FDI into the UK creates a **demand for the £** which leads to the **£ appreciating**. FDI by UK firms abroad creates a supply of £'s which leads to the £ depreciating

4. **The current account:** EU exports have to be paid for in €'s. EU imports have to be paid for in local currencies, which requires €'s to be supplied to the forex market. Due to this, an increasing net exports will result in an appreciation of the € and falling **net exports** will result in a depreciation of the €

5. **Changes in tastes/preferences:** As global demand for **quinoa** increased as it b**ecame fashionable**, Bolivia's exports of quinoa increased dramatically which put **upward pressure on their currency**. Foreigners demanded the Boliviano in order to pay for the quinoa

6. **Speculation:** the vast majority of currency trades are speculative. Speculation occurs when **traders buy a currency** in the expectation that it will be worth more in the short to medium term, at which point they will sell it to **realise a profit**

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7. Net Portfolio Investment: Portfolio investment into the UK creates a **demand for the £** which leads to the **£ appreciating**. Portfolio investment by UK firms abroad creates a supply of £'s which leads to the £ depreciating

8. [popover id="RbhwpSYhQds6BEol" label="Remittances"]: Some countries receive high levels of remittances which help to keep the demand for their currency strong e.g. the Philippines

9. **Relative growth rates:** Countries with stronger economic growth rates will attract higher levels of FDI resulting in an appreciation of their currency

10. **Central Bank intervention:** Any form of monetary policy is likely to influence exchange rates e.g. higher interest rates will increase the hot money flows. Direct intervention using foreign reserves will also influence the exchange rate

Consequences of Foreign Exchange Rate Fluctuations

- Changes to exchange rates may have far-reaching impacts on an economy

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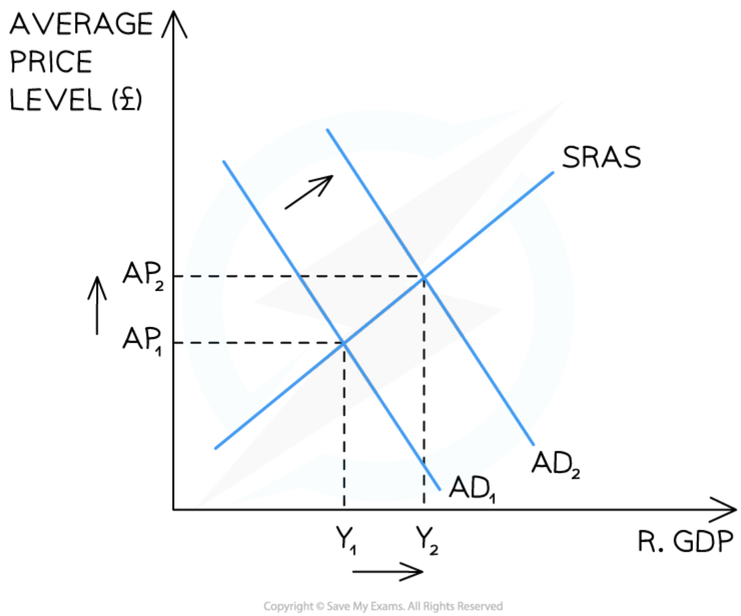
1. Likely impact on the macro economy of a currency depreciation



A depreciation means that imports are more expensive and exports are cheaper. Net exports should rise leading to an increase in AD from AD1 → AD2

2. Likely impact on the macro economy of a currency appreciation

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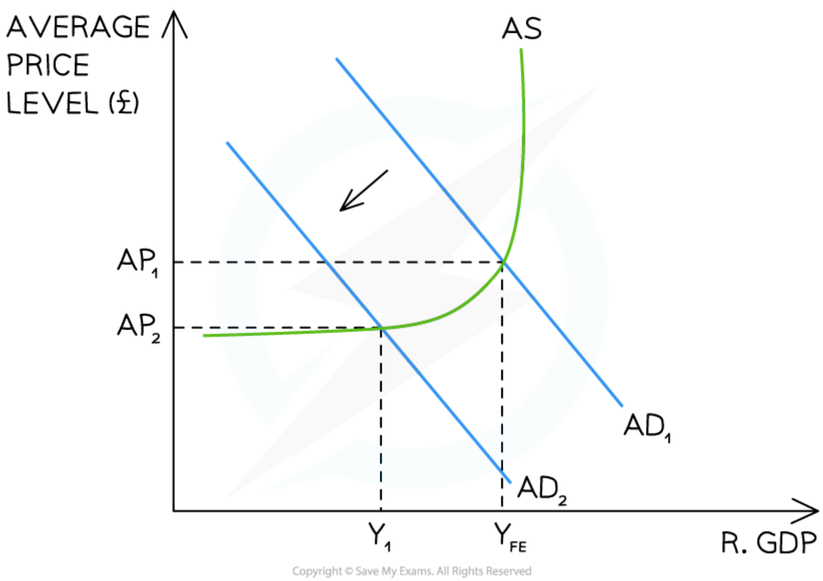

An appreciation means that imports are cheaper and exports are more expensive. Net exports should fall leading to a decrease in AD from AD1 → AD2

Impact of an Appreciation or Depreciation on the Economic Indicators

Economic Indicator	Explanation

The Current Account	• From a UK perspective, **the depreciation** of the £ causes **exports** to be cheaper for foreigners to buy and **imports** to the UK are more expensive
	
	• The **extent** to which a currency depreciation improves the **current account balance** depends on the **price elasticity of demand for exports and imports**
	  ◦ This follows the **revenue rule** which states that in order to increase revenue, firms should **lower prices** for products that are price elastic in demand
	  ◦ If the **price elasticity of demand for UK exports is elastic,** then depreciation of the currency will result in a larger than proportional increase in demand for UK exports, which will rapidly improve any **current account deficit**

Economic growth	• Net exports are a component of aggregate demand ◦ A depreciation that results in an **increase in net exports** will lead to economic growth

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Inflation	• Cost-push inflation can be caused by a **depreciating currency** as the price of **imported raw materials** increases with a weaker currency
	• Net exports are a component of aggregate demand
	  ◦ A **depreciation** that results in an **increase in net exports** will lead to an increase in aggregate demand
	  ◦ This may lead to an increase in demand-pull inflation
	• An **appreciation** of the currency will have the opposite effect

Unemployment	• If **depreciation** leads to an increase in exports, **unemployment is likely to fall** as more workers are required to produce the additional products demanded • An **appreciation** of the currency will have the opposite effect

Living standards	• The impact of **depreciation** on **living standards** can be muted
	  ◦ As imports are more expensive, households face **higher prices and less choice,** which detracts from living standards
	  ◦ Rising exports can decrease unemployment and **increase wages/income** which means an improved standard of living for some households
	• The impact of an **appreciation** of living standards will be the opposite

4.6 Balance of Payments

4.6.1 Components of the Balance of Payments

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An Introduction to the Balance of Payments

- The **Balance of Payments (BoP)** for a country is a record of all the financial transactions that occur between it and the rest of the world

- The **BoP** has two main sections:
  - **The current account:** all transactions related to goods/services along with payments related to the transfer of income
  - **The financial and capital account:** all transactions related to savings, investment and currency stabilisation

- Money flowing into an account is **recorded** in the relevant account **as a credit (+)** and money flowing out **as a debit (-)**
  - If more money flows into an account than out of it, there is a **surplus** in the account
  - If more money flows out of an account than into it, there is a **deficit** in the account

The Current Account

- The Current Account is often considered to be the **most important account** in the BoP
- This account records the **net income** that an economy **gains from international transactions**

An Example of the UK Current Account Balance for 2017

Component	2017
Balance of trade in goods (exports - imports)	£-32.9bn
Balance of trade in services (exports - imports)	£27.9bn
Sub-total trade in goods/services	**£-5bn**
Net income (interest, profits and dividends)	£-2.1bn
Current transfers	£-3.6bn
Total Current Account Balance	**£-10.7bn**
Current Account as a % of GDP	3.7%

- **Goods** are also referred to as **visible** exports/imports
- **Services** are also referred to as **invisible** exports/imports
- **Net income** consists of income transfers by citizens and corporations
  - Credits are **received from UK citizens** who are abroad and send remittances home
  - Debits are **sent by foreigners** working in the UK **back to their countries**
- **Current transfers** are typically payments at **government level** between countries e.g. contributions to the World Bank

The Capital Account

- The **Capital Account** records **small capital flows** between countries and is relatively inconsequential
- The capital account is made up of two sections:

1. **Capital transfers**
   Smaller flows of money between countries
   E.g. **Debt forgiveness** payments by the government toward developing countries
   E.g. **Capital transfers** by **migrants** as they emigrate and immigrate

2. **Transactions in non-produced, non-financial assets**
   Small payments are usually associated with royalties or copyright e.g. royalty payments by record labels to foreign artists

The Financial Account

- The **Financial Account** records the flow of all transactions associated with changes of ownership of the country's foreign financial assets and liabilities

- It includes the following sub-sections

1. **Foreign Direct Investment (FDI)**
   Flows of money to purchase a controlling interest (10% or more) in a foreign firm. Money flowing in is recorded as a credit (+) and money flowing out is a debit (-)

2. **Portfolio Investment**
   Flows of money to purchase foreign company **shares and debt securities** (government and corporate bonds). Money flowing in is recorded as a credit (+) and money flowing out is a debit (-)

3. **Official Borrowing**
   Government borrowing from other countries or institutions outside of their own economy e.g. loans from the International Monetary Fund (IMF) or foreign banks. When the money is received, it is recorded as a credit (+) and when the money (or interest payments) are repaid, it is recorded as a debit (-)

4. **Reserve Assets**
   These are assets controlled by the Central Bank and available for use in achieving the goals of monetary policy. They include gold, foreign currency positions at the International Monetary Fund (IMF) and foreign exchange held by the Central Bank (USD, Euros etc.)

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Interdependence Between the Accounts

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- It is called the BoP as the **current account should balance with the capital and financial account** and be equal to zero
    - If the current account balance is **positive**, then the capital/financial account balance is **negative** (and vice versa)
    - In reality, it never balances perfectly and the difference is called 'net error and omissions'

- If there is a **current account deficit**, there must be a **surplus** in the **capital and financial account**
    - The excess **spending on imports** (current account deficit) has to be financed from money flowing into the country from the **sale of assets** (financial account surplus)

- If there is a **current account surplus**, there must be a **deficit** in the **capital and financial account**
    - The excess **income from exports** (current account surplus) is financing the **purchase of assets** (financial account deficit) in other countries

Balance of Payments Calculations

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Worked Example

The following table provides selected data from the balance of payments for a country in the European Union for the 2018

Data	€ (million)
Net capital transfers	–278
Net current transfers	–179
Net direct investment	351
Exports of services	419
Imports of goods	839
Net investment income	154
Import of services	445
Exports of goods	872

Calculate the current account balance of this country in 2018 [2]

Step 1: Recall the formula for calculating the current account balance

Net trade in goods + net trade in services + net income + net current transfers

The items *'Net capital transfers'* and *'Net investment income'* are not included in current account calculations and should be ignored

Step 2: Substitute the appropriate values

Net trade in goods = (872–839) = 33

Net trade in services = (419–445) = -26

Net income transfers = 154

Net current transfers = -179

Step 3: Complete the calculation

33 - 26 + 154 -179 = -18

(1 mark for the correct working)

Step 4: Check the units and ensure your answer uses the correct units

€-18 m

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(2 marks for the correct answer or 1 mark for any correct working)

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4.7 Sustainable Development

4.7.1 The Sustainable Development Goals

Defining Sustainable Development

- **Sustainable development** is economic development that meets the needs of the present generations without compromising the ability of **future generations** to meet their own needs
- In 2015 the United Nations Member States committed to a shared blueprint for peace and prosperity for people and the planet, now and into the future
    - This blueprint is called *The 2030 Agenda for Sustainable Development*
- Integral to the blueprint are the 17 **Sustainable Development Goals (SDGs)** which recognise that ending poverty must go hand-in-hand with strategies that improve health and education, reduce inequality, and generate economic growth – while tackling climate change and working to preserve oceans and forests
    - The SDGs build on more than fifty years of work by countries and the United Nations

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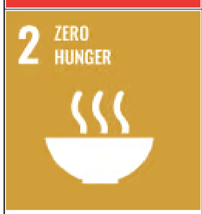
The 17 Sustainable Development Goals

- The SDGs provide both a target for sustainable development and also a metric to measure and gauge the progress made

An Explanation of the 17 SDGs (Source: UN SDGs)

2030 Goal	Explanation
	• End all forms of poverty by 2030, including absolute and relative poverty
	• End hunger, achieve food security and improved nutrition and promote sustainable agriculture
	• Ensure healthy lives and promote well-being for all at all ages
	• Ensure inclusive and equitable quality education and promote lifelong learning opportunities for all
	• Achieve gender equality and empower all women and girls
	• Ensure availability and sustainable management of water and sanitation for all

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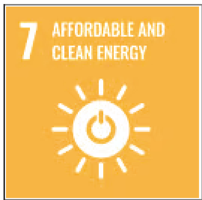
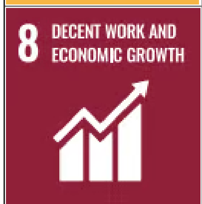
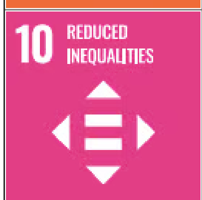
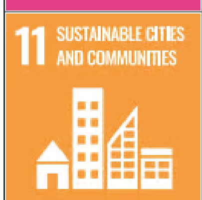
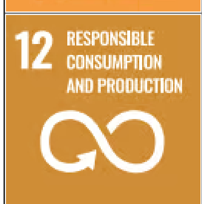
	• Ensure access to affordable, reliable, sustainable and modern energy for all
	• Promote sustained, inclusive and sustainable economic growth, full and productive employment and decent work for all
	• Build resilient infrastructure, promote inclusive and sustainable industrialization and foster innovation
	• Reduce inequality within and among countries
	• Make cities and human settlements inclusive, safe, resilient and sustainable
	• Ensure sustainable consumption and production patterns
	• Take urgent action to combat climate change and its impacts
	• Conserve and sustainably use the oceans, seas and marine resources for sustainable development

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	• Protect, restore and promote sustainable use of terrestrial ecosystems, sustainably manage forests, combat desertification, and halt and reverse land degradation and halt biodiversity loss
	• Promote peaceful and inclusive societies for sustainable development, provide access to justice for all and build effective, accountable and inclusive institutions at all levels
	• Strengthen the means of implementation and revitalize the Global Partnership for Sustainable Development

4.8 Measuring Economic Development

4.8.1 Single Indicators of Development

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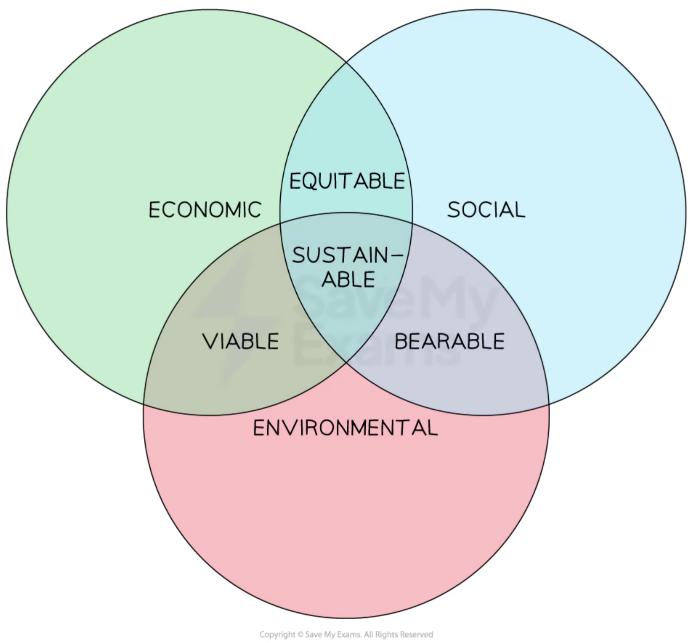
The Multidimensional Nature of Economic Development

- The **17 Sustainable Development Goals** demonstrate the complexity of the nature of economic development
- The different elements can be separated into three categories: **economic, social and environmental**
- **Sustainable economic development** occurs at the intersection of all three and is represented in the diagram below



Sustainable economic development is a multi-dimensional concept incorporating economic growth, environmental care and social progress

- **Viable** refers to the fact that the combination of economic and environmental progress is happening with some care, however it is not sustainable in the long term
- **Bearable** refers to the fact that the interaction of society and the environment is happening with some thought, however it is still not sustainable in the long term
- **Equitable** refers to the fact that the interaction of the economy and society is happening with some attention to well-being, however it is still not sustainable in the long term

- Due to this complexity, elements of economic development can be measured using single or composite indicators

Single Indicators of Economic Development

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- A single indicator is one factor, such as GDP per person (capita), used to measure the development of a country
- Single indicators measures only one development characteristic within a country

1, GDP/GNI per person (per capita) at PPP

- **Real GDP** is the **value of all goods/services** produced in an economy in a **one-year** period - and **adjusted for inflation**
  - For example, if **nominal GDP** is £100bn and **inflation is 10%** then **real GDP** is £90bn

- **GDP per capita** = GDP / the population
  - It shows the **mean wealth** of each citizen in a country
  - This makes it easier to compare **standards of living** between countries:
    - For example, Switzerland has a much higher GDP/capita than Burundi

- **Gross national income (GNI)** measures the **income** earned by citizens operating **outside of the country + the GDP**
  - Many citizens **employ their resources** outside of a country's borders - and then send the income home

- **Purchasing power parity (PPP)** is a **conversion factor** that can be applied to GDP, GNI and GNP
  - PPP calculates the relative **purchasing power** of different currencies
  - It shows the number of **units of a country's currency** that are required to buy a product in the **local economy**, as $1 would buy of the **same product** in the **USA**
  - The **aim of PPP** is to help make a more accurate **standard of living comparison** between countries where goods/services cost **different amounts**

- Using **real GDP/Capita** provides better information than real GDP as it takes **population differences** into account
- Using **real GNI/capita** is a more realistic metric for analysing the **income available per person than GDP/capita**
- Using **GDP/GNI per person (per capita) at PPP** allows for comparisons between countries which take into account the substantial differences in the cost of living

2. Health and education indicators

- Multiple single indicators for health and education can **provide useful data for comparisons** between countries
- Typical **single health indicators** include:
  - Infant mortality rate
  - Life expectancy
  - Number of doctors per 1,000 of the population
  - Diabetes incidence
- Typical **single education indicators** include:

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- Youth literacy rate
- Adult literacy rate
- Mean years in school
- Ratio girls/boys in school
- Math achievement 8th grade

3. Economic/social inequality indicators

- Typical single **economic and societal indicators** include:
  - The Gini Coefficient
  - Murders per 1000 of the population
  - Percentage of women in national parliaments

4. Energy indicators

- Typical **single energy indicators** include:
  - Coal consumption per person
  - Electricity generation per person
  - Residential electricity usage
  - Oil consumption per person

5. Environmental indicators

- Typical **single environmental indicators** include:
  - CO2 emissions per person
  - Total CO2 emissions
  - Agricultural water withdrawal
  - Primary forest area

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4.8.2 Composite Indicators of Development

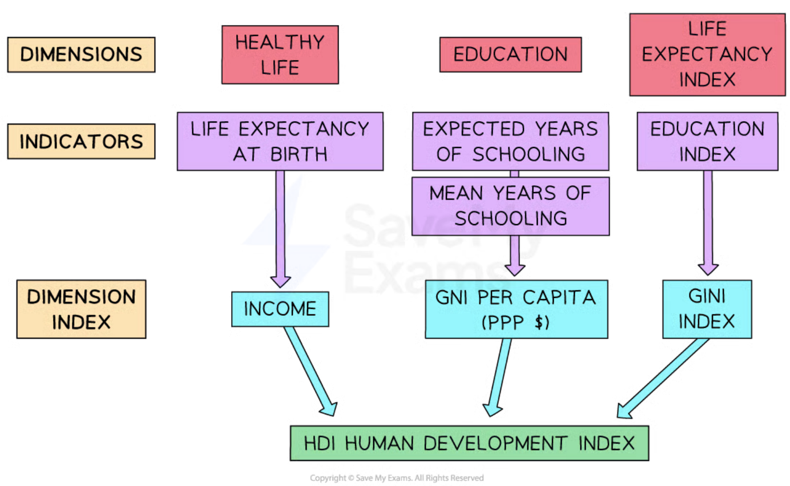
The Human Development Index (HDI)

- **Economic development** is the sustainable increase in living standards for a country, typically characterised by increases in life span, education levels, & income

- Composite indicators include indicators such as the Human Development Index (HDI), the Gender Inequality Index (GII), Inequality Adjusted Human Development Index (IHDI), and the Happy Planet index (HPI)

The Human Development Index (HDI)

- Developed by the United Nations, it is a combination of 3 indicators



The components of the Human Development Index

1. **Health**, as measured by the life expectancy at birth e.g.in 2019 it was 81.2 years in the UK
2. **Education**, as measured by a combination of the **mean** years of schooling that 25 year old's have received, together with the **expected years** of schooling for a pre-school child
3. **Income**, as measured by the real gross national income per capita at purchasing power parity (PPP)

- Each indicator is given **equal weighting** in the index
- The index ranks countries on a score between 0 & 1
  - The closer to 1, the **higher the level of economic development** & the better the **standard of living**

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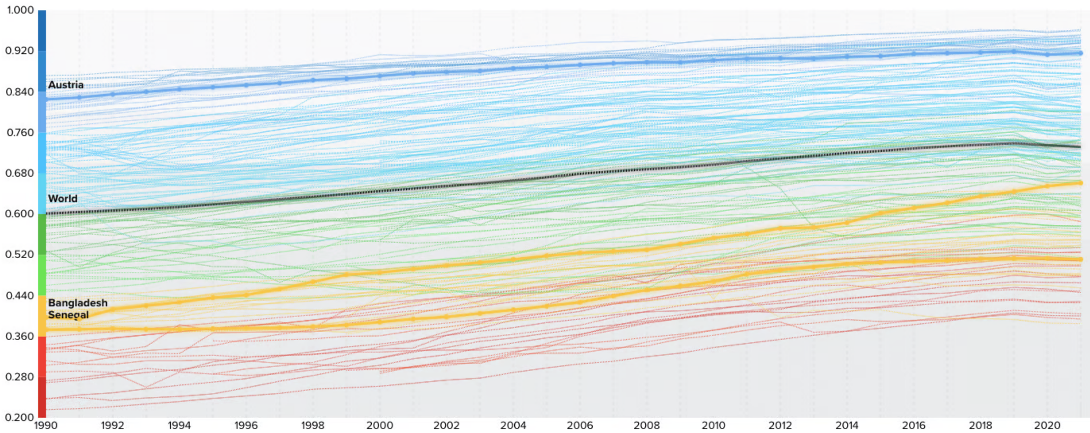

The Human Development Index scores from 1990 to 2021 (Source: UNDP Data Centre)

- A value of < 0.550 is considered **low development** e.g. Senegal was at 0.514 in 2021
- A value of 0.550–0.699 is considered **medium development** e.g.Bangladesh was at 0.667 in 2021
- A value of 0.700–0.799 is considered **high development** e.g Thailand was at 0.777 in 2021
- A value ≥ 0.800 is considered **very high development** e.g. Austria was at 0.918 in 2021

Inequality adjusted Human Development Index (IHDI)

- Created in 2010 to deal with the lack of information that the HDI provides on **inequality**
- The IHDI will be **equal** to the HDI value when there is **no inequality**, but falls below the HDI value as inequality rises
- This means that the IHDI measures the level of human development when **inequality** is accounted for
- The difference between the HDI and IHDI can be expressed as a percentage and represents the loss in **potential human development** due to inequality
- It provides greater insight into the **differences in human development** that exist in a country as opposed to the average human development

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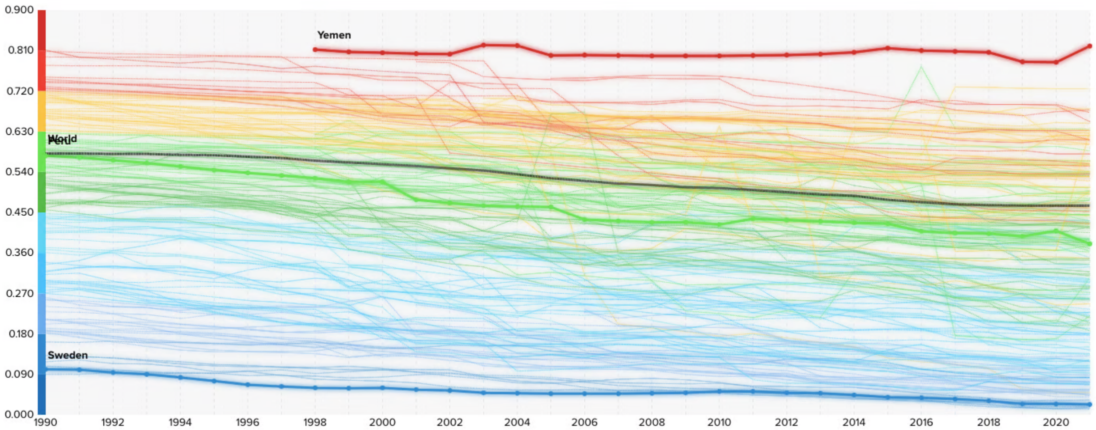
Gender Inequality Index (GII)

- The **Gender Inequality Index (GII)** measures gender inequality using three dimensions:
  - Reproductive health
  - Empowerment
  - The labour market
- Countries are graded on a scale of 0→1
  - The **lower the value** the better the inequality between men and women, and vice-versa



Sweden, Peru and Yemen all score vastly differently on the GII index with Sweden the most equal and Yemen the least equal (Source: UNDP Data Centre)

Happy Planet Index (HPI)

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- The Happy Planet Index (HPI) attempts to measure sustainable wellbeing
- Countries are ranked by how efficiently they deliver long, happy lives using the earth's scarce resources in a sustainable way
- The HPI scores countries with a lower ecological footprint higher than countries with more environmental degradation
- The HPI measures a country's progress using three variables
  - Wellbeing
  - Life expectancy
  - Ecological footprint

- $\text{HPI Score} = \dfrac{\text{wellbeing} \times \text{life expectancy}}{\text{ecological footprint}}$

RANK	COUNTRY	LIFE EXPECTANCY	WELL BEING	ECOLOGICAL FOOTPRINT	HPI SCORE
1	COSTA RICA	80.4 years	7.00/10	2.65 gha/p	62.1
2	VANUATU	70.5 years	6.96/10	1.62 gha/p	60.4
3	COLOMBIA	77.3 years	6.35/10	1.90 gha/p	60.2
150	CENTRAL AFRICAN REPUBLIC	53.3 years	3.08/10	1.21 gha/p	25.2
151	MONGOLIA	69.9 years	5.56/10	10.08 gha/p	24.5
152	QATAR	80.2 years	6.37/10	15.04 gha/p	24.3

The top 3 and bottom 3 countries on the HPI in December 2022 (Source: Happy Planet Index)

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4.8.3 Evaluating the Different Approaches

Evaluating the Different Approaches used to Measure Development

- All **development indicators** have limitations
- Due to the **multi-dimensional nature** of economic development, it is necessary to use a **range of indicators** in order to gain insights into the many dimensions of quality of life, well-being, human development and happiness
- **Composite indicators** provide better insight than single indicators
- Single indicators can be useful in targeting just one aspect - or in **prioritising different aspects** of development
- **Qualitative data** is used to measure many aspects of economic development and this can be subject to bias and errors in data interpretation
- It requires **time** to gather qualitative data and this means that the data often lags reality by several years
- **Data collection and statistical reporting** is subject to political agendas and often the data presented has to be questioned in light of these e.g. many Middle East countries moved from the bottom third to the top third in the Gender Inequality index (GII) in 2017, a very unlikely transition in such a short time period

The Advantages and Disadvantages of Using the HDI

Advantages	Disadvantages
• It is a composite indicator which provides a **more useful** comparison metric than single indicators do • It incorporates three of the **most important metrics** for households i.e. health, education and income • It is widely used all over the world which provides an opportunity for **meaningful comparisons** • It provides a goal for governments to use when developing their policies e.g. it may help identify that the education levels are holding back improvements to the HDI and **government policy** can target that • It provides citizens with an understanding of how their **quality of life** compares to other countries	• It does not measure the **inequality** that exists as it uses the mean GNI/capita • It does not measure or compare the levels of absolute and relative poverty that exist • For many countries it does not provide useful **short-term information** as gathering the data required for the calculation is difficult. This means the **data often lags reality** by several years

The Relationship Between Economic Growth & Economic Development

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- Data shows that economic growth often has a very positive impact on economic development
- Economic growth can lead to higher income, however, the **equity in the distribution of this income** influences the level of economic development that occurs as a result
  - Where the equity in distribution is higher, economic development is greater
  - Where the equity in distribution is lower, economic development is lower
- In most cases **growth precedes development**, but his is not always true e.g. Bangladesh used a range of strategies (including micro-finance) to transform the quality of life for many households
- In some cases (usually in developing countries) economic growth is tied to **one industry** & generates so many negative externalities of production that the standard of living **decreases** for many even as growth increases

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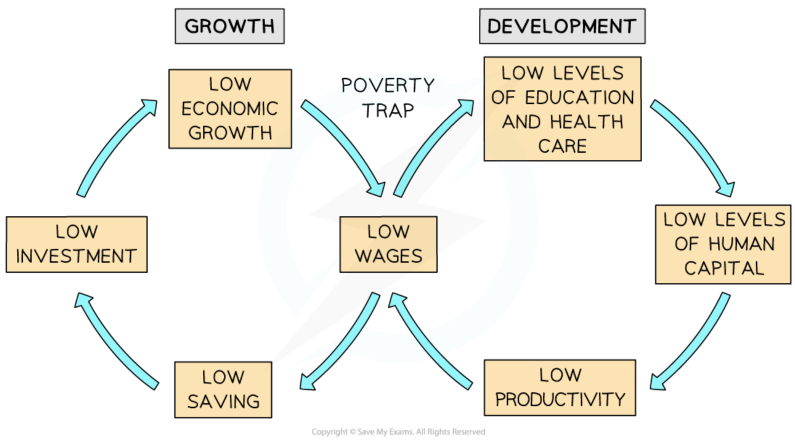
4.9 Barriers to Economic Growth & Development

4.9.1 Poverty Traps

Understanding Poverty Traps

- There are many **causes of poverty.** However, poor countries have several **common characteristics** which can be summarised in a **poverty cycle diagram**



Poverty is caused by a lack of both economic growth and human development

Development

- **Low wages:** represent the intersection of economic growth and human development and are the major cause of poverty
    - Low wages are usually the result of **unemployment**, informal employment, a lack of skills, or a primary sector based economy

- **Low levels of education and healthcare:** cost money and with lower wage levels these are not accessible
    - People find it harder to stay well or to **recover from illness**

- **Low levels of human capital:** low education and healthcare lead to low levels of human capital, which reduces productivity

- **Low productivity:** results in low wages and the cycle continues

Growth

- **Low wages:** represent the intersection of economic growth and human development and are the major cause of poverty

- **Low saving:** with low wage levels it is much harder to save as any money is spent on necessities

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- **Low investment:** savings drive investment as firms are able to borrow money from commercial banks. Low levels of savings mean that banks have less money available for investment
- **Low economic growth:** low levels of investment hold back productivity and economic growth

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Types of Economic Barriers

Economic Factors that Influence Growth & Development

Factor	Explanation

Dependency on the primary sector	• In 2022 copper exports from Zambia accounted for 70% of their total exports & **primary products** in excess of 90%. They are suffering from over-specialisation
	• Primary products tend to have a very low-income **elasticity of demand (YED).** As world income rises, there is a less-than-proportional increase in demand
	  ◦ This means that there is limited scope to continue increasing demand
	• Primary products have very little added value
	  ◦ Exporting **manufactured products** raises the added value, income & profits
	
	• Due to the inelastic nature of both the demand & supply of commodities, small changes in demand or supply can lead to large changes in price, meaning that prices can be volatile
	  ◦ When commodity prices rise, **GDP rises** - & vice versa

Rising income inequality	• A **more equal distribution** of income means that more households are able to consume a wider range of goods ◦ Economies with a smaller **medium-income band** face less consumption which leads to less aggregate demand and less economic growth • Rising income inequality worsens the problem as the rich get richer and the poor, **relatively poorer**
Lack of access to international markets	• **International trade** is a significant source of economic growth and higher incomes, leading to economic development • Many countries **cannot access** more economically developed markets due to the trade barriers put in place by developed economies to protect their firms • The **World Trade Organisation (WTO)** aims to increase trade liberalisation so as to improve access for all countries

Informal economy	• Workers in the informal economy are not taxed on their wages • The **lack of tax revenue** reduces the provision of infrastructure, merit and public goods • Many developing countries have a larger informal than the formal economy
Capital flight	• Occurs when money or assets **rapidly leave** a country • This may happen due to political upheaval, economic sanctions, war, or changes to government policy (e.g. interest rates) ◦ Sanctions applied to Russia in 2022 resulted in $75 billion of **capital outflows** • Capital flight reduces the money available for **investment,** reducing growth & development
Indebtedness	• The higher the level of borrowing from institutions like the **International Monetary Fund (IMF)**, the higher the monthly repayments • Repaying debt reduces the money available for investment and expenditure on merit and public goods • The higher the debt the worse the **potential economic growth**
Lack of access to infrastructure & appropriate technology	• Good infrastructure **reduces business costs** & attracts foreign direct investment • Some developing countries have such **poor infrastructure** which makes it difficult to generate economic activity ◦ This is one reason why China has invested so heavily in infrastructure projects in Asia & Africa as it unlocks **economic potential**
Low levels of human capital	• Low levels of education and healthcare reduce productivity • Investing in **supply-side policy** to improve health and education increases the potential output of the country (shifts the **production possibility frontier** outwards) • Higher education/skill levels → higher human capital → increased productivity → higher output → higher economic growth → higher income

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Geography including landlocked countries	• Geographic features can limit economic growth • **Landlocked countries** find it harder/more expensive to import and export products (shipping freight is much cheaper than air freight) • Natural features such as **deserts** reduce the quantity of **productive land** that can be used to generate output and economic growth
Tropical climates and endemic diseases	• Tropical climates are often associated with **debilitating diseases** such as malaria or dengue • These reduce the **productivity** and output of the workforce and limit/reduce economic growth

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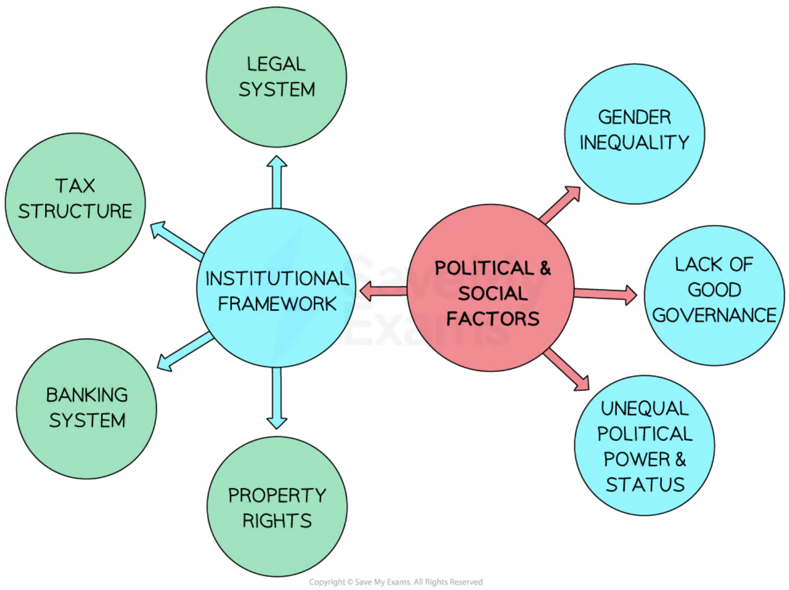
Types of Political & Social Barriers

- Aside from the economic factors discussed above, a range of non-economic factors can have significant influences on economic growth & development



Political & social factors which hinder growth & development

The institutional framework

- This refers to the **functions of government** including the legal system, law enforcement, banking, tax structures and property rights

Legal system	• A strong legal system **builds confidence** in an economy • Legal institutions help to create boundaries that households and firms can operate within • This certainty attracts **overseas investment** • This certainty helps to make **business easier** to conduct leading to higher economic growth
Tax structure	• A **progressive tax system** redistributes from those with higher income to those with lower income & reduces **income inequality** • Sometimes the benefits of a good **progressive tax** system are eradicated by weak tax collection and tax enforcement

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Banking system	• Lack of access to **credit and banking** limits economic growth • Financial institutions enable individuals & firms to **borrow money** which can be used for investment or to generate growth • A lack of financial institutions prevents this from happening
Property rights	• In many countries, the property is the main household asset which can be used to secure loans or generate income • A lack of property rights in some **developing countries** prevents this from happening

Lack of good governance

- Leads to inefficient use of resources & poor decision-making. It may also result in laws/regulation which directly inhibits growth & development
- Often money intended for investment is siphoned off by corrupt politicians resulting in a lower level of investment. Corruption also **diverts funds** to certain groups who have bribed or lobbied officials (e.g. multinational firms) resulting in projects that deliver a **low level of growth & development**

Unequal political power & status

- Countries with strong trade union membership provide workers with more power and higher levels of income
- With low trade union membership, the **exploitation** of workers through low wages is easier and income inequality is worse
- Countries with a class system are less incentivised to increase economic growth and development in such a way that it removes the class barriers. This limits growth and development

Gender inequality

- Gender, race or **any other discrimination** increases income inequality in an economy leading to lower levels of economic growth
- Gender inequality **reduces the incentive** for women to work and this can mean a loss of productivity to an economy, leading to lower economic growth

Evaluating Barriers to Growth & Development

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- There are a **common set of factors** which prohibit economic growth and development, however, each country is unique and is likely to have a different combination of factors which are more prominent

- Understanding **the context** of the country is vital to evaluating how significant the barrier to economic growth is
  - E.g. Romania has a **history of corruption** which has reduced its development significantly when compared to other Eastern European countries
  - E.g. India has had **infrastructure problems** (old rail systems and poor roads) which have limited its ability to grow. To address this weakness, significant government investment has been taking place over the past 10 years and the economy is responding well
  - E.g. Malawi is a landlocked country whose exports are primarily agricultural. Agriculture accounts for 30% of its GDP and the cost of export is higher for a landlocked country. This reduces profits and limits economic growth.

Exam Tip

The data response in paper will frequently have extracts which paint a picture of a developing economy. As you read through the data, think about the **economic, political and social barriers** to development and growth and seek to identify which ones seem to be most prominent in the extracts presented. Reading with this focus helps you to evaluate the context as you assimilate the information and puts you in a better position to answer the questions which follow.

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4.10 Economic Growth & Development Strategies

4.10.1 Trade Strategies, Diversification & Social Enterprise

Trade Strategies

- Increasing international trade helps to increase economic growth and development
- Four of the most commonly used strategies to increase international trade include **import substitution, export promotion, economic integration and diversification**

Strategies to Increase International Trade

Strategy	Explanation	Advantages	Disadvantages
Import substitution	• Aims to **increase domestic production** and output by moving consumers away from imports **by using tariffs or quotas** to increase import prices. This encourages them to buy locally	• Less dependence on imports • May increase employment in the country • Supports **local firms**	• Higher prices and **less choice** for consumers • Possibility of **retaliation** from other countries • Distorts the efficient **allocation of resources** as more inefficient domestic firms increase production • May **raises costs** for manufacturers who depend on imported components
Export promotion	• Aims to increase the level of exports through **subsidies** or facilitating international trade fairs at which local firms can connect with **international buyers**	• Greater output generates higher economies of scale • Greater output creates more employment • National **specialisation** increases • **International competition** leads to innovation and increased efficiency	• Some firms may be unable to compete internationally and fail • There is an opportunity cost to the government for supporting firms through export promotion

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Economic integration	• A process in which countries become **more interdependent** as they form an agreement which **decreases barriers to trade** (tariffs, quotas etc.) and increasing common fiscal and/or monetary policies	• **Decreases prices** and increases choice • Access to a wider range of technology • More political cooperation between countries • **Expands markets** for domestic firms • Generates **higher efficiency** in the global allocation of resources	• Some loss of national sovereignty may occur • Some integration requires **common barriers** (e.g. tariffs) to be erected to third part nations which may limit other opportunities for increasing trade
Increasing diversification	• Occurs when a country is able to increase the number of products that it offers for export and this **reduces risk** - if one product fails others may well still be successful	• Reduces the problems associated with **over specialisation** such as price volatility (e.g. in 2019, 71% of Zambia's exports were copper and it's GDP is significantly influenced by the price of copper) • Creates **new employment opportunities** • Reduces risk of failure during recessions or periods of economic slowdown	• Firms may fail to compete as **global competitors** may be well established • It takes **time and money** to create new industries

Social Enterprise	• A social enterprise focuses on meeting specific social objectives such as worker welfare, or profit sharing with workers, or **providing equal ownership** of the business to employees e.g Bouwland Wines in Stellenbosch, South Africa gave equal ownership shares to its 60 employees	• Raises **motivation**, productivity and output • Can create new **employment** opportunities • Raises **income** within the communities	• These ventures tend to be small and very **localised** • It can be difficult for them to generate economies of scale or to compete internationally

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4.10.2 Market-Based & Interventionist Policies

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Market-Based Policies

- **Market-based strategies** create the conditions for private individuals & firms to pursue an economic activity with the aim of **maximising output and profit**

Market-based Strategies to Generate Economic Growth & Development

Strategy	Explanation	Advantages	Disadvantages
Trade liberalisation	• Removing the barriers to international trade such as tariffs, quotas etc.	• More trade increases output, employment & incomes • Lowers **costs of production** for firms • May result in lower prices for consumers • More efficient global allocation of resources	• Global competition intensifies and some firms may fail • There may be an element of structural unemployment as inefficient industries die out

Privatisation	• Government firms are usually so big that private enterprise refrains from trying to compete with them. Privatisation encourages new firms to enter the market & compete, thus increasing the **total supply** in the economy	• May increase **competition** leading to an increase in output, employment & incomes • Private firms may be **more efficient** than government firms • Competition may result in **cheaper prices** for consumers • The money from the sale of assets can be used to provide more merit and public goods	• Government assets are often sold off cheaply at prices below **fair market value** • The quality of services may deteriorate as private firms focus on profit maximisation • **Unemployment** may increase as private firms seek to cut their wages in order to maximise profits • Prices may actually **rise** as firms provide a **monopoly service** e.g. rail travel
Deregulation	• This is the process of removing **government controls/laws** from markets in order to increase competition	• Any regulation increases costs of production for firms and **deregulation decreases costs** which may result in greater supply • Less regulation may result in **innovation and more enterprise** in an economy	• Deregulation may create an environment of **corruption** leading to inefficiency • Deregulation may increase the quantity of **negative externalities** • Deregulation may allow foreign firms to monopolise industry within the nation, leading to **higher prices and less output**

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Interventionist Policies

- **Interventionist strategies** are put in place by governments to correct the **failings** of the free market and promote the **welfare/development** of its citizens
- Interventionist strategies aim to increase human capital, productivity and output

Interventionist Strategies to Generate Economic Growth & Development

Strategy	Explanation	Advantages	Disadvantages
Tax policies	• A **progressive tax system** redistributes from those with higher income to those with lower income & reduces **income inequality**	• Redistribution often starts with the provision of **free education & healthcare** paid for from tax revenue • Tax revenue provides the means of supporting **poorer households** and the unemployed	• Sometimes, the benefits of a good progressive tax system are eradicated by the penalties imposed through multiple regressive (indirect) taxes • If the tax burden is too high it may become a **disincentive** to work
Transfer payments	• Transfer payments are usually given to the **poorest & most vulnerable** people in society and include **unemployment & disability payments**, pension payments, heating discounts, public transport subsidies etc.	• The poorest households are supported • Money received from transfer payments generates **consumption** in the economy and increases aggregate demand	• Poorer countries have less money available to support the poor • There is an **opportunity cost** for the government associated with each transfer payment • Supporting the poor makes **good economic sense** but is sometimes politically unpopular

Minimum wages	• **Minimum wages** are set above the free market rate and firms are not allowed to pay anyone less than the **legal rate**	• Workers receive higher wages and have more **disposable income** • Consumption increases leading to increased aggregate demand • **Standard of living** increases with higher income	• **Costs of production** for firms increase, possibly leading to less international competitiveness • With higher costs of production, output may fall leading to **increased unemployment**

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Provision of Merit Goods

- Merit goods are **beneficial to society** but are **under-provided** in a market
- Governments often have to **subsidise** these goods in order to lower the price and/or increase the provision
- The provision of merit goods can result in significant improvements to human development and quality of life

The Provision of Merit Goods to Aid Economic Growth & Development

Strategy	Explanation	Advantages	Disadvantages
Education programs	• These include pre-school, primary, secondary and tertiary education programs which are **free at the point of consumption**, but paid for with tax revenue	• Education helps to intervene and break the **poverty trap** by increasing human capital • Increased human capital results in higher productivity and output • Higher output can lead to **higher wages** which improve the standard of living • Higher wages may lead to more **consumption** and an increase in aggregate demand	• Education programs take a **long time** before there is an increase in productivity • There is an **opportunity cost** associated with the provision of education • Education may still be **under consumed in developing nations** as children are required to work for the family: family survival depends on the income they generate

Health programs	• These range from emergency-only healthcare to full healthcare and preventative healthcare (e.g. cancer screening) programs, which are **free at the point of consumption**, but paid for with tax revenue	• **Universal access to vaccinations** can improve life expectancy and productivity significantly • Improved health care helps to break the poverty trap	• Each health care intervention by the **government requires expenditure** and so carries an opportunity cost • How much health care should be provided is a normative issue and is subject to **political pressure and ideology**
Infrastructure projects	• Infrastructure - including energy, transport, telecommunications, clean water and sanitation -	• Infrastructure can play a direct role in improving the **health and standard of living** • Telecommunications speed up the flow of information and **exchange of knowledge and ideas** which can directly help to improve human capital and the standard of living • Access to energy has a significant **effect on productivity** e.g. the opportunity cost of previously spending time looking for heating fuel can now be used more productively	• Each infrastructure project requires significant **government spending** and so carries an opportunity cost • Infrastructure projects may take a long time to complete • Infrastructure projects are subject to **political pressure** and lobbying

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Inward Foreign Direct Investment (FDI)

- Inward FDI occurs when investment by foreign firms results in more than a **10% share of ownership** of domestic firms
- Foreign FDI has the potential to **generate significant economic growth** as more economic activity, employment and output is generated
- Foreign FDI has the **potential to raise household income** which helps to break the poverty cycle
- The impact of FDI on economic growth depends on **how the FDI occurs**
  - E.g. Chinese firms frequently invest overseas, but bring their own employees with them - and send all of their profits home - the economy and individuals within the economy benefit less than they could have
  - E.g. Indian firms frequently invest overseas and tend to hire local employees and reinvest more of the profits than Chinese firms generally do

Advantages and Disadvantages of FDI to Generate Economic Growth and Development

Advantages of FDI	Disadvantages of FDI
• FDI can be a major **source of finance** in less economically developed countries • FDI helps to generate extra national income which can increase the level of **savings** - and higher savings can help to increase funds available for domestic investment • Expansion of supply can lead to **increased employment** opportunities • The government may receive **higher tax revenue** generated by the increased profits from the additional level of national output • As more foreign firms invest, governments often start to develop **new infrastructure** to support their business activity	• Weak local regulations are often exploited leading to poor working conditions and increased negative externality's of production • **Profits** tend to be moved off-shore or returned to the home country of the multinational firms which means that less is reinvested back into the development of the host nation • Multinational firms often pay very little tax to host nations as they use **sophisticated corporate practices** to reduce the amount of tax they are liable for (e.g.transfer pricing) • Local firms may **struggle to compete** with multinational firms who are now based in their country - and they go out of business • Multinationals are likely to have the power to keep **wages low** • Multinationals may use workers from their country for **management roles** and only employ local unskilled labour for manual tasks. The workers may not develop many new skills from the role

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4.10.4 Foreign Aid & Development Assistance

Foreign Aid

- Foreign aid is often offered to developing nations in several different forms, including:
  - Humanitarian/development aid
  - Debt relief
  - Official Development Assistance (ODA)
  - Non-governmental organizations (NGOs)

- **Contextual factors** can influence the effectiveness of any of these and some that work well in one context may be less effective in another

1. Humanitarian/development aid

- Two of the most common forms are grants & soft loans

An Evaluation of Humanitarian Aid

Advantages	Disadvantages
• Aid has proven beneficial in times of distress • It is particularly helpful in response to large-scale one-off events such as earthquakes or tsunamis	• Critics argue that aid **breeds dependency**, corruption & disincentivises individual responsibility ◦ E.g. The Central African Republic receives **ongoing food aid**

2. Debt relief

- Many developing nations have borrowed significant sums of money in the past which have to be **repaid (with interest)** over a long period of time
- The opportunity cost of these repayments is significant & often includes
  - Loss of infrastructure development
  - Inability to create a welfare system
  - Investment in human capital/education
- Countries began to default on their loans in 1982 (Mexico was the first) & this has led to the **restructuring** of these loans to make it more affordable
- More recently there has been significant progress in **writing off** the entire debt of the most **heavily indebted poor countries (HIPC)** so that they can focus on building their economies

An Evaluation of Debt Relief

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Advantages	Disadvantages
• The actual repayment of debt is removed or reduced • The opportunity cost of **debt repayments** is reduced or eliminated • The Government is able to use the money saved to provide new services and additional public/merit goods	• The country may have a lot more funds available than ever before and this can breed corruption as individuals in government seek to get their hands on it • Once the debt is forgiven, many **developing nations** borrow more money and the cycle starts again

3. Official development assistance (ODA)

- ODA can be **bilateral** (from donor government to recipient government) or provided through a **multilateral**
  development agency, such as the United Nations
- Two of the most common forms of ODA are grants & soft loans
- The United Nations has set a target for **more economically developed countries** to spend 0.7 per% of their gross domestic product (GDP) on ODA to help countries eliminate poverty and become developed

An Evaluation of ODA

Advantages	Disadvantages
• Funds are available to the LEDC over a long-term period to help with the economic development goals • Bilateral ODA can help to develop the relationship between the two countries, possibly **facilitating the exchange** of resources, ideas and technology	• Countries may become dependent on the ODA • **Corruption** may mean funds are diverted from their true purpose • ODA in the form of loans has to be repaid and these repayments carry an opportunity cost

4. Non-governmental organizations (NGOs)

- These are typically **voluntary**, community-based organisations which do not aim to make a profit but seek to meet a need or **provide a service**
- They operate locally, nationally and/or internationally
- With a community based emphasis, they are able to
  - Engage in **small scale projects** giving control to community stakeholders

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- Draw on local skills
- Encourage sustainability & remove the need for **aid**
- Tackle **environmental sustainability** using local knowledge & resources

- NGOs have played a major role in many LEDCs and their **aid often comes with fewer conditions** or expectations than ODA
- Examples of NGOs include Oxfam International, Save the Children International and World Vision International

An Evaluation of NGOs

Advantages	Disadvantages
• NGOs can elicit support for particular need from a very wide audience including the **global public** and many wealthy governments • They often have **specialists working for them** who provide in country support so as to increase the efficiency of their aid • They conduct research, gather data and as a result often make **highly specific project proposals** aimed at directly improving the standard of living • NGOs can help develop **human skills** in the countries in which they work and this helps to break the poverty trap	• The country receiving the aid can become overly dependent on it • The scope of what an NGO can do may be limited or only **focussed on one segment** of the population e.g children

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Multilateral Development Assistance

- **Multilateral organisations** are made up of member governments from around the world
  - They pool their resources together which enables large-scale development programmes to be funded
- **The World Bank** and the **International Monetary Fund (IMF)** play an active role in providing multilateral development assistance

An Explanation of Organisations that Assist in Development

Organisation	Explanation of what they do
World Bank	• Founded in 1944 as the International Bank for Reconstruction and Development to fund **postwar redevelopment** • They provide **reconstruction loans** to countries devastated by war • They **provide loans** to developing countries to aid in their development • They provide loans to countries to assist with the development of infrastructure • They work with governments and institutions so as to encourage **economic reform** and trade liberalisation
International Monetary Fund (IMF)	• Founded in 1944 with the aim of establishing a **stable global financial system** that could help with postwar reconstruction efforts and better deal with challenges such as the **Great Depression** of the 1930s • John Maynard Keynes was one of two founders • They aim to facilitate a stable global financial system • They oversee exchange rates and the system of international payments that occurs between nations and individuals • They **monitor** country policies and national, regional and global economic and financial developments through a formal system known as **surveillance** • They provide member countries with currency to help deal with **balance of payments** problems

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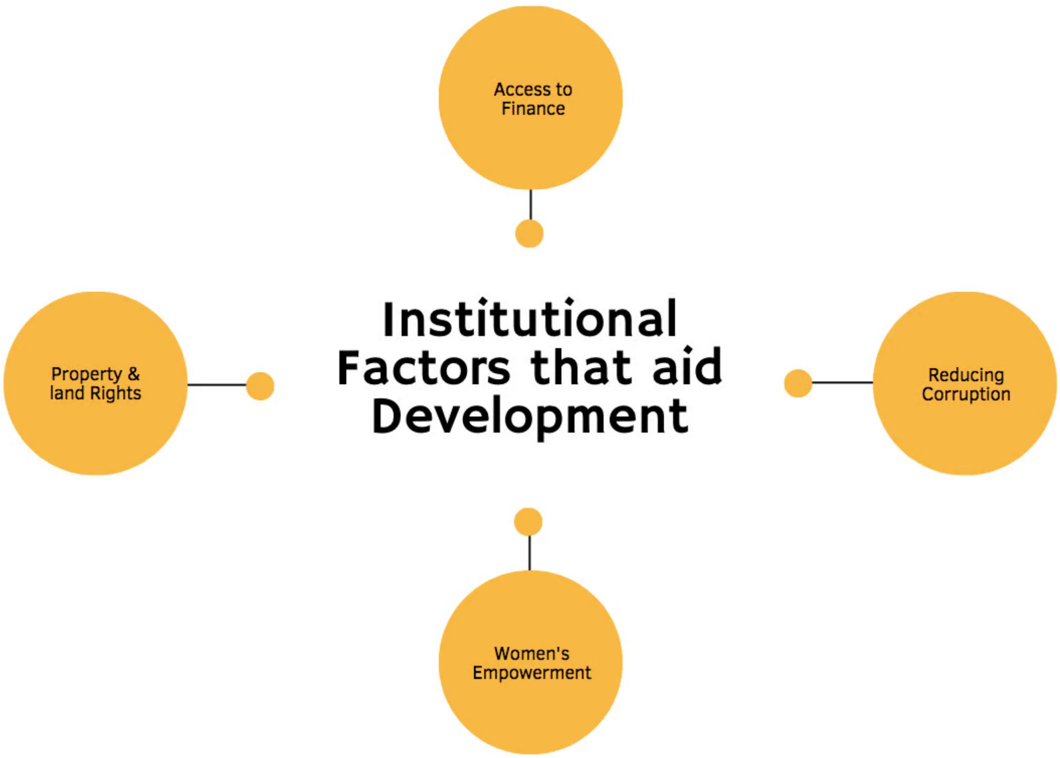
4.10.5 Institutional Change

Changing Institutional Factors

- **Sound institutions,** free from corruption and well-established help a country to progress in human development



Strong institutions help to create an environment that generates significant human development and economic growth

1. Access to credit and banking (finance)

- Financial institutions enable individuals and firms to **borrow money** which can be used for investment or to generate growth
- A lack of financial institutions prevents this from happening and causes the poverty trap to continue

- **Mobile banking** has increased significantly in most developing countries
  - This allows customers to conduct financial transactions more easily and facilitates a flow of finance in more remote areas

- Microfinance has been very successful in breaking the poverty trap for some households in LEDCs
  - **The Grameen Bank** pioneered the use of microfinance in Bangladesh and the country saw significant gains in economic development

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The Advantages and Disadvantages of Microfinance

Advantages	Disadvantages
• Small but meaningful loans can be made to poor households to help them **start a business** • The loans can be **targeted at women** • Running a business improves **human capital** and also raises income • Loan repayment helps to build **self esteem**	• Some loans are not repaid (a very small %) • Some **microfinance organisations** raise money from private donors and have been criticised for taking high management fees and salaries e.g. Kiva

2. Property and land rights

- In many countries, property is the main household asset which can be used to secure loans or generate income
- A lack of property rights in some **developing countries** prevents this from happening and causes the poverty trap to continue

The Advantages and Disadvantages of Permitting Property Rights

Advantages	Disadvantages
• The more certain the **legal protection of property rights**, the easier it is for households to access loans • Property rights also provide **shelter security** • Property rights help households to **generate income**	• The issuing of property rights can lead to **property monopolies** over time as wealthier individuals purchase multiple properties • Property monopolies could reduce the amount of property available for purchase or rent - and **raise housing or rental prices**

3. Women's empowerment

- **Gender inequality** reduces the incentive for women to enter the workforce resulting in a smaller production possibility curve for the nation
    - This represent a loss of efficiency for a nation
    - Household income is suppressed which worsens the quality of life

- **Increasing women's empowerment** reverses these effects
    - The additional income helps to break the poverty trap in LEDCs

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- Increased opportunity **incentivises young girls** to study harder which helps to close any existing **education gaps** between genders

4. Reducing corruption

- **Corruption** reduces investment, limits economic growth and **affects the pattern of government spending** within a country
  - These consequences of corruption hold back economic development and growth
  - Corruption is often enabled or led by the government or figures in the government

Tackling corruption has the following advantages:

1. There is **more confidence** in the economy and foreign direct investment increases
2. Money allocated to development projects in the country actually gets used for development
3. As national output rises, **tax revenue rises** and the government is able to provide more services, merit goods, and public goods
4. An increase in national output leads to more employment opportunities, which can raise household income

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4.10.6 Evaluating Market Orientated Approaches Versus Government Intervention

Pros & Cons of Market Oriented Approaches

- **Market orientated approaches** aim to reduce government intervention and free up private-sector economic activity so that national output (real GDP) increases
- As national output increases, the potential to break the poverty trap increases and this can lead to better economic development in a nation

Pros and Cons of Market-Orientated Approaches

Pros	Cons
• **Competitiveness:** the more competitive the environment the more **foreign firms** are likely to invest as competition lowers costs and generates innovation • **Efficiency:** Less government intervention should result in better allocation of resources as the process is led by the market forces of demand and supply • **Economic growth:** free markets encourage entrepreneurship in the search of profit and this increases real GDP • **Increased FDI:** Multinational corporations prefer to invest in economies where the markets are more open, where there is less regulation and government intervention • **Trade liberalisation:** Removing the barriers to international trade such as tariffs and quotas increases economic growth, raising household income	• **Increased market failure:** with less government intervention the amount of negative externalities will increase (both production and consumption) • **Development of a dual economy:** Many LEDCs have both a large informal sector and a thriving formal sector based around the activities of multinational corporations which contributes to growing income inequality • **Increasing inequality:** the benefits of free markets are increasingly concentrated in the hands of a few as those with assets continue to buy up the factors of production

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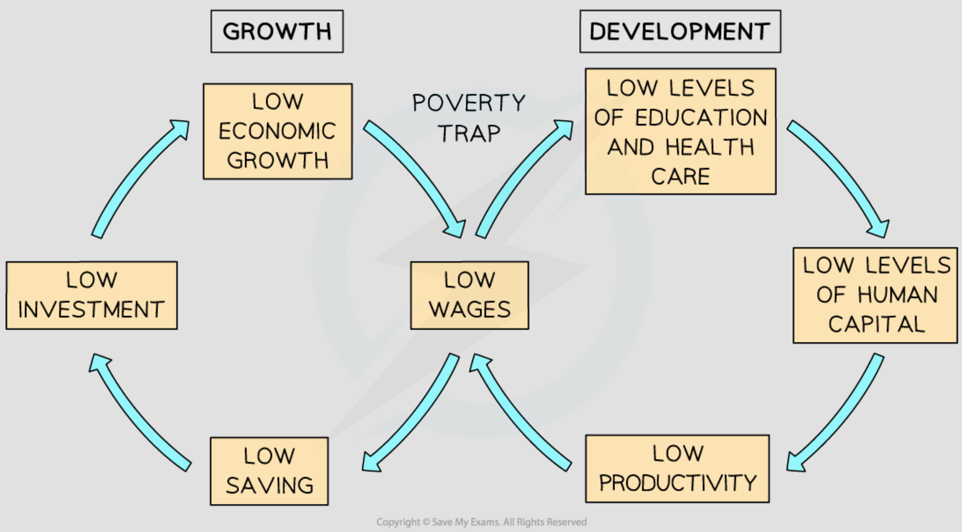
Exam Tip

You will notice a lot of similarities in the lists on this page with the pros and cons of supply-side policy, but there is one distinct difference. When evaluating supply-side policy, the focus is on increasing national output (real GDP). When evaluating pros and cons in the context of economic development, focus on how to market policies have the potential to improve lives and the standard of living.

One way to do this is to always link a policy to the poverty trap diagram - and then explain where the policy would intervene to break the poverty trap. Here is an example



More international trade increases national output → more workers are required to produce this output → employment increases → human capital increases as a result of employment → productivity increases → wages increase → health and education increase → leading to higher human development and a better standard of living

Pros & Cons of Government Intervention

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- **Government intervention** can be vital to the development of its citizens
- Provision of services, merit goods, and public goods enhances the lives of a country's citizens

Pros and Cons of Government Intervention

Pros	Cons
• **Infrastructure:** energy, transport, health and telecommunications infrastructure improves the standard of living • **Investment in human capital:** education increases skills leading to higher productivity in an economy • **Provision of social welfare:** support mechanisms for the most vulnerable in society helps to raise the standard of living • **Stable economic growth:** government intervention can even out the swings in the business cycle • **Reduction in income inequality:** governments are able to regulate the disparity between rich and poor through the use of policies such as progressive taxation • **Institutional systems:** Strong institutions such as police and defence forces can be used to deal with national emergencies such as earthquakes which helps a country to recover more quickly	• **Inefficiencies:** The government focusses on services and not necessarily on generating profit. This can generate inefficiencies in resource allocation and the development of large, overstaffed organisations • **Corruption:** large amounts of money generated through taxation can prove tempting to those managing the budgets leading to the misuse of government funds and other forms of corruption • **Government capture:** powerful business people or large corporations can build such strong relationships with government ministers that they end up controlling the resources through the influence • **Poor planning and decision-making:** politicians are assigned to run departments in which they do to necessarily have any expertise and this can lead to poor planning and decision making • **Fluctuating political agendas:** government terms are relatively short and two party government systems tend to result in wild fluctuations of policy which can create instability

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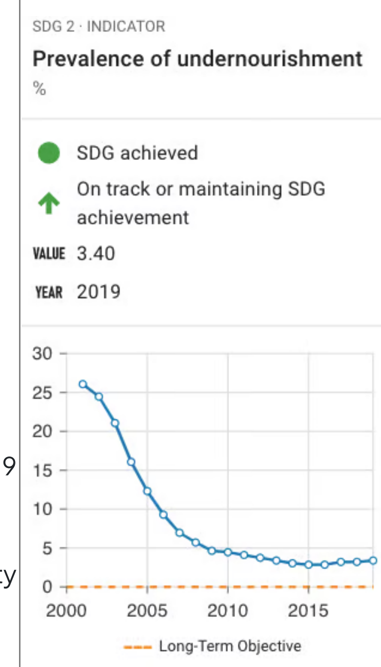
4.10.7 Progress Towards Sustainable Development Goals

Case Study 1 - Armenia

Armenia's Progress Towards Three of the SGDs (Source: SDGIndex.org)

Goal	Progress	Chart
	• **The prevalence of undernourishment** considers the percentage of the population whose food intake is "insufficient to meet dietary energy requirements for a minimum of one year" (SDGIndex) • "Dietary energy requirements are defined as the amount of dietary energy required by an individual to maintain body functions, health and normal activity" (SDGIndex) • There has been **good progress** with the value falling from 27 in 2001 to 3.40 in 2019 • **Undernourishment causes productivity to fall** and it can be assumed that with more nourishment, health and productivity will improve • Since 2015, there has been a **slight increase** in the undernourishment indicator	

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8 DECENT WORK AND ECONOMIC GROWTH	• This metric consider "the percentage of adults, 15 years and older, **who report having an account** (by themselves or with someone else) at a bank or another type of financial institution, or who have personally used a mobile money service within the past 12 months" (SDGIndex) • **Access to banking** increases the ability to make transactions that can improve the standard of living e.g. remote vendors selling agricultural products can receive payment by mobile phone • Between 2014 and 2018 there has been a **significant improvement** in access to banking moving from 20% of the population to 50% • This value is still well below the target but **the data is not current** and judging by the trend, the current percentage could be a lot higher	
16 PEACE, JUSTICE AND STRONG INSTITUTIONS	• The number of **intentional homicides per 100,000 people** • "Intentional homicides are estimates of unlawful homicides purposely inflicted as a result of **domestic disputes and interpersonal violence** and do not include all killing, such as killing in armed conflict" (SDGIndex) • The progress in Armenia between 2000 and 2020 has been erratic • Overall, there is a **positive downward trend** from a value of 3 in 2000 to a value of 1.7 in 2020 • The value peaked in 2008/9 at 3.4	

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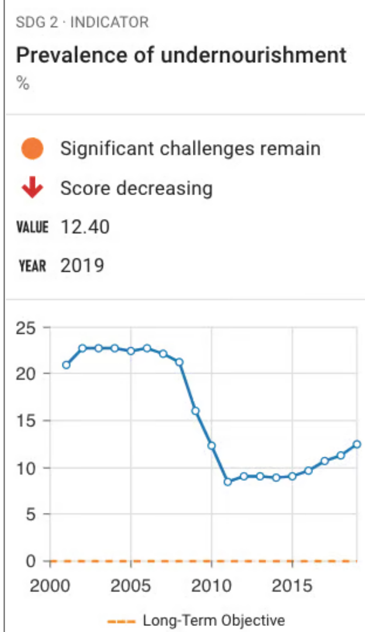
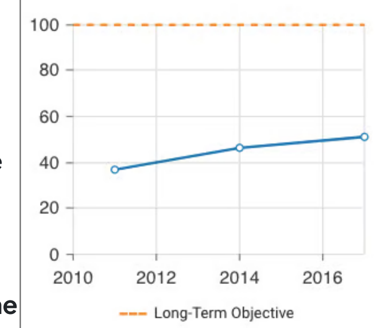
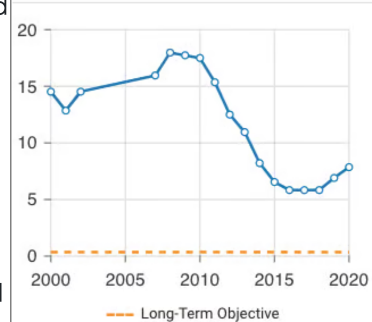
Case Study 2 – Ecuador

Ecuador's Progress Towards Three of the SGDs (Source: SDGIndex.org)

Goal	Progress	Chart
	• **The prevalence of undernourishment** considers the percentage of the population whose food intake is "insufficient to meet dietary energy requirements for a minimum of one year" (SDGIndex) • "Dietary energy requirements are defined as the amount of dietary energy required by an individual to maintain body functions, health and normal activity" (SDGIndex) • Between 2008 and 2011 there was **good progress** with the value falling from 22 to 8 • Undernourishment has been increasing slowly, but steadily since then and in 2020 was at 13 • **Undernourishment causes productivity to fall** and it can be assumed that with increasing undernourishment, health and productivity will worsen	

8 DECENT WORK AND ECONOMIC GROWTH	• This metric considers "the percentage of adults, 15 years and older, **who report having an account** (by themselves or with someone else) at a bank or another type of financial institution, or who have personally used a mobile money service within the past 12 months" (SDGIndex) • **Access to banking** increases the ability to make transactions that can improve the standard of living e.g. remote vendors selling agricultural products can receive payment by mobile phone • Progress is slow. Between 2011 and 2018 there has been a **small improvement** in access to banking moving from 38% of the population to 50% • In the final 4 years the increasing trend was starting to flatten • This value is still well below the target but **the data is not current. However,** judging by the trend, the current percentage is not likely to be much higher	SDG 8 · INDICATOR Adults with an account at a bank or other financial institution or with a mobile-money-service provider % of population aged 15 or over Significant challenges remain Score moderately improving, insufficient to attain goal VALUE 51.25 YEAR 2017 
16 PEACE, JUSTICE AND STRONG INSTITUTIONS	• The number of **intentional homicides per 100,000 people** • "Intentional homicides are estimates of unlawful homicides purposely inflicted as a result of **domestic disputes and interpersonal violence** and do not include all killing, such as killing in armed conflict" (SDGIndex) • The progress in Ecuador between 2000 and 2020 has been mostly positive • It **initially increased** between 2001 and 2007 when it peaked at a value of 18 • Homicides then fell steadily until 2018 with the **lowest recorded value of 6** • Since 2018 there has been a concerning **upward trend** in this value • Overall, there is a **positive downward trend** from a value of 15 in 2000 to a value of 8 in 2020	SDG 16 · INDICATOR Homicides per 100,000 population Major challenges remain Score stagnating or increasing at less than 50% of required rate VALUE 7.78 YEAR 2020 

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