IMAS

Institute of Management Accounting and Strategy

# IMAS CLASS NOTES

## Fundamentals of Business Economics
## BA1

# Macroeconomic and Institutional Context 2: The International Economy





We are now focusing on the International Economy and International Trade.

Balance of Payments: A balance between Exports and Imports.

# The Benefits of International Trade

- **Specialisation** – enables countries with different skills and resources to specialise in the production of certain goods.
- **Economies of Scale** – countries can benefit from serving large markets including those of other countries.
- **Competition** – there will be an increase in competition.
- **Lower prices**
- **Greater choices for consumers**

# Limitations to Specialisation





In practice it is not easy for countries to fully specialise due to:

- **Factor immobility** – in the real world, factors tend to be fairly immobile in the short run.
- **Transport costs** – distribution costs may still make products from other countries expensive than the locally produced products.
- **Size of the market** – for countries to benefit from Economies of scale, there should be a ready market for its products on the international markets.
- **Government Policies** – governments can install barriers to trade for political reasons.

# Protectionism





Many countries do not engage in free trade but seek to restrict the flow of imports in their domestic economies.

Arguments for Protectionism

- To protect employment.
- To help infant industries.
- To protect declining industries to allow structural readjustment.
- To prevent unfair completion (eg fake products and dumping).
- To protect the balance of payments.
- To raise revenue.
- To maintain security on strategic industries.

# Arguments against Protectionism





- Inefficiency is encouraged.
- Resources are misallocated.
- The cost of living is raised.
- Retaliation may occur.

# The methods of Protection

There are two groups of trade barriers – Tariffs and non-tariff barriers (NTBs) which include:

- Tariffs (taxes charged on imports)
- Quotas
- Hidden restrictions (eg administrative devices, official persuasion, and public procurement).
- Subsidies (where the government wants to do export promotion), but these are discouraged by the WTO.

# Trade Agreement





In many parts of the world, governments have created trade agreements and common markets to encourage free trade. However the WTO is against these trade agreements because in most cases they encourage trade among the members only but have high trade barriers for non-members.

The different trade agreements are as follows:

- Bi-lateral and multi-lateral trade agreements – between 2 or more countries to remove tariffs and quotas on most if not all goods.
- Free trade areas – If the members of a multi-lateral free trade agreement are in the same geographical area then at times its referred to as a free trade area.
- Customs union – this is a free trade area with a common external tariff.
- Single markets – this is a customs union with free movement of goods and services as well as free movement of Factors of production.
- Economic unions – this is a single market with a common currency. The greatest currently being the Eurozone, these are the countries within the European Union which have adopted the Euro.

# Arguments regarding Trading Blocks





Their supporters say they encourage *trade creation* and *low prices* within members as restrictions are removed. However opponents state that:

- Member countries are forced to buy with the block even when there are cheaper resources are available outside.
- These blocs encourage regional fortress mentality which can lead to conflicts between different regional trading blocs.
- The blocs can lead to the development of protectionism worldwide yet the WTO is trying to create free trade.

# Balance of Payments



This is an account showing the financial transactions of one nation with the rest of the world over a period of time.

The balance of payment is split into three parts:

- The Current account
- The Capital Account
- The Financial Account

**Note**: The accounts are supposed to balance since credits are supposed to be equal to debits. However there are certain cases where there may be deficits or surpluses.

# The Current Account





This is made up of 2 parts:

- Visible Trade – This shows the trade in goods.
- Invisible Trade – This shows the trade in **services**, **investment income** (interests, profits and dividends) and **transfer** of money between individuals and national bodies (eg government transfers to embassies).

The **Current account balance** surplus is generally a good sign. A *deficit/surplus* on the Current account will be balanced by a *surplus/deficit* on the combined Capital account and Finance Account.

# The Capital and Financial accounts





These accounts records *capital* and *financial* movements by firms, individuals and governments. The ***balancing item*** is also included here, which reflects errors and omissions which occur in the collection of data (a positive balancing item shows unrecorded net exports, while a negative shows unrecorded net imports).

# Types of flows





- **Real foreign direct investment** – where investors have some form of control over the business.
- **Portfolio investment** – the investor has no control over the enterprise.
- **Financial derivatives** – any financial instrument whose underlying value is based on another asset, such as foreign currency, interest rates.
- **Reserve assets** – foreign financial assets that are controlled by monetary authorities (Central Banks). E.g gold and foreign currency

# Equilibrium and disequilibrium

The balance of payments accounts should always balance.

Current account + Capital account + Financial account + Balancing item = 0

Persistent imbalances in certain sections, such as the *visible trade* under the *current account* indicate *fundamental disequilibrium*.

Such disequilibrium will drive governments to undertake policy action to create/restore equilibrium(Increase interest rates or use official reserves).

Actions taken to address the balance of payments problems may constrain policies which are designed to achieve other economic objectives such as economic growth.

# Causes of Balance of Payments deficit





A structural BOP deficit in the current account is usually due to a high demand for imports coupled with a weak export performance especially in manufacturing products.

- Import Penetration – where imports are taking a large share of the market or when imports are maintaining their share of growing markets. This can be due to many reasons like *growth in consumer spending, imports becoming more competitive, domestic currencies overvalued, foreign currencies may be undervalued*.
- Export Performance – Some of the factors that influence export performance are, the willingness and ability of domestic firms to supply abroad, price competitiveness of exports, some countries have surplus capacity which can be used when income rises.

# Policies to correct the BOP deficit





Many policies have been advocated to restore the balance of payments to equilibrium, usually when deficits have been a regular feature.

# Do nothing





If a country is using the floating exchange rate it is claimed that it leads to an automatic correction of the BOP. For example:

- If imports exceed exports then a BOP deficit occurs.
- If we are using Sterling, it means that more sterling is being sold to buy imports, than the sterling which is bought to purchase UK exports.
- This excess supply of sterling over demand for sterling will lead to a weakening of sterling against other currencies.
- This makes UK exports to be cheaper and imports expensive.
- As a result export volumes will rise and imports will drop leading to the correction of the BOP.

# Deliberate Depreciation of the exchange rate





Depreciation or *devaluation* can be done through the buying and selling of foreign currency on the market to induce ***expenditure switching*** by consumers. This can occur in two ways:

- Imports become expensive and hopefully the domestic consumers will switch to local goods.
- An increase in exports since they become cheaper.



However a depreciation or devaluation will not immediately benefit the BOP in practice:

- There is an initial worsening of the current account since volumes are fixed and prices adjust automatically. However with time goods become more elastic leading to a change in production and consumption patterns.
- There is also some evidence that following depreciation, exporters maintain their foreign exchange prices rather than lowering them, this will raise their short-run profits at the expense of long-run sales growth.

# Deflation

This is an effective but generally an undesirable policy. Domestic *deflation* to induce ***expenditure reduction*** by consumers.

- The government through a **tight fiscal policy** or **restrictive monetary policy** reduces demand locally.
- The BOP is corrected because the demand for imports is weakened and even the demand for local products which may lead local firms to switch their resources towards export markets.

Although deflation improves the current account it has some costs for the economy.

- Less demand in the local economy means less supply and a rise in unemployment.
- The general effect is economic growth will be stifled due to depressed business optimism, lowering investment and under-utilizing resources.

Deflation is often used together with depreciation (devaluation)

# Import Controls





These have the effect of causing ***expenditure switching*** rather than ***expenditure reduction***. Quotas prevent the purchase of imports and Tariffs increases the prices of imports.

However members of the WTO are not allowed to use these kinds of policies.

# Supply side policies





These policies attempt to improve the efficiency of the supply base of the economy. This is believed to boost the competitiveness of local products on the international market.

However there has been little evidence that this has brought about any permanent improvement in the balance of payments.

# Globalisation

**Globalisation** is the growing interdependence of countries worldwide.

**Internationalisation** refers to the increasing spread of economic activities across geographical boundaries.

Globalisation is a more complex form of Internationalisation, For example:

- Erosion of trade barriers
- Homogenising of tastes across different nations
- Firms selling same products across markets
- Greater harmonisation of laws in different countries
- Dilution of traditional cultures

# Factors driving Globalisation





- Improved communication
- Political realignment (growth of trade agreements)
- Growth of Global firms and industries
- Cost differentials
- Trade liberalisation (by WTO)
- Liberalisation of International capital markets

# Impacts of Globalisation





- Industrial relocation (**off-shoring**)
- Emergence of growth markets (opening up of new markets)
- Access to markets and enhanced competition
- Cross-national business alliances and mergers
- Widening economic divisions between countries

# The world Trade organisation (WTO) and The General Agreements on Tariffs and Trade (GATT)

After the World War 1 attempts have been made to reduce trade barriers to free trade around the world. Thus the GATT came into being in 1948.

In 1995 the WTO based in Geneva replaced GATT and it has a number of roles:

- To ensure that member countries continue to comply with previous GATT agreements.
- To negotiate future trade liberalisation agreements.
- To resolve trade disputes between nations.

The WTO has more authority than GATT as it has the power to police and enforce trade agreements. It is also against the development of trading blocs and customs unions.

# The European Union (EU)





The EU is an example of a Single market and the Euro zone an Economic union. It has its origins in the Treaty of Rome (1957), and the aims of the treaty were as follows:

- Elimination of Tariffs and Quotas.
- Establishment of a common customs tariff and a common commercial policy towards non-members.
- Removal of barriers of the movement of persons, services and capital.
- Establishment of common policies on transport and agriculture.
- The prohibition of business practices that restricts or distort competition.
- The association of overseas countries in order to increase trade and development.

# Objective

Consist of Canada, France, Germany, Italy, Japan, Russia, United Kingdom and United States. Together these countries represent about 65% of the world economy.

The agenda of G8 meetings is usually about issues such as

- Global warming.
- Poverty in Africa.
- Fair trade policies.
- AIDS.
- Macroeconomic management.
- Energy issues and climate changes.
- Development issues and creating relations with developing countries.
- Issues of international concern such as terrorism and organised crime.

The G8 does not have any formal resources or powers like other organisation such as the WTO.

Check also the **Euro Zone** Page 216 and the **G20** page 218.

# External Analysis of the Macro Environment

An organisation needs to do an external analysis of its external environment within which it operates. There are various factors in this environment which may represent ***threats*** or ***opportunities***.

The business will have to scan its external environment for factors relevant to the organisations current and future activities.

There are a number of *strategic management tools* that can assist in this process. These include the **PESTLE framework** which helps in the analysis of the macro and general environment.

# PESTLE anlysis

The PESTEL analysis divides the business environment into four main systems- Political, Economic, Social(and Cultural) and Technical. Others includes Ecological/Environmental and Legal.

Some factors affect every industry, but industries will vary in how much they are affected.

# PESTEL approach





- Political influences and events – legislation, government policies
- Economic influences – economic growth, changes in consumer incomes and expenditure, population growth
- Social influences – social, cultural, beliefs, values, population shifts, life styles, education, health
- Technological influences – changes in material supply, processing methods and new product development.
- Ecological influences – impact the organization on its environment
- Legal influence – changes in laws and regulations affecting (competition, patents, sale of goods, industrial standards etc)