**Economics 2018 – CSQ – Trade, Protectionism, Forex & Globalisation – Q1**

**The benefits and costs of globalisation**

## **Extract 6: Love imported goods, but hate losing American jobs?**

The United States (US) imported $2.69 trillion in 2016. That includes $2.2 trillion in goods and $502 billion in services. America is the world's second-largest importer. The [European Union](https://www.thebalance.com/what-is-the-european-union-how-it-works-and-history-3306356) imports more, at $2.24 trillion. [China](https://www.thebalance.com/china-economy-facts-effect-on-us-economy-3306345) is third, importing $1.4 trillion. Combined, these countries import $5.8 trillion, or one-third of the world's total imports of $15.34 trillion.

The largest US import category is capital goods at $590 billion. Businesses import telecommunication, semiconductors, computers and related equipment. Consumer goods is almost as large, at $584 billion. Most of this is cell phones, televisions, apparel and footwear. Services is a large and growing category. In 2016, US service imports totalled $502 billion. More than half of US imports come from five countries: China, Canada, Mexico, Japan and Germany.

US imports more than it exports. That is despite being the third-largest exporter in the world. That creates a US trade deficit of $502 billion.  Even though America exports billions in oil, consumer goods and automotive products, it imports even more of those same categories.

Everything that is imported is obviously not made in the US. For that reason, it creates US unemployment. The biggest change occurred with the growth of imports from China. In 2007, 28 percent of all imports were from China and other low-income countries. This was a dramatic rise from 2000, when this value was only 15 percent. At the same time, the US was losing manufacturing jobs. A study found that in 2000, more than 10 percent of the labour force worked in manufacturing but by 2007, it had dropped to 8.7 percent. Imports create US jobs in transportation, distribution and marketing. However, it is unlikely that these job gains offset the job losses in manufacturing.

**How trade deficit leads to US unemployment? – higher imports means that there will be less demand for local production – lesser demand for local workers – rise in unemployment**

* **Lower export demand for US goods from China – decrease local production – decrease demand for workers – rise in unemployment – Why US export decreases?**
* **Price of US goods increases due to higher COP or appreciation of US dollars**
* **US investment in China rises – US produces US goods in China and sells to Chinese – decrease the need for Chinese to imports US goods – decrease US export demand**

Although America can produce all it needs, China, Mexico and other emerging market countries can produce it for less. Their cost of living is lower, which allows them to pay their workers less. That makes them better than American companies at producing what US consumers want. For example, Indian technology companies can pay their workers just $7,000 a year, much lower than the US minimum wage. In other words, there is a trade-off between plentiful US jobs and low-cost products.

Many people say we should only buy items that are "made in America." That would solve the problem only if everyone were willing to pay higher prices.

Source: The Balance, accessed 19 Apr, 2017

# Extract 7: The cost of Brazil’s closed economy

Brazil is an unusually closed economy as measured by trade penetration, with exports plus imports equal to just 27.6 per cent of GDP in 2013. Notably, Brazil’s trade openness lags far behind its peers among the BRICS (Brazil, Russia, India, China and South Africa) countries, all of which reached trade-to-GDP ratios of at least 50 percent in recent years.

Very few Brazilian firms export and of all Brazilian exporters, a much smaller number of firms make up the overwhelming share of exports. The top one percent of exporting firms generates 59 percent of total exports, while the top 25 percent of firms account for 98 percent of export revenue. (low level of export capacity)

Brazilian exporters also lack dynamism. Brazil has a very low entry rate – very few companies become new exporters. On the flipside, established exporters have a very high survival rate. (less new exporting firms) – create market power

Brazil’s extraordinary lack of openness and its small number of exporters are closely related to the fact that Brazilian companies are poorly integrated into transnational value chains. This can be observed in the very high share of domestic value added in Brazilian exports, which implies that such exports incorporate few components and intermediate goods imported from other countries. The reasons behind this include precarious logistics and high transaction costs related to international trade, as well as deliberate policy decisions to favour local content over international integration.

(high degree of protectionism)

Over the past decade, Brazilian companies have also faced serious challenges to competitiveness, such as exchange rate appreciation and defensive trade policies. Brazilian exports have remained mostly “made in Brazil,” while many emerging economies today boast an export base that is largely “made in the world.”

Brazil’s first priority should be to remove local content requirements that keep foreign investment away and hurt local firms in the process. Opening up and moving toward integration into global value chains could produce efficiency gains and help Brazil address its productivity and competitiveness challenges.

Source: World Bank Group, 15 Feb 2015

**Extract 8: What is driving Brazil’s economic downturn?**

Brazil’s economic situation has deteriorated significantly in recent years. The economy entered into recession in 2014 and the situation worsened in 2015, with real GDP likely to have declined by 3%, while inflation has remained close to 10%. The downturn of the non-energy commodity price cycle revealed the underlying structural weaknesses in the Brazilian economy.

In the first decade of the century, Brazil benefited from strong demand, particularly from China for some of its key export commodities such as iron ore, soybeans and raw sugar. Supported by positive terms of trade effects, Brazil’s annual GDP growth rate averaged 3.1% over this period.

Since the fall in world commodity prices in 2011, these terms of trade effects have reversed. As a result, GDP growth has been consistently lower than predicted, while structural weaknesses underlying the economy have resurfaced. These weaknesses include a burdensome tax system, poor infrastructure, limited competition, the high costs of starting a business and high tariff rates.

Source: ECB Economic Bulletin, Jan 2016

Solutions – conduct expansionary FP with focus tax reduction, supply side with focus on infrastructural development and liberalization of the market, regulation of cost of business

**Table 1: Total merchandise trade for selected economies (US$ million)**



Source: WTO, World Trade Statistical Review 2016

**Table 2: Exchange rates: Units of national currency per US dollar**

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
|  | **2010** | **2011** | **2012** | **2013** | **2014** | **2015** |
| **Brazilian Real** | 1.759 | 1.673 | 1.953 | 2.156 | 2.353 | 3.327 |
| **Chinese Yuan** | 6.77 | 6.461 | 6.312 | 6.196 | 6.143 | 6.227 |

Source: [OECD,](https://data.oecd.org/) accessed Aug 2017

Brazilian Real has depreciated against US dollar while the Chinese Yuan has appreciated against US dollar from 2010 to 2015

**Questions**

|  |  |
| --- | --- |
| **(a)** | Using Table 1, compare the change in China’s balance of trade in goods with that of the US between 2010 and 2015. [2]  |
|  |  |  |  |
| **(b)** | Explain how the theory of comparative advantage can be applied to account for the pattern of trade between the US and her trade partners. [3]  |
|  |  |  |  |
| **(c)** | With reference to Extract 6, explain the ‘trade-off between plentiful jobs and low-cost products’. [3]  |
|  |  |  |  |
| **(d)** | **(i)** | With reference to Table 2, how does the value of the Brazilian Real in 2015 compare to its value in 2010? [1]  |
|  |  |  |  |
|  | **(ii)** | How could the difference in the value of the Brazilian Real observed in **(d)(i)** be explained by the fall in world commodity prices? Explain with the help of a diagram. [3] |
|  |  |  |  |
| **(e)** | Discuss whether Brazil’s defensive trade policies is the key reason for its lack of export competitiveness. [8]  |
|  |  |  |  |
| **(f)** | Assess whether opening up its economy is the best option for the Brazilian government to achieve sustainable economic growth. [10]  |

 **[Total: 30]**

**Suggested Answers**

**(a) Using Table 1, compare the change in China’s balance of trade in goods with that of the US between 2010 and 2015. [2]**

Both China’s trade surplus and US’ trade deficit rose. However, China experienced an improvement in her trade surplus but US experienced worsening trade deficit.

OR

China’s trade surplus increased more significantly (by 226.7%) than the rise in US’ trade deficit (by 16.3%)

**(b) Explain how the theory of comparative advantage can be applied to account for the pattern of trade between the US and her trade partners. [3]**

**Pattern trade – composition of trade, volume of trade and direction of trade**

The theory of comparative advantage states that even if one country has absolute advantage in the production of both goods in a 2-commodity-2-country model, it will still be mutually beneficial for both countries to specialize in the goods that they can produce at a lower opportunity cost and exchange.

US has natural factor endowment of oil reserves 🡪 able to produce one unit of oil at a lower opportunity cost than China 🡪 US gives up less of alternative goods such as television 🡪 more cost-efficient for US to specialize in production of oil since she can produce cheaper oil compared to China 🡪 US exports oil to China

China has factor endowment of large labour supply 🡪 able to produce low-end labour-intensive manufactured such as footwear or television at a lower opportunity cost compared to US 🡪 since China can produce such goods cheaper, China exports the goods to US 🡪 US imports those good she lack comparative advantage in.

**Why SG is able to experience dynamic comparative adv** – switch from electronic and electrical to pharmaceutical and aeronautical industry – development of skills of the workers, political stability to attract FDI

**(c) With reference to Extract 6, explain the ‘trade-off between plentiful jobs and low-cost products’. [3]**

Opening up 🡪 specialize based on CA and remove trade barriers such as tariffs 🡪 cheaper imports and imported inputs 🡪 lower cop 🡪 lower price of final goods (low-cost products) 🡪 reduce dd for local substitutes 🡪 less production 🡪 fall in derived demand for local workers 🡪 rise in unemployment🡪 cheaper goods obtained at the expense of plentiful jobs

OR

To protect domestic employment 🡪 e.g. tariffs on imports 🡪 reduce Qdd of imported goods because more expensive 🡪 increase demand for local subtitutes 🡪 greater production in local firms 🡪 rise in derived demand for labour 🡪 more local job opportunities🡪 fall in unemployment 🡪 plentiful jobs locally but imported goods more expensive 🡪 higher cop 🡪 higher price of final goods (high-cost products) 🡪 plentiful jobs obtained at the expense of cheaper goods.

**(d)(i) With reference to Table 2, how does the value of the Brazilian Real in 2015 compare to its value in 2010? [1]**

The Brazilian Real has depreciated against US$ in value from 2010 to 2015

**(d)(ii) How could the difference in the value of the Brazilian Real observed in (d)(i) be explained by the fall in world commodity prices? Explain with the help of a diagram. [3]**

Brazil export commodities such as soybeans, iron ore and raw sugar which are price inelastic in demand due to the nature of the good being a necessity.

Fall in world commodity prices means fall in prices of soybeans, iron ore and raw sugar exports 🡪 given PEDx<1 🡪 Qdd will rise less than proportionately, ceteris paribus 🡪 Brazil’s X revenue will fall.



As seen from the diagram, since export revenue fall, there would have been a fall in demand for Brazilian Real 🡪 surplus of Brazilian Real in foreign exchange market exerts downward pressure on exchange rate 🡪 depreciation.

**(e) Discuss whether Brazil’s defensive trade policies is the key reason for its lack of export competitiveness. [8]**

**1. meaning of defensive trade policies – protectionism**

**2. how these policies will lower export competitiveness (tariffs)**

**3. other factors affecting the export competitiveness**

Introduction:

Brazil has remained a relatively closed economy. Brazil’s lack of export competitiveness is driven by the country’s own supply-side capacity, government policies as well as external factors. One of the government policies mentioned was its defensive trade policies. These refer to trade policies that support or protect domestic firms from foreign competition through various means such as tariffs, quotas, subsidies to domestic firms and rules and regulation. She imposed tariffs and favoured local content as it is stated that ‘Brazilian companies have also faced serious challenges to competitiveness’ due to defensive trade policies.

[Explain how tariffs cause exports to lose competitiveness and other factors contributing to the country’s inability to keep export prices competitive]

Main Body:

**Tariffs imposed by Brazilian government and rules and regulations that favour local content can cause exports to lose competitiveness.**

Tariffs 🡪 raises cost of production for foreign producers exporting their goods to Brazil 🡪 increases the price of Brazil’s imports 🡪 local firms depending on foreign imported inputs such as steel to produce final goods will face a rise in their cost of production, assuming revenue remains unchanged 🡪 lower profits will reduce the supply of the goods 🡪 shortage of final goods such as steel-related products will exert upward pressure of price of these goods 🡪 higher price of final goods including those exported out 🡪 X loses price competitiveness.

**Defensive trade policies also reduce competition for local firms which may result in exports losing price competitiveness.**

Defensive trade policies such as tariffs will raise the price of imported goods 🡪 Quantity demanded for imports will fall and consumers will switch over to buy domestic substitutes 🡪 local firms are assured of rise in demand to generate revenue and profits 🡪 lack of competition in the industry due to protectionist measures🡪 complacency of local firms due to lack of competitive pressure on profits 🡪 ‘Brazilian exporters also lack dynamism’ 🡪 does not engage in cost-cutting measures to keep prices low 🡪 fall in productivity 🡪 higher average cost 🡪 higher price of exports 🡪 X lacks price competitiveness

**However, there are other factors such as poor infrastructural facilities and appreciation of Brazilian Real which contributed to X losing price competitiveness.**

 Poor infrastructural facilities such as absence of efficient transportation system 🡪 local firms may face higher cost of production due to greater costs incurred in delivering goods 🡪 lower profits will reduce supply of goods🡪 shortage drives up price of X 🡪 X lose competitiveness for reasons other than defensive trade policies

The appreciation of Brazilian Real means that more foreign currency is needed to purchase 1 unit of Brazilian Real 🡪 making Brazil’s X more expensive in foreign currency 🡪 worsening the problem of higher X prices.

**Evaluation:**

The lack of export competitiveness could have taken place internally due to ‘high costs of starting a business’ as well as poor infrastructural facilities. The high barriers to trade in some industry may internally have caused complacency to arise which caused prices of goods to be higher that they should be.

Given that Brazil is a developing country, it is highly likely that it may lack the funds to develop the economy sufficiently to support firms to produce efficiently. This could also lead to higher price of exports.

Although it seems like defensive trade policies such as tariffs or quotas may limit supply of goods and cause price of exports to be higher for firms dependent on imported inputs, given that Brazil is not a very open economy to begin with, this means that a large number of local firms depend on local inputs to produce their final goods which are exported out. Hence, the defensive trade policies may not be the main reason for exports losing competitiveness but may worsen the problem of export losing competitiveness due to internal problems.

**(f) Assess whether opening up its economy is the best option for the Brazilian government to achieve sustainable economic growth. [10]**

Introduction:

Brazil's economy is in a recession with inflation. Its weak economic performance is due to both falling prices of its exports as well as supply side factors such as inefficiency in production. One of the reasons for its economic problems is its closed economy and thus some recommended opening up its economy.

[Explain and evaluate how opening up of economy and other policies can help the country to achieve both actual and potential economic growth to ensure economic growth is achieved without depleting resources for future generation]

Thesis:

**Policy 1: Signing FTA**

Opening up via signing FTA 🡪 boosts external demand due to specialisation based on CA🡪 rise in (X-M) 🡪 rise in income in one sector triggers further rise in induced spending in other sectors 🡪 multiple rise in AD 🡪 boost EG in SR.

Opening up e.g. lower trade barriers 🡪 increase competition in domestic markets 🡪 spurs domestic firms to become more efficient 🡪 can increase productivity due to contestable market 🡪 can boost X competitiveness 🡪 boost economic growth.

Through FTAs Brazil can have greater access to foreign markets. This means that domestic firms can grow in size and benefit from large scale production further enhancing export competitiveness 🡪 rise in (X-M) 🡪 boost economic growth in SR.

Opening up its economy also means that it would allow more foreign investments into the country. Foreign investments not only provide the needed funds for capital formation. It also benefits Brazil when there is transfer of technology and expertise. There could also be a rise in exports when these foreign firms produce goods and services in world markets. Hence there is a rise in AD and so real GDP rises. Furthermore, rise in I can help to increase country’s productive capacity of economy 🡪 rise in LRAS 🡪 rise in potential economic growth 🡪 allowing for sustainable economic growth.

Greater ability to import cheaper resources also means that Brazil will be able to slow down the rate of utilizing her fixed resources🡪 rate of depletion of resources slowed down 🡪 allowing for more sustainable growth

Draw AD-AS diagram to show how AD and AS will both increase and achieve higher real GDP without rising price.

**Evaluation:**

1. Even with signing more FTA 🡪 FDI may not increase large extent 🡪 poor infrastructure 🡪 cop may be high 🡪 domestic firms may not be able to penetrate foreign markets 🡪 export earnings may not increase significantly and so economic growth may not be significant.

The increased competition could be a threat especially for the less efficient firms. As consumers switch demand towards relatively cheaper foreign goods, the demand for Brazil's goods and services fall. This will reduce the revenue and profit of domestic firms. Some will be forced to shut down.

Need to improve on infrastructure (structural reform) 🡪 build better infrastructure 🡪 rise in G and I 🡪 AD and LRAS increase 🡪 boost actual and potential EG

2. Brazil is dependent on export of primary commodities such as soybeans whose terms of trade is declining due to falling export prices. With such an area of specialisation, the benefits of international trade for Brazil may not be significant unlike other countries that specialise in high value-added industries such as high end manufacturing.

3. However, opening up may tackle the root cause of complacency problem amongst domestic firms which lack ‘dynamism’ 🡪 increased competition will ensure their become more cost-efficient 🡪 produce at lower cop to produce more competitive exports so as to sustain market demand 🡪 boost export competitiveness further aiding in economic growth.

**Policy 2: Supply-side policies such as investment in skills training and increase competition in domestic industries**

Need training of workers policy and reduce power of market dominance to ensure they do not limit competition and subsidising smaller firms to ensure they can match the low price of big firms in the midst of competition 🡪 enhances productivity of firms 🡪 boost FDI and X 🡪 rise in AD and LRAS 🡪 boost actual and potential EG

**Evaluation:**

1. Need funds to invest in human capital. Brazil’s government may not have sufficient funds to do so. Furthermore, there may be little incentive for workers or the unemployed to go for training especially when the employment prospects is low or when they do not perceive high returns to re-skilling or re-training.

2. Time lag – longer time for supply-side policies to take effect.

3. Long term effect is positive.

Conclusion

Opening up its economy is certainly one of the ways to spur domestic firms to become more efficient with the increased competition. The increased flow of FDIs also increases the country’s productive capacity as well as generate export earnings for the country. In addition, through FTAs, Brazilian firms are able to gain access to international markets, thereby generating export earnings for Brazil to enjoy economic growth. These gains can be realised if Brazilian firms are competitive globally. The extract mentioned that only a few Brazilian firms are able to penetrate the global market because of their lack of competitiveness. As such, I think that whilst opening up its economy is good, more fundamentally, Brazil needs to work at improving its infrastructure, tax system, and its labour force – in order that the country is able to penetrate foreign markets successfully in new export industries. Thus, supply-side policy, though take a long time, is the best option to achieve sustained economic growth.