- **Regulation:** This is protectionism in the form of excessive bureaucracy, unnecessarily strict health and safety regulations and/or customs checks, and government procurement policies that favour domestic producers. Import licenses which importers are required to obtain before they can legally produce goods from abroad also restrict imports. The EU is especially notorious for setting very high standards for goods imported; especially food, to protect the trading bloc.

Benefits of Protectionism

For consumers:

- Protectionism may sometimes be used to safeguard consumers from the over-consumption of demerit goods such as alcohol, tobacco and narcotics that might arise from the availability of cheap foreign supplies of these goods.

For producers:

- Infant industries are nurtured and protected from international competition, so they have a chance to develop. In less developed economies, short-term protection can allow recently established industries to develop and take advantage of unexploited economies of scale.
- The decline of dying industries such as the textile industry is cushioned, and jobs protected.
- Some producers are protected from unfair competition from goods being 'dumped' from abroad. These goods may be sold in the export market at prices lower than they would normally be sold domestically, due to advantages like government subsidies.

For employment:

- Competitive disadvantages may cause domestic firms to shut down, increasing unemployment, especially in labour-intensive industries. In such cases, protectionism aids the macroeconomic objective of low levels of unemployment.

For economic growth:

- Tariffs are a source of government revenue. Thus, consistently, tariffs will aid economic growth as GDP increases.

For the balance of payments:

- Too many imports will lead to a current account deficit; thus, trade barriers reduce the need to set up systems to rectify persistent balance of payments problems.

Costs of Protectionism

For consumers: As free trade provides consumers with cheaper prices, protectionism will reverse this, leading to a reduction in consumer surplus and general economic welfare of consumers. Also, quotas may restrict consumer choice, also reducing welfare.

For producers: Infant industries run the risk of becoming over-dependent on trade barriers and never learning to become fully efficient. Thus, in the long run, they may become unable to compete on a global scale.

For economic growth: Protectionism could anger other countries, leading to retaliation that may involve a refusal to import from that country. This will reduce national income, potentially causing a slow-down of economic growth or a recession.

For the balance of payments: A fall in exports could also lead to a current account deficit, affecting the balance of payments.

UNIT 2: BALANCE OF PAYMENTS AND EXCHANGE RATES

The balance of payments is a record of a country's financial transactions with other countries over a given period. It measures the value of the flow of trade and services into and out of a country, usually in a calendar year. Three sections of the balance of payments:

1. **Current account**- goods and services.
- Trade in goods: fuel, manufactured goods, etc.
- Trade in services: banking, insurance
- Primary income: From investments- interest, profits, dividends, migrant remittances. From employment- salaries/wages paid to foreign workers by UK sources and payment to UK workers from abroad.
- Secondary income (Transfers)- payments to the EU, foreign aid.

2. **Capital account-** Capital transfers e.g. debt forgiveness, transfer of capital assets because of immigration and emigration.

3. **Financial account**
- Portfolio investment- including transactions in equity securities, such as common stock, and debt securities, such as banknotes, bonds, and debentures.
- Foreign Direct Investment (FDI)
- Reserve assets: Borrowing or repaying debt from abroad, increase/decrease in foreign currency reserves, increase/decrease in gold reserves, borrowing from or repaying debts to the IMF.

Causes of Current Account Deficits

Demand side causes (cyclical): High incomes at home
Low incomes abroad
Strong exchange rate

Supply side causes (structural): Persistently high relative inflation
High unit labour costs- Low productivity
High minimum wages
Strong trade unions
Poor investment
Loss of comparative advantage
Resource depletion
Inadequate research, development and innovation

Consequences of Current Account Deficits

1. Lowers aggregate demand because the biggest component of the current account is the trade balance. A negative trade balance usually means a current account deficit which means X-M (net exports) is negative, causing AD to fall. Lower economic growth, higher unemployment rate.

2. Debt burdens- Countries that have current account deficits will often finance them by running financial account surpluses, and the easiest way to do this is to borrow from the rest of the world, therefore issuing more debt- Selling government bonds, corporate bonds, company shares. As debt increases, confidence will be lost in the country's abilities to pay the debt back. Investors will start to pull away from investing in the economy, and this will cause panic and

Advantages of Fixed Exchange Rates

1. Removes uncertainty associated with fluctuating prices - good for trade and investment.
2. Monetary discipline imposed to avoid inflation and maintain competitiveness. The country cannot rely on a fall in exchange rate to regain competitiveness lost through inflation. Central banks are forced to deal with international trading problems.

Disadvantages of Fixed Exchange Rates

1. Countries must hold large supplies of their own currency, gold and foreign currencies to support their currency. This involves an opportunity cost in terms of other uses the government could have put the money e.g. NHS, improving the country's infrastructure, providing food for Somalia etc. Governments must have a list of priorities for its spending plans.
2. Fixed exchange rates do not automatically adjust balance of payments disequilibrium. The country may have to impose barriers to trade.
3. Governments may feel obliged to defend a fixed rate even when it is untenable. This can be costly and even futile.
4. Speculative flows of money are so large that it may be difficult for a government to prevent the markets from driving the currency up or down in value.

Floating Exchange Rates

A floating exchange rate system is one where the value of a currency is determined by the forces of demand and supply on the foreign exchange markets and can fluctuate freely without any government intervention.

£'s are demanded by:

- Foreign residents wishing to buy UK exports and hire UK services.
- People wishing to invest in the UK due to a high interest rate or confidence in the UK economy.
- Speculators wishing to take advantage of a future expected rise in the value of the £ to make a capital gain - hot money.
- Foreign Direct Investors wishing to invest in the UK economy.
- Governments wishing to add £'s to their reserves.
- Foreign governments wishing to lower the value of their currencies.

£'s are supplied by:

- UK residents wishing to invest abroad, buy imports and pay for foreign services.
- People moving money out of the UK due to relatively low interest rates.
- Speculators wishing to take advantage of a future rise in the value of another currency - 'hot money'.
- Foreign Direct Investors leaving the UK economy
- Governments wishing to replace £'s in their reserves with other assets.
- Foreign governments wishing to raise the value of their currencies by selling pounds.
- Pessimism in the state of the economy- capital flight.

Advantages of a Floating Exchange Rate

1. In a free foreign exchange market, the balance of payments will automatically balance. The credit side of the balance of payments constitutes the demand for sterling. For example, when people abroad buy UK exports or assets, they will demand sterling to pay for them and when UK residents buy foreign goods or assets, the imports of them will require foreign currency to pay for them. Therefore, a floating exchange rate ensures that the demand for pounds always equals the supply. It also ensures that the credits on the balance of payments are equal to the debits:

The forms of aid are the Official Development Assistance (ODA), the flow of capital from one government to another and unofficial aid from NGOs e.g. Oxfam, who decide to spend money in developing countries.

Types of aid

1. Humanitarian aid- The main aim of this is to alleviate short-term suffering. Such aid is given to countries in times of war, political instability, natural disasters.
    - Food aid- the direct export of food to developing countries
    - Medical aid- the direct export of medical services and supplies to developing countries.
    - Emergency aid- providing emergency lighting, electricity, cooking facilities, etc.

2. Development aid- The main aim of this is to promote economic development in LEDCs.
    - Long-term loans- These often come with low interest rates, repaid over about 20 years.
    - Tied aid- This is aid offered with a caveat that imports of certain goods and services can only be purchased from the donor country.
    - Project aid- This is when money is given to developing countries for the funding of key infrastructural projects e.g. building roads and bridges.
    - Technical assistance aid- This is aid for the development and advancement of technology in developing countries by subsidising innovation, research and development, and promote capital advancements in technology.
    - Commodity aid- Aid given to countries looking to improve productivity and regain competitiveness. Here, money is used to buy commodities, lowering costs of production and aiding competitiveness, growth and productivity.

Benefits of Aid

- Evidence shows that aid packages do bring economic improvements to LDCs. For instance, the impact of the aid given to Indonesia following the tsunami in 2004. Aid packages have also contributed to vaccination programmes which have resulted in a decrease in infant mortality. Education programmes have been established in many countries and the numbers attending primary school have increased significantly in recent years. In Africa, enrolment in primary education has risen from 57% in 1999 to 70% in 2005.
- Third world countries tend to have a high propensity to spend and a low propensity to save so there is little money for investment. Foreign aid is needed to provide LEDCs with money for investment needed to stimulate economic growth.
- Any investment will lead to a more than proportionate change in income (multiplier effect). For example, a grant given for a road building project will not just benefit those using the roads. Workers involved in building the road will receive incomes, their spending will become income for another group of people and so on.
- Export revenues are often small. Countries need to gain revenue from exports to purchase imports – imported capital equipment is often vital to development. Foreign aid can be used to purchase this equipment.
- Foreign aid can help to fund expenditure on health, education and social welfare and general infrastructure, which are vital to development and improving living standards. Better education and training leads to greater productivity. A healthier workforce means there will be fewer days lost through illness. Better infrastructure will mean quicker delivery and communication times thus reducing costs.
- Aid has helped to increase agricultural productivity through training.

Disadvantages of Foreign Aid

- Much of financial aid is often wasted through corruption, bad management, poorly thought-out schemes or spent on arms deals. Sub-Saharan African countries are notorious for this.

- Dependency on aid encourages laziness from domestic producers, reducing the incentive to innovate and invest.
- Historically most aid has been bilateral. This lack of a single, unified system has meant that the money has not been systematically, rationally or efficiently allocated. A failure of coordination of the distribution of official funds could occur.
- Developed countries could grow "aid-weary" and some would argue, justifiably so.
- Aid in the form of loans could lead to indebtedness problems suffered by developing nations.
- The tying of aid is not costless to the recipient country. The OECD has reported that this type of aid will often increase the cost of foodstuffs that countries will be tied into buying from the donor country, leading to a fall in economic welfare for the citizens of the recipient country. Therefore, if aid is tied, third world countries could be worse off than if they had looked for a loan at market rate of interest.
- Third world countries do not always have the skilled workers or infrastructure necessary to carry out manufacturing projects successfully. A school building project may be half complete due to insufficient funds or unavailability of workers. Some projects will be initially worthwhile but once the aid is withdrawn, may be unable to survive. For instance, $2bn went into roads in Tanzania but the network was no better afterwards because of poor maintenance.
- Aid can create a crowding out effect on possible inward foreign investment. This means that the money provided by aid displaces potential funds from private investors who could be uncomfortable funding projects in countries that are aid dependent. For some economists, this aid dependency is a key reason why development has been much slower in Africa than in China and India, where development has been largely based upon private inward investment.

Conclusion: ODA has successfully provided basic humanitarian needs in the many crises that happen on a regular basis across the world. However, ODA may have an adverse impact on future economic growth, the exact opposite effect of what it sets out to achieve.

The IMF

The IMF is an organisation of 188 countries, working to foster global monetary cooperation, secure financial stability, facilitate international trade, promote high employment and sustainable economic growth, and reduce poverty around the world.

The IMF provides policy advice and financing to its members when they are suffering economic difficulties. IMF and Development

Several developing countries have sought IMF help in the last two decades as current account deficits associated with the international debt problem have become too large to finance. The conditions which the IMF have attached to its lending mean that it has a key role to play in development in these countries.

The conditions imposed by the IMF have typically included the reduction in protectionist barriers, devaluation of the official exchange rate, greater openness to foreign investment and tight domestic fiscal and monetary policies.

These conditions are designed to promote trade orientated growth in the long term. Possible benefits include:

- A reduction in domestic inflation because of tightening monetary and fiscal policy. The market economy functions more effectively with low inflation, and the country's exports will be more price-competitive.
- More foreign investment will increase the economy's capacity shifting its production possibility frontier outwards.
- Devaluation of the exchange rate makes the country's exports cheaper to people in other countries.

as they know more about their intended actions than the insurer. For example, interventions such as liquidity assurance and emergency liquidity create an incentive for commercial bankers to take on excessive risk knowing that if those risks go bad, a third party e.g. the Bank of England or the tax payer will have to bail them out. It is unlikely that moral hazard could ever be fully eliminated from the financial services sector, but tighter supervision of firms may reduce that risk.

4. **Regulatory capture:** This occurs when a body responsible for supervision of an industry loses its focus on its duty to protect the public interest and represents the industry instead. This could result from strong relationships between regulators and commercial bank operators. When the costs of regulation are considered, government failure could occur as the costs in the case of regulatory capture outweigh the benefits.

<u>Disadvantages of Regulation</u>

1. **Externalities:** Deregulation could have unintended negative consequences. For example, deregulation to remove/reduce capital ratios, liquidity ratios, leverage ratios or reserve requirements could open the door to banks taking excessive risk. Over-regulation on the other hand could force bankers to move to the shadow banking industry where regulation isn't as restrictive e.g. hedge funds and mutual funds where larger profits can be made.
2. **Inefficiency:** In the case of maximum interest rates, an excess demand will occur in the market. This is inefficient. It is also an incentive to bad borrowers to come into the market. Furthermore, it discourages lending; and this could harm economic activity.
3. **Administration and enforcement costs:** Regulatory bodies are very costly to maintain. If there isn't much to benefit from regulation, then the costs would outweigh the benefits meaning a market/government failure has occurred. Even if there are benefits, an opportunity cost exists. The money used to fund these organisations could be used in other sectors e.g. health and education.

<u>Evaluation</u>

- A balance is needed to protect consumers and prevent systemic risk but to maintain bank profitability, which could be decimated by excessive regulation; a major disincentive. If banks are driven out of the industry by too much regulation, an oligopoly or monopoly situation could occur.
- Regulation should promote equity i.e. promote public interest but should not damage efficiency. E.g. with maximum interest rates, efficiency will be harmed. A lack of competition will also occur as firms are not incentivised to join the market, and this could encourage existing firms to slack in efficiency.
- Benefits must outweigh the costs. If costs outweigh the benefits, then there is rational for deregulation.

<u>The Role of the Financial Sector and its Impact on the Real Economy</u>

The real economy is where goods and services are produced, and the financial sector involves trading securities. The two are interlinked as production depends on investment. Theoretically, manufacturers could invest in new technology without sophisticated financial infrastructure, but financial services make that simpler as fluctuations in production costs may be ironed out, making future planning easier.

- ➢ <u>High levels of government subsidy / financial support</u> - over time, total government spending can rise because of the many competing financial demands placed upon politicians and the effects of lobbying by (often influential / powerful) pressure groups. In some countries, public spending is bloated by very generous systems of farm / food / energy subsidies that are politically hugely difficult to remove. The state might also get locked into providing financial support for loss-making businesses and industries such as airlines.
- ➢ <u>Interest payments</u> - If interest rates increase on government debt, the amount the government pays in interest payments increases, so the deficit might increase.

These reasons explain why many countries run a structural budget deficit. This means that the budget deficit will not disappear even when the economy is in a boom.

<u>How do Governments Finance Fiscal Deficits?</u>

Borrowing: In the case of a fiscal deficit, the government will have to borrow from the private sector. In the UK, the Debt Management Office (DMO) sells bonds and gilts; government stock such as savings certificates or bonds, to the private sector. The public-sector debt is the total amount of debt owed by the government.

Contractionary Fiscal Policy:

- **Increase in income and corporation tax rates-** more revenue for the government.
  However, this could cause lower spending which will shift AD to the left or lower investment which will also reduce SRAS and a fall in economic growth.
  Eval: Depends on timing. In a recession, tax rate increases could cause a significant drop in spending. During high growth, tax rate increases won't affect spending that much. Could also be a disincentive to workers, therefore, unemployment rises.
  Also, Laffer curve: The author of this Keynesian theory argues:
  1. As more money is taken from a business in the form of corporation tax, the less money it can invest. Businesses are more likely to find ways to protect their capital from taxation or to relocate all or parts of their operations overseas, and investors are less likely to risk their capital if a larger percentage of their profits are taken.
  2. When workers see an increasing portion of their salaries being taken in the form of income taxes and due to increased efforts on their part, they will lose the incentive to work harder.
  3. For every type of tax, there is a threshold rate above which the incentive to produce more diminishes, thereby reducing the amount of revenue the government receives.
- **Reduction in government spending-** This feeds into demand through supply- therefore, more supply side policies e.g. privatisation, deregulation, welfare benefits being reduced.
  Privatisation- Reducing government spending on public services by privatising them. This solves the structural issue of government inefficiency. Aside from reducing expenditure and thus debt, this will improve productive efficiency by introducing the profit motive and the element of competition. Prices will also fall, increasing the disposable income of consumers and marginal propensity to consume; increasing AD.
  Deregulation- Reducing government spending on the deregulation of private firms. This will increase productive efficiency due to lower costs or give firms to increase salaries, generating higher income and Marginal Propensity to Consume, which will increase AD.
  This will make more funds available to the government to be kept as revenue and not converted to expenditure.
  However, deregulation could end up reducing consumer welfare as firms have less incentive to be fair in their dealings in terms of collusion and the prevention of monopolies.
  Eval: Depends on what aspect of government spending is reduced. Above mentioned will work but if the government reduces capital spending in areas like education, subsidies and healthcare, the LRAS could also be affected (leftward shift), which means reduced productivity and cost push inflation.

General evaluation: