

June 2005 Unit 6

Question One

a) Factors include:

- i) ICT revolution enabling fragmentation of production. Production can seamlessly be conducted globally because of increasing speeds and falling cost of data transfer via the internet. Manufacturers have been taking advantage of this and separating each production process to where they can be produced at least cost.
- ii) Falling costs of transport due to increasing use of containerisation and economies of scale for freight companies. This has allowed manufacturers to penetrate further markets. Consumers are also buying more goods from distant destinations because delivery costs are falling.
- iii) Rising income levels in countries like China have allowed manufacturers and service providers to open up plants in Asia because economies of scale are large enough in emerging markets. Richer consumers are also developing taste for products of MNC's. Eg. the mushrooming of Tesco hypermarkets in Asia.

- iv) Efforts of the WTO and bilateral trade negotiations have reduced trade barriers, as have the formation of trade blocs such as the EU, NAFTA and AFTA. Rising levels of global competition have also forced many governments to deregulate their markets thus encouraging MNC presence in their countries.

Eval

- i) The formation of trade blocs may have reduced trade between blocs. For example the number of trade disputes between the EU and the US have increased recently.
 - ii) Occasionally threatened by cheap foreign goods, countries unilaterally raise trade barriers → eg US blocking imported steel with tariffs.
- b) The decline in non-renewable energy resources will cause the price of such resources to rise.

In the short run, because demand for any given resource is inelastic, net importer countries will see import expenditures rising resulting in cost-push inflation and stagflation. The extent of the loss of jobs depends on

the ability of economies to absorb rising energy costs. For example many developed countries and NIC's have not yet seen a fall in GDP from the recent oil price increase. Some like the US have buffered themselves with stockpiles, others like Malaysia absorb rising oil prices via govt. subsidies. After a lag however, growth will slow.

Oil exporting countries however will enjoy windfall gains. Some countries like Dubai and Bahrain are wisely using the additional income to diversify their economies. Others like Iran are channeling the funds to development of nuclear capabilities and other military pursuit.

In the long run, the rising cost of energy will force private and govt. sectors to seek alternative sources of energy. For example with rising oil prices, the demand for oil hungry vehicles will fall while the demand for fuel efficient hybrid cars will rise. With these expectations, car companies are channeling more funds to R&D. Once the demand hits critical mass, the price of hybrid vehicles should fall because of economies of scale resulting in a sharp fall in the demand for oil. Many governments are also discovering cheaper additives such as ethanol (sugar in Brazil) and palm oil

bio fuel. These additives lower the demand for oil while boosting the demand for local crops from which these additives are derived.

Finally, rising price of oil is causing oil companies to seek previously uneconomical sources of oil, such as oil sands in Alaska and in inaccessible rainforests. The negative externalities resulting from environmental degradation will also unfortunately increase. However this will probably be offset by the increasing use of cleaner energy in vehicles.

Question 2

a) Factors include:

i) The value of the £. Probably the most important contributor to the decline of UK exports of manufactures since it began rising in 1996.

ii) Loss of comparative advantage in manufacturing due to relatively high labour costs and low productivity. Results in high production cost. Also results in driving away FDI.

iii) Lack of investment in capital equipment

and R&D. The former results in a low capital to labour ratio as well as relatively slow introduction of newer production technology. The latter means that UK manufactures cannot capitalise on the relatively high inelastic demand of ~~new~~ products embodying the latest technology.

- iv) Inadequate expenditure on marketing and after sales support. This means that the UK is not able to compete with countries whose products are heavily branded like Japan and the US. Many foreigners also stay away from UK manufactures that require maintenance because of the difficulty in finding service outlets and spare parts.

Evaluation:

- i) The UK's labour market and industrial structure is quite flexible and competitive relative to other Western EU countries. This is why it ranks above Germany and France on the competitiveness league table.
- ii) Smaller UK manufacturers have managed to do well by staying nimble and at the cutting edge of market trends. Eg clothing brands like Miss Selfridge & Topshop.

b) One economic effect is to make the per unit manufacturing cost in the UK rise relative to its trading partners. This will translate into higher prices of UK exports relative to imports. This in turn will cause the trade deficit to worsen. The exact impact on the trade balance will depend on several things:

i) How much of the higher cost will UK producers absorb and how much will they pass on to consumers. This in turn depends on the level of competition in markets.

ii) The relative elasticity of demand for UK exports. If UK exports are relatively price inelastic the increase in price will not adversely affect exports too much.

The second economic effect will be to cause a greater imbalance in growth of different sectors. A loss of competitiveness in the UK will adversely affect the manufacturing sector which is already facing a prolonged recession. This is because most manufactures are tradeable - UK consumers can choose to buy cheaper imports. On the other hand most service industries are non-tradeable. $\therefore$ even if UK haircuts become more costly, Britons are unlikely to drive to France for a haircut.

∴ Demand is less likely to be adversely affected. The gap between manufacturing and service sector performance will widen.

Thirdly lower UK competitiveness will cause FDI to go to other more competitive economies such as China and India. This lower FDI will not only trigger a demand deficient recession but may also cause UK's competitiveness - especially the adoption of new technologies - to fall further behind the rest of the world. This is because most FDI into the UK comes from countries that invest heavily in R&D like the US and Japan. However the negative impact of the fall of FDI on AD is likely to be relatively small because much of AD in the UK is consumer driven.

In the long run a sustained fall in UK competitiveness may cause the trade deficit to widen enough that it triggers a depreciation of the £. The demand ~~res~~ for £ from foreigners wanting to buy UK exports will fall relative to the rising supply from Britons wanting to exchange their £ for foreign currencies. While this depreciation may eventually correct the trade imbalance, it will undoubtedly cause the price of imported raw materials and oil (which is denominated in USD) to rise. This will

cause production costs to rise resulting in a leftward shift of the AS. This in turn will cause stagflation. A rising £ at this point in time is an unwelcome development given the skyrocketing price of oil in the past 2 years.

Question Three

a) Import restrictions may be implemented for several reasons:

i) To protect a country from dumping.

Eval: Difficult to prove intent. Dumping argument often invoked unfairly.

ii) To protect an infant industry.

Eval: Industry usually ends up becoming inefficient because of the protection.

iii) To allow sunset industries to be phased out gradually.

Eval: Govt must stick to commitment to phase out tariffs. Otherwise special interest groups will ensure industry stays alive.

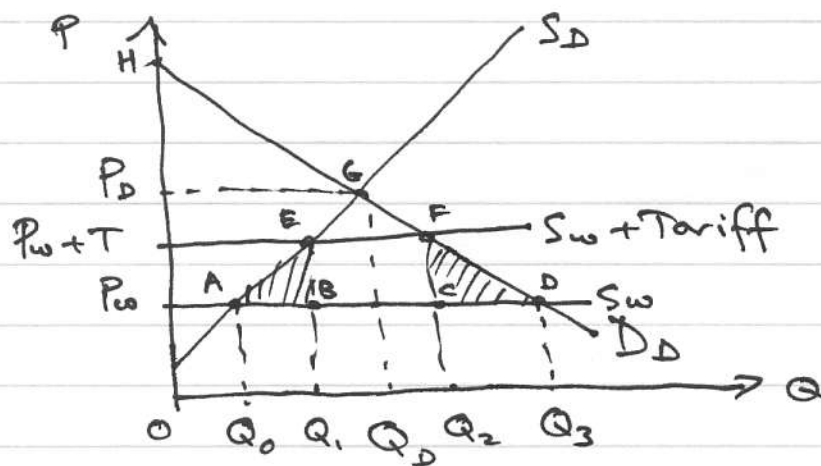
iv) To protect strategic industries.

v) To correct trade imbalance.

Eval: Will only work if other country does not retaliate.

vi) To protect domestic consumers from negative externalities $\rightarrow$ Eg: Tobacco & alcohol tax.

b) Impact of tariff.



With Free Trade:

- i) Domestic consumers only pay P_w .
 - ii) Qty demanded is OQ_3 .
 - iii) Domestic qty supplied is OQ_0 .
 - iv) Total imports $= Q_3 - Q_0$.
- Total import expenditure is ADQ_3Q_0 .

With Tariff:

- i) Domestic consumers pay $P_w + T$. Consumer surplus falls from HDP_w to $HEF, P_w + T$.
- ii) Domestic suppliers command higher price, produce more. TR increases to $P_w + T, E, Q_1, O$.
- iii) Total imports fall to $Q_2 - Q_1$. Total import

expenditure is BCQ_2Q_1 .
iv) Govt collects $EFCB$ in taxes.

Eval: Deadweight welfare loss of $FDC + EBA$.

Secondly other industries may suffer lower profits and job losses. Eg US Steel Tariffs in late 90's caused job losses in construction and auto industry as well as industries hit by retaliatory measures by trading partners $\rightarrow$ eg Russian ban on US poultry.

Thirdly there may be some improvement in the Terms of Trade. For example if the US restricted its imports of electronics, global prices may fall. This means that for every export sold by the US, more imports can be bought. Again the likelihood of this happening depends on:

- i) The extent of a country's monopsony power.
- ii) The absence of retaliation from trading partners.

Finally consumer welfare may fall. This is not only due to lower consumer surplus but also because:

- i) Less consumer choice.
- ii) Stronger monopoly power by local producers.
- iii) Falling real disposable income may cause undue burden to poorer households.
i.e. tariffs are highly regressive.