- *Devaluation/depreciation of the country's currency* – this may not be possible where a country employs a floating exchange rate, but nevertheless where it can be used, it makes exports seem more internationally competitive, improving the trade balance

4.1.7.5 Significance of global trade imbalances

→ Like the UK, the USA has experienced large current account deficits, while in contrast China has experienced huge current account surpluses

→ Whether such global imbalances can be sustained in the long-term is a major question

→ On the one hand, if the deficits are easily financed by inflows on the financial account, there may be no cause for concern

→ Further, under a system of floating exchange rates there should be a degree of automatic adjustment

→ On the other hand, continuous deficits by the USA have, in effect, been financed by the Chinese through loans, which may not be sustainable in the long-run

4.1.8 Exchange rates

→ The *nominal exchange rate* is the number of units of the domestic currency that can purchase a unit of a given foreign currency

→ The *real exchange rate* is calculated to measure the movements of the competitiveness of a country's currency vis-à-vis another country's currency on the basis of the inflation differential between the two countries

→ In other words, the real exchange rate is the nominal exchange rate adjusted to reflect the different inflation rates in the countries of the two currencies concerned

→ *Effective exchange rates* are estimated to measure the movements of a country's currency value or average exchange rate in a basket of currencies of trading partner countries

→ A country's *trade-weighted exchange rate* is a common form of the effective exchange rate; it is the average exchange rate of a basket of currencies, weighted by the amount of trade with each country

4.1.8.1 Exchange rate systems

→ The exchange rate is the rate at which one currency exchanges for another

→ In other words, it is the *price* of one currency in terms of another, e.g. £1 = $1.50

→ There are three main exchange rate systems: floating, fixed and managed

4.1.8.1.1 Floating exchange rates

→ Under a system of floating exchange rates, market forces (supply of, and demand for, the currency in the foreign exchange market) determine the value at which one currency exchanges for another

4.1.8.1.2 Fixed exchange rates

→ Under a system of fixed exchange rates, the value at which one currency exchanges for another is fixed by the central bank or the government against another currency or a basket of currencies or gold

4.1.8.1.3 Managed exchange rates

→ Under a system of managed exchange rates, market forces determine the value at which one currency exchanges for another but intervention by the central bank influences the exchange rate of the currency

4.1.8.2 Distinction between revaluation and appreciation

→ A revaluation occurs when the government intervenes to force the price of a currency upwards (strengthen the exchange rate) – either in a fixed or a managed currency system

4.2 POVERTY AND INEQUALITY

4.2.1 Absolute and relative poverty

4.2.1.1 Absolute poverty

- → According to the World Bank, people are considered to be living in absolute poverty if their incomes fall below the minimum level to meet basic needs such as food, shelter, clothing, access to clean water, sanitation facilities, education and information
- → This minimum level is referred to as the *poverty line*
- → One of the key Millennium Development Goals was to halve the number of people living in absolute poverty by 2015
- → This target of reducing extreme poverty rates by half was met in 2010, when 700 million people fewer people than in 1990 were living in conditions of extreme poverty
- → However, in 2017, there were still around 765 million people living in poverty worldwide
- → In 2015, the Millennium Development Goals were replaced by the Sustainable Development Goals, the first of which was to 'End poverty in all its forms everywhere'

4.2.1.2 Relative poverty

- → People are considered to be in relative poverty if they are living below a certain income threshold in a particular country, e.g. below 60% of the median income
- → Therefore the concept of relative poverty is:
  - Subjective
  - Subject to change over time
  - Not comparable between countries, i.e. someone deemed relatively poor in the USA would be regarded as being incredibly rich in Malawi
- → Relative poverty arises from inequality

4.2.1.3 Measures of absolute and relative poverty

4.2.1.3.1 Measure of absolute poverty

- → Absolute poverty is based on a set standard that is consistent over time and between countries, referring to the ability of individuals or groups to meet their basic needs
- → In 2015, the World Bank set the international absolute poverty line at $1.90 a day, at 2005 GDP measured at purchasing power parity, i.e. adjusted for international purchasing power

4.2.1.3.2 Measure of relative poverty

- → Relative poverty is measured in comparison with other people in the country
- → Relative poverty lines are defined in relation to the overall distribution of income or consumption in a country, so if a person is living below a certain income threshold in a particular country, they would be classified as being in relative poverty
- → For example, in the EU, people whose income is less than 60% of median income are considered to be 'at risk of poverty' and are said to be in relative poverty

4.2.1.4 Causes of changes in absolute and relative poverty

- → Changes in any of the following factors may result in changes in absolute and relative poverty:
  - Aid
  - Debt relief
  - Fair-trade schemes
  - Microfinance schemes
  - Employment opportunities
  - Education and training

- → Multi-dimensional poverty is made up of several factors that constitute poor people's experience of deprivation – such as poor health, lack of education, inadequate living standards, disempowerment, poor quality of work and threat from violence
- → Therefore the global MPI combines two aspects of poverty:
  - Incidence, i.e. the percentage of people who are poor
  - The intensity of people's poverty, i.e. the average of the components identified above in which poor people are deprived

4.3.1.4 Other indicators

- → These includes:
  - The proportion of the male population engaged in agriculture
  - Energy consumption per person
  - The proportion of the population with access to clean water
  - Mobile phones per thousand of population
  - The proportion of the population with internet access

4.3.2 Factors influencing growth and development

- → All countries face constraints on growth and development, but the nature of these constraints vary greatly between the developed and developing world
- → The developing world faces a number of constraints:
  - Primary product dependency
  - Volatility in commodity markets
  - Level of savings and investment
  - Foreign exchange gap
  - Capital flight
  - Demographic factors
  - Access to banking and credit
  - Infrastructure
  - Education and skills
  - Absence of property rights
  - Non-economic factors

4.3.2.1 Primary product dependency

- → Primary products may be divided into hard commodities, such as copper, tin and iron ore, and soft commodities, which are mainly agricultural crops, such as wheat, palm oil and rice
- → A range of issues face countries dependent on primary products, including the following:
  - *Price fluctuations* – see 'Volatility in commodity markets', section 4.3.2.2
  - *Difficulty of planning investment and output* – the price fluctuations cause uncertainty, which is a deterrent to investment
  - *Natural disasters* – extreme weather such as hurricanes, tornadoes, droughts and tsunamis can cause severe disruption to the production of primary products, especially agricultural products
  - *Protectionism by developed countries* – for example, the huge subsidies given to US cotton farmers have created great difficulties for Indian cotton farmers, who are unable to compete, e.g. the EU's CAP means that there is no free access to European markets for food from developing countries
  - *Low income elasticity of demand for primary products* – the Prebisch-Singer hypothesis states that the terms of trade between primary products and manufactured goods tend to deteriorate over time

4.3.3.1.5 Microfinance schemes

- Microfinance is a means of providing extremely poor families with small loans (microcredit) to help them engage in productive activities or grow their small businesses
- It can help the poor to increase income, build businesses and reduce vulnerability to external shocks
- The pioneer of microfinance was Muhammad Yunnus, who established the Grameen Bank in Bangladesh
- The key features of microfinance are the following:
    - Microcredit insists on repayment (in contrast to development aid)
    - Interest is charged to cover the costs involved
    - The focus is on groups whose alternative sources of finance are limited to the informal sector, where the interest charged would be high
- The main clients of microfinance are:
    - Women (who form more than 97% of the clients)
    - The self-employed, often household-based entrepreneurs
    - Small farmers in rural areas
    - Small shopkeepers, street vendors and service providers in urban areas
- Despite some obvious successes, microfinance has been criticised on several grounds:
    - Concerns have been raised about the repayment rate, collection methods and questionable accounting practices
    - On a larger scale, some argue that an overemphasis on microfinance to combat poverty will lead to a reduction of other assistance to the poor, such as official development assistance or aid from non-governmental organisations (NGOs)

4.3.3.1.6 Privatisation

- The sale of publicly owned assets to the private sector through the issue of shares has been a popular policy in developed economies for many years and has also been adopted in some developing countries
- Privatisation is seen as a way of increasing efficiency and productivity as a result of competition and the profit motive, which are characteristics of the private sector

4.3.3.2 Interventionist strategies

- These strategies involve intervention by the state in order to influence the allocation of resources
- Examples include the following:
    - Development of human capital
    - Protectionism
    - Managed exchange rates
    - Infrastructure development
    - Promotion of joint ventures
    - Buffer stock schemes

4.3.3.2.1 Development of human capital

- Countries with poor education standards and low school enrolment ratios are likely to experience slow rates of economic growth
- Improvements in access to education and in the quality of education would help to increase the skills and productivity of the workforce
- Such improvements would also encourage FDI by global companies in these countries

4.3.3.2.2 Protectionism

- This strategy is aimed at constructing a path towards diversification and industrialisation

4.3.3.3.3 Developments of primary industries

- Some developing countries have achieved growth and development on the basis of investing in primary industries
- The case for focusing on agriculture and hard commodities may be that the country has a comparative advantage in production of those goods and so resources are more efficiently allocated to that use
- Such a comparative advantage should be viewed in a dynamic context, i.e. as the country experiences growth, the government may use its tax revenues
- As a result of such a dynamic, the country may gain a comparative advantage in other products
- Some countries have specialised in producing primary products with a high income elasticity of demand, e.g. Peru produces asparagus; Chile produces blueberries, wine and papaya; Bolivia produces tin
- Consequently, during periods of world economic growth, they have benefited from significant increases in demand

4.3.3.3.4 Fair trade schemes

- The aim of fair trade schemes is 'to address the injustice of low prices' by guaranteeing that producers receive a fair price
- It means that producers get paid an above-market price for their produce, provided they meet particular labour and production standards
- This premium is passed back to the producers to spend on development programmes
- The market for fair trade products has been growing rapidly and there are now over 2,500 product lines, including chocolate, tea, coffee, bananas, wine and clothes

4.3.3.3.4.1 Advantages of fair trade schemes

- Producers receive a higher price
- Extra money is available to spend on education, health, infrastructure, clean water supplies, conversion to organic farming and other development programmes in the producers' countries
- There are smaller price fluctuations, allowing producers to be shielded from market forces
- The extra money can also be used to improve the quality of products
- Producers are enabled to diversify into other products

4.3.3.3.4.2 Criticisms of fair trade schemes

- Distortion of market forces: low prices are due to overproduction and producers ought to recognise this as a signal to switch to growing other crops; further, the artificially high prices encourage more producers to enter the market
- Certification is based on normative views on the best way to organise labour, e.g. in the case of coffee, certification is only available to cooperatives of small producers
- Guaranteeing a minimum price provides no incentive to improve quality
- It is an inefficient way to get money to poor producers: consumers pay a large premium for fair trade goods but much of this goes to supermarkets in profits; only 10% of the premium paid for fair trade coffee trickles down to the producer
- The schemes may create a dependency trap for producers

4.3.3.4 Aid

- The term 'aid' is used to describe the voluntary transfer of resources from one country to another or loans given on concessionary terms, i.e. at less than the market rate of interest
- Official development assistance refers specifically to aid provided by governments and it excludes aid given by voluntary agencies

- Aid may also be given for emergency relief, e.g. in response to natural disasters or to support refugees fleeing a civil war
- This kind of aid is not usually contentious and so the focus here is on aid given for more general, development-focused purposes
- The UN goal for the amount of aid offered by developed countries (agreed in 1970) in 0.7% of GDP
- There are various types of aid:
    - *Tied aid* – this is aid with conditions attached, e.g. there might be a requirement to buy goods from the donor country or the aid might be given on condition that there are some economic and political reforms
    - *Bilateral aid* – this is aid given directly by one country to another
    - *Multilateral aid* – this occurs when countries pay money to an international agency which then distributes it to countries on the basis of certain criteria
- The arguments in favour of aid include the following:
    - The reduction in absolute poverty
    - Filling the savings gap experienced by many developing countries (this may be related to the Harrod-Domar model)
    - Providing funds for infrastructure – essential if the country is to industrialise; aid, therefore, will help to increase aggregate demand and investment will have a multiplier effect on GDP, which in turn will help to promote sectoral development
    - Improving human capital through promotion of healthcare, education, training and expertise (e.g. the training of teachers and doctors); in some countries, aid might be used to help the prevention and treatment of AIDS
    - Possible contribution to increased globalisation and trade, both of which are frequently associated with growth and development
    - The reduction of world inequality
- There are powerful arguments against the use of aid, except in the case of emergency aid:
    - It results in a dependency culture, i.e. the recipients become dependent on it and do not therefore pursue appropriate macroeconomic policies to achieve independent growth and development
    - Aid might not benefit those for whom it is intended, e.g. it could be diverted into military expenditure or 'lost' through corruption
    - There is no clear evidence that aid contributes to the reduction of absolute poverty or to growth and development
    - Right-wing economists argue that aid distorts market forces and results in an inefficient allocation of resources, while left-wing economics regard aid as a form of economic neo-imperialism by which donor countries aim to secure political influence through aid
    - Aid in the form of concessional loans involves the repayment of interest, in which case there will be an opportunity cost for the developing countries, e.g. improvements in the health and education services

4.3.3.5 Debt relief

- The burden of debt bears heavily on some countries, e.g. the Gambia, Mali, Nicaragua, Bolivia and Malawi
- The debt is often owed to a combination of the IMF, the World Bank, governments and banks in developed countries
- The problem is that servicing the debt may account for a disproportionate amount of public expenditure, to the extent where resources available for health and education are severely limited – as a result, there is pressure to cancel the debts of the poorest countries

- → From the 1980s until 2008, its primary role was to ensure stable public finances
- → However, since 2008 it has once again assumed a role in macroeconomic management not only in the UK but also in China, the USA and a variety of other countries
- → Key features of fiscal policy include the following:
    - *Automatic stabilisers* – some forms of government expenditure and taxation change automatically in line with GDP and the state of the economy
    - *Discretionary fiscal policy* – deliberate changes in taxes and public expenditure designed to achieve the government's macroeconomic objectives

4.5.3.5.2 Distinction between a fiscal deficit and a national debt

- → A *fiscal (budget) deficit* occurs when public expenditure (both current and capital) is greater than tax revenues
- → Public sector net borrowing is the official term used to describe a fiscal deficit
- → The *national debt* or public sector net debt is the cumulative total of past government borrowing

4.5.3.5.3 Distinction between structural and cyclical deficits

- → The *'structural' fiscal deficit* is an estimate of how large the deficit would be if the economy were operating at a normal sustainable level of employment and activity
- → However, it is difficult to estimate exactly what this 'normal' level would be
- → The *'cyclical' fiscal deficit* is that part of the fiscal deficit associated with recession

4.5.3.5.4 Factors influencing the size of fiscal deficits

- → Factors influencing the size of fiscal deficits include the following:
    - *GDP* – during a recession, real GDP will be falling, and in turn public expenditure on automatic stabilisers will be rising while tax revenues will be falling, leading to an increasing fiscal deficit
    - *The size and age distribution of the population* – an increase in the size of the population is likely to mean an increase in public expenditure on health, education and infrastructure
    - *Discretionary fiscal policy* – the 2008 financial crisis led to the resurrection of fiscal policy as a means of managing the economy in several countries; in July 2015, South Korea pumped $10 billion into its economy to offset falling exports and an outbreak of Middle East respiratory syndrome (MERS)
    - *Debt interest* – the massive increase in fiscal deficits from 2008 in the UK and many developed economies led to sharp rises in these countries' national debts, resulting in higher interest payments on the national debt

4.5.3.5.5 Factors influencing the size of national debts

- → The national debt of an economy would be affected by the following:
    - *Fiscal deficits or fiscal surpluses* – if a country had persistent fiscal deficits then the national debt would be increasing, whereas if there were persistent surpluses then the size of its national debt is likely to fall
    - *Fiscal deficits might be caused by recessions* – this could result in automatic stabilisers, i.e. government expenditure on means-tested benefits would increase, whereas tax receipts would fall; further, fiscal deficits might arise because of aging populations, which result in increased expenditure on state pensions, healthcare and social care