Unit 8 International aspects

Assessment: model answers

1 South Africa imposes a quota on Chinese imports

(a) Clothing and textiles are visible imports and will be recorded as debits from the balance of trade in the current account of the balance of payments.

(b) A quota is a physical limit on the volume of a product that can be imported into a country. By placing a quota on an imported product a government will restrict its supply and this will force up its market price. As a result, consumers will have less choice and face higher prices. If cheaper close substitutes are available, consumers will switch their demand to these; however, this too will tend to push up their market prices unless supply of the substitutes also increases. Domestic producers able to supply substitutes may benefit from this increase in demand and may respond by increasing output and taking on more labour, thereby boosting employment and incomes in the economy.

However, some domestic producers may rely heavily on imports of materials and components to produce finished clothing. Quotas on their supply will increase their production costs and may even result in a shortage of supply if few alternative sources are available to them. If so, they may be forced to cut back their production and possibly also their workforces.

(c) Consumer demand for imports of cheap clothing and textiles from China rose rapidly in 2006. Following this, the South African government imposed a quota on the imports in the first quarter of 2007. This will have restricted their supply and therefore increased their price in South Africa. Consumer demand for the Chinese imports will have contracted significantly as consumers switched their demand to cheaper alternatives from Malawi and Zimbabwe, although the article suggests China continued to export to South Africa through these countries.

(d) Membership of a trade union could benefit textile workers in a number of ways, principally because the union will represent and defend their interests in negotiations with employers over wages and working conditions, including reduced hours of work, increased holiday entitlements and improved health and safety at work. The union may also aim to agree improved sick pay, pensions and other benefits for its members, and often encourage employers to increase worker participation in business decision making. In addition, trade unions will often provide training and education courses to their members to develop the skills they need to do their jobs. This of course can also benefit the employers they work for because better-skilled workers will be more productive. Unions may also provide free or low-cost social and sporting facilities for their members to use. However, members may be required to pay a monthly or annual fee to remain a member of the union and to enjoy these benefits.

If there was no union representation each textile worker would have to negotiate on his or her own for increased pay and better working conditions with his or her employer. With few rights, a worker could face being sacked for asking. In contrast, the trade union will have significant bargaining power in negotiations with employers if it represents the majority of workers in the industry and is able to restrict their supply through limits on membership or
through industrial action. However, by restricting the supply of labour to the textile industry the union may secure higher wages and other benefits but at a lower level of employment because of the increased cost of labour.

Ultimately a union can threaten to instruct its membership to take strike action if employers are unwilling to agree improvements in wages and working conditions. This ultimately may include strike action, although striking workers may suffer lost wages and hardship if the union is unable to provide them with income support. Jobs may also be threatened if strike action causes firms to lose significant sales and customers from which they may be unable to recover.

On balance, I suspect union representation of workers in the textile industry has been beneficial to them, despite some limitations of union membership and actions, through improvements in their wages and working conditions. There are many examples around the world of textile workers without union protection working long hours for very low wages in ‘sweat shops’ to produce cheap clothing and fabrics for export.

(e) The weight of evidence presented in the article suggests the quota system was not a success since it failed to stimulate domestic production and employment.

The article suggests imports from China fell by 35% following the introduction of a quota, but clothing and textile imports from other countries subsequently increased so there was net overall reduction of just 13%. The article reports suspicions that China was simply exporting its clothing and textiles to South Africa via other African countries.

This might suggest, firstly, the quota on Chinese imports was not tight enough and, secondly, it should have been extended to imports of clothing and textiles to other countries. If the quota was tighter and applied to other countries the subsequent fall in supply in South Africa would have increased prices more significantly and caused a far greater contraction of consumer demand for the imported products.

However, increasing and extending the quota may still not have had the desired outcome. This is because, as the article goes on to highlight, South African companies relied heavily on imported materials and fabrics to produce garments and the quota had created a shortage. As a result, domestic firms were forced to cut back their production and workforces. For example, the article reports the lack of raw materials ‘forced one company to reduce its workforce by 8% despite previously investing heavily for a planned expansion’.

In addition, other South African manufacturers were unable to increase their output to meet consumer demand because of labour issues. The manufacturers are reported as arguing the unions wanted long-term employment guarantees for their members. However, this would mean firms would find it difficult to reduce their workforces as demand changed or to replace labour with new, more productive technologies. As such this would increase costs relative to overseas producers who had this flexibility to manage their workforces efficiently.

2

(a) Minerals and precious stones are visible exports from Namibia so they would be recorded in the balance of trade which is part of the balance of payments on current account.
(b) International trade enables economies to specialize in the production of those goods and services their natural, human and man-made resources are best able to produce because they have an absolute or comparative cost advantage over producers in other countries. They can then trade their surplus output with other countries to obtain the other goods and services they need and want. Through specialization and trade therefore, output, incomes and living standards will be much higher.

However, a country can overspecialize by producing too narrow a range of goods and services. If there is a fall in demand for the products a country specializes in, or another country becomes more efficient in their production, that country can lose significant trade. Many domestic firms may be forced to close and many jobs and incomes will be lost.

Overdependence on overseas producers to provide many of the goods and services individual and business consumers need and want in a country may also be risky. Overseas producers may abuse this market power to restrict supply to force up prices and their profits. Problems with weather patterns or industrial disputes overseas will also hold up supplies that may be vital for continued production in the countries’ many industries.

The economic risks of overspecialization can therefore be high and a country may therefore try to encourage greater diversification in its industrial base. This may require it to use trade barriers against producers from other countries that are more efficient in the production of these products in order to protect its domestic firms and jobs. However, trade barriers will restrict consumer choice and other countries may also retaliate with trade barriers of their own which can harm the industries the country is trying to protect.

It is therefore difficult to argue conclusively whether it is better for a country to produce many products and protect its markets from international trade or whether it is better to try to achieve specialization in some products only. It will depend on which strategy secures the most economic advantage and gains. Both strategies involve potential gains but also losses in terms of consumer choice, employment, incomes and growth.

(c) It is possible for there to be an increase in the value of minerals and precious stones exported despite a fall in their volume if there was at the same time an increase in their price that more than offset the fall in quantity traded. Other things unchanged, the market prices of minerals and precious stones will rise if there is a fall in their market supply. This is shown in the diagram below by a shift to the left in the market supply curve from SS to S1S1. As supply falls market demand contracts until a new equilibrium price is established at P1. At P1 the value of exports is P1 × Q1, which is greater than the original value of P × Q. This is because the demand curve is relatively steep such that the rise in price is proportionately greater than the fall in quantity traded. That is, total export revenue has risen because demand is relatively price inelastic.
First we should consider why a government might want to influence its balance of payments. The main reason is because it has a large balance of payments deficit or surplus. A deficit means a country is losing income because payments overseas exceed credits received from other countries. Domestic firms that experience a fall in demand for their products may cut back production and reduce their demand for labour, resulting in higher unemployment. The value of the national currency on the foreign exchange market is also likely to fall and this will increase the cost of imports.

A large surplus may also be problematic. Exporting firms will enjoy significant and rising overseas revenues from the sale of their exports, but the increase in income from exports may cause demand-push inflation when it is spent in the domestic economy. A surplus will also tend to push up the exchange rate and will increase the price of exports in international markets and could result in falling demand for exports and therefore job losses. A country with a surplus may also come under political and economic pressure from other countries to reduce it so they can reduce their trade deficits.

However, given the above, the first action a government could take is to do nothing because adjustments in the exchange rate should help to correct any imbalance. If there is a deficit, the exchange rate will fall making imports dearer and exports cheaper for overseas consumers to buy. If demand for imports falls and overseas demand for exports rises this should help close the deficit.

Similarly, if there is a surplus the appreciation in the exchange rate will make imports cheaper and exports more expensive. As demand adjusts the surplus should close. However, much will depend on how much the exchange rate changes and the relative elasticity of demand for imports and exports. For example, a persistent trade surplus may itself be a symptom of rapid industrial expansion in an economy in industries in which it has developed a comparative or absolute cost advantage.

Likewise, a large and growing trade deficit may be a symptom of slow or negative economic growth and a declining industrial base, with fewer firms in the economy over time able to produce goods and services for export or to compete at home with imported products. As a result, a balance of payments deficit could become long term. Closing the deficit may then require the development of new industries able to compete effectively with overseas producers. Trade barriers may be effective in protecting new, infant or sunrise industries, such as those involving new technologies, from overseas competition. This will give new firms the chance to develop, grow, and become globally competitive with the potential to provide many more jobs and incomes in the future. They may not otherwise get the chance to develop and grow if they are quickly eliminated by competition from lower-cost economies overseas. Providing them with protection from overseas competition may allow them to grow to take advantage of economies of scale and become internationally competitive. The danger is that infant industries may continue to require protection from cheaper imports even when they have become established.

In contrast, reducing or removing trade barriers to allow free trade may help a country reduce a trade surplus.

If internal demand is a problem, then a government may use fiscal and monetary policy to influence consumer demand. For example, cutting public spending and/or raising taxes can reduce demand for imports to help reduce a deficit. However, the fall in demand may also harm domestic producers. Raising the interest rate will reduce borrowing and demand for imported goods but can also attract investments from overseas to help reduce a deficit.
If there is a surplus, a government may use expansionary fiscal and monetary policy to increase demand for imports but this could create inflationary pressures if aggregate demand expands more rapidly than the aggregate supply of goods and services.

3

(a) An economy should specialize in the production of those goods and services it is best able to produce because it has the natural, human or man-made resources to do so. Specialization allows an economy to produce a greater volume of those goods and services more efficiently than industries in other countries because it has an absolute or comparative advantage in their production. Rather than allocating resources to the production of a wide range of different goods and services in which it has a cost disadvantage compared to firms overseas, it makes sense for an economy to specialize and then engage in international trade to import these other goods and services. An economy can do this by earning revenues from the export of those goods and services in which it has a cost advantage.

(b) A country may attempt to protect its own industries from overseas competition through the use of import restrictions and subsidies for its domestic firms.

A tariff is an indirect tax on the price of imported goods entering a country. By raising the price at which imports are sold it is hoped consumer demand for them will contract and that consumers will instead buy relatively cheaper substitutes produced by indigenous firms.

Subsidies can be paid to domestic firms in a country by its government to lower or offset their costs of production. This will allow these firms to supply their products at lower prices to domestic and overseas consumers. This will tend to expand consumer demand for their products at the expense of rival firms in other countries.

(Alternatively, describe quotas, embargoes and/or excessive quality standards and bureaucracy.)

(c) A natural resource is an unprocessed or raw material that can be used in the production of other goods and services. For example, sand is used to produce glass. Other examples include trees, plants and animals; minerals, such as coal, land and soils; water; and even air. All of these may be used as factors of production. Primary industries, such as mining, quarrying, farming and fishing, produce or extract natural resources including coal, iron ore, crude oil, seeds and grains, and of course fish. Naturally occurring productive resources are collectively called ‘land’ by economists.

(d) Increasing global demand and trade means many scarce natural resources are being used up ever more quickly to produce goods and services, provide jobs and generate incomes. The increased transportation of ever more people, goods and services across international borders has also increased pollution and is contributing to global climate change. Increasingly people are asking whether it is wise for countries to exploit their natural resources or better to conserve them. We can use economics to analyse this issue and determine whether or not it is economically sensible to conserve or exploit natural resources.

Many countries, and especially many developing and less-developed countries, rely heavily on the extraction and sale of their natural resources, such as crude oil, many mineral deposits, agriculture and timber, to provide jobs and incomes. If they conserved their natural resources they could suffer even greater poverty and levels of unemployment.
However, it may be possible to both protect and exploit a limited natural resource at the same time. For example, some countries have set up national parks to protect their wildlife and habitats. Some tourism is allowed which provides incomes and jobs for gamekeepers and owners of places where tourists can stay and eat. Similarly, many countries no longer hunt whales but instead offer whale-watching holidays, which help to generate jobs and incomes.

In a free market economy scarce resources are allocated by the price mechanism and the interaction of consumer demand and producer supply. Firms that waste natural resources will face higher costs than those who use them more efficiently and will not be able to compete. They must either become more efficient in their use of natural resources or they will go out of business. Furthermore, as natural resources are used up their market prices will tend to rise. Rising prices for natural resources should encourage greater conservation and waste reduction, and investments by firms in alternative production methods, which use up fewer natural resources. For example, these may include investments in solar panels and wind turbines to generate electricity instead of relying on coal- and oil-burning power stations, which pollute the environment.

However, firms in a market economy may not take full account of the harm their productive activities do to the natural environment or the depletion of natural resources. They will mostly be concerned with their own private costs and benefits, and how much profit they make. For example, a company in Brazil cutting down trees to supply wood may not be concerned with the negative impacts of deforestation in the Amazon rainforest on animal and plant life, or the global climate. Similarly, consumers may not know the true external costs of the goods and services they buy and consume. For example, the price consumers pay to fly on low-cost airlines may not reflect the pollution aircraft cause.

A government may therefore introduce measures to help conserve some scarce natural resources, for example by introducing taxes on goods and services which pollute the environment, and subsidizing the production of products which have no or only relatively low external costs in production or consumption. By making the production of products with high external costs less profitable these measures should help encourage labour and man-made resources to be moved into the production of products that do not deplete natural resources. Employment and wealth will be created in industries that are more environmentally friendly as a result. For example, car manufacturers can switch resources from the production of petrol-driven cars into the production of cars that run on less harmful bio-fuels or rechargeable batteries.

Measures to conserve natural resources therefore need not mean they are wasted and economies are worse off as a result. Economists are concerned with allocating scarce resources in the most efficient way possible to maximize economic welfare. In some cases this may mean it is more economic to conserve some natural resources

Or use them more efficiently. Production that damages the natural environment, destroys plant and animal life, pollutes the air and seas and contributes to dangerous climate change may not be allocating resources most efficiently even if it makes a profit because these external costs are overlooked.