5. (a) State the meaning of EACH of the following acronyms:

(i) CET

....

....

(1 mark)

(ii) WTO

....

....

(1 mark)

(b) Differentiate between EACH of the following pairs of economic concepts:

(i) Absolute advantage and comparative advantage

....

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A and Country B, and two products, rice and cloth. Assume, also, that each country has two baskets of resources (see Table 20.1).

Table 20.1 A simple world economy

	Rice	Cloth
Country A	10	18
Country B	20	8
World output	30	26

With one basket in rice production and one basket in cloth production, Country A produces 10 units of rice and 18 units of cloth. With one basket in rice production and one basket in cloth production, Country B produces 20 units of rice and 8 units of cloth. Country A has an absolute advantage over Country B in the production of cloth. Country B has an absolute advantage over Country A in the production of rice. This is because, given the same resources, Country A can produce more cloth than Country B, and Country B can produce more rice than Country A. Country A puts its two baskets of resources into cloth production. Country B puts its two baskets of resources into rice production. Country A therefore specialises in the production of cloth and Country B specialises in the production of rice. Then, the two countries can trade. Table 20.2 shows the results of specialisation.

Table 20.2 The results of specialisation

	Rice	Cloth
Country A	0	36
Country B	40	0
World output	40	36

Note that, when there is specialisation, world output increases (from 30 to 40 for rice, and from 26 to 36 for cloth). Each country can then trade the good that it produces for the good that it does not produce.

The theory of comparative advantage

comparative advantage ▶

This theory states that a country should specialise in the production of the good in which it has the least opportunity cost or the greatest advantage. Comparative advantage occurs when a country can produce a good at the lowest opportunity cost when compared with other countries which have the same resources. When a country produces a good in which it has a comparative advantage, it can trade this for goods in which it has a lower comparative advantage.

Assume the same case of a simple world economy with two countries (Country X and Country Y), two products (rice and cloth), and two identical baskets of resources for each country.

Table 20.3 Absolute advantage

	Rice	Cloth
Country X	100	50
Country Y	5	20
World output	105	70

As shown in Table 20.3, Country X can produce 100 units of rice and 50 units of cloth, using a basket of resources for the production of each good. On the same basis, Country Y can only produce 5 units of rice and 20 units of cloth. Country X has an absolute advantage in both rice and cloth production. It might appear that specialisation and trade will not benefit Country X.

ITQ8
Why does country X have an absolute advantage in the production of both goods?

David Ricardo, a nineteenth-century economist, developed the theory of comparative advantage. He argued that, in a situation where one country has the absolute advantage in the production of both goods, specialisation and trade can still benefit both countries.

Let us analyse this situation.

Table 20.4 A table of opportunity costs

Country X	It has to give up 0.5 C to obtain 1 R	It has to give up 2 R to obtain 1 C

Structure of the balance of payments

We will now look at the structure of balance of payments accounts. Table 22.1 shows the balance of payments accounts for Trinidad and Tobago for the year 2007.

Table 22.1 Balance of payments for Trinidad and Tobago, 2007, US$ million

		Inflows	Outflows	Net	
A.	**Current account**				
	Export of goods	13391.3			
	Import of goods		7669.9		
	Export of services	923.8			
	Import of services		377.4		
	Balance of trade			+6267.8	
	Transfers			+60.2	
	Investment income			–963.7	
	Current account balance				**+5364.3**
B.	**Capital account**				
	Capital account balance				**–3468.6**
	Net errors and omissions				**–354.6**
C.	**Official reserves account (Official financing)**				
	Change in reserves (– increase)				–1541.1
			+		0

As can be seen, the balance of payments is made up of three subsections or smaller accounts. They are:

A. the current account;
B. the capital account;
C. the official reserves account.

current account ▶ The current account records:

- trade in goods;
- trade in services;
- transfers to and from private individuals and government;
- flows of income from investments.

merchandise balance ▶ visible balance ▶ The export of goods and the import of goods are the first two items on the current account. The balance for these two items is called the 'merchandise balance' or the 'visible balance'. This sub-account is called the 'visible trade account'. It is the value of goods exported minus the value of goods imported.

ITQ1
Calculate the merchandise balance.

In Trinidad and Tobago, the value of exports exceeded the value of imports. There is a surplus on the visible trade account, as inflows exceed outflows.

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Balance of payments surpluses

Factors that give rise to a balance of payments surplus

A balance of payments surplus occurs when inflows are greater than outflows. The country is receiving more income from abroad than it is making payments. A surplus might be due to:

- falling demand for imported goods and services;
- increasing demand by foreigners for locally produced goods and services;
- a decrease in holidays taken abroad;
- an increase in foreign visitors to the country;
- individual and governmental transfers into the country being greater than transfers out;
- investment incomes paid into the country to domestic investors who invested abroad being greater than those being paid out to foreigners who invested locally;
- greater investments in the local economy by foreigners than foreign investment made by domestic residents abroad.

All of the reasons for a balance of payments surplus, as for the deficit, are given on the assumption that all other factors remain constant – again, the *ceteris paribus* assumption.

The impact of a surplus

A surplus on the balance of payments accounts will lead to a number of consequences:

Hi! Nice to see ya!

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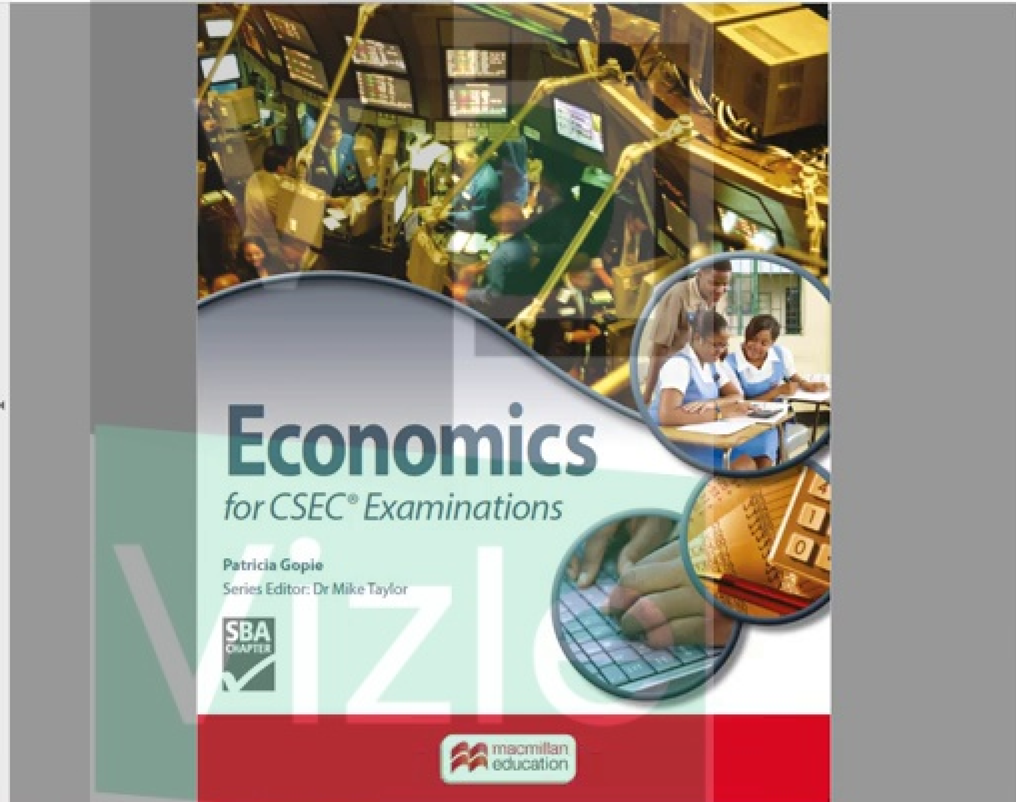

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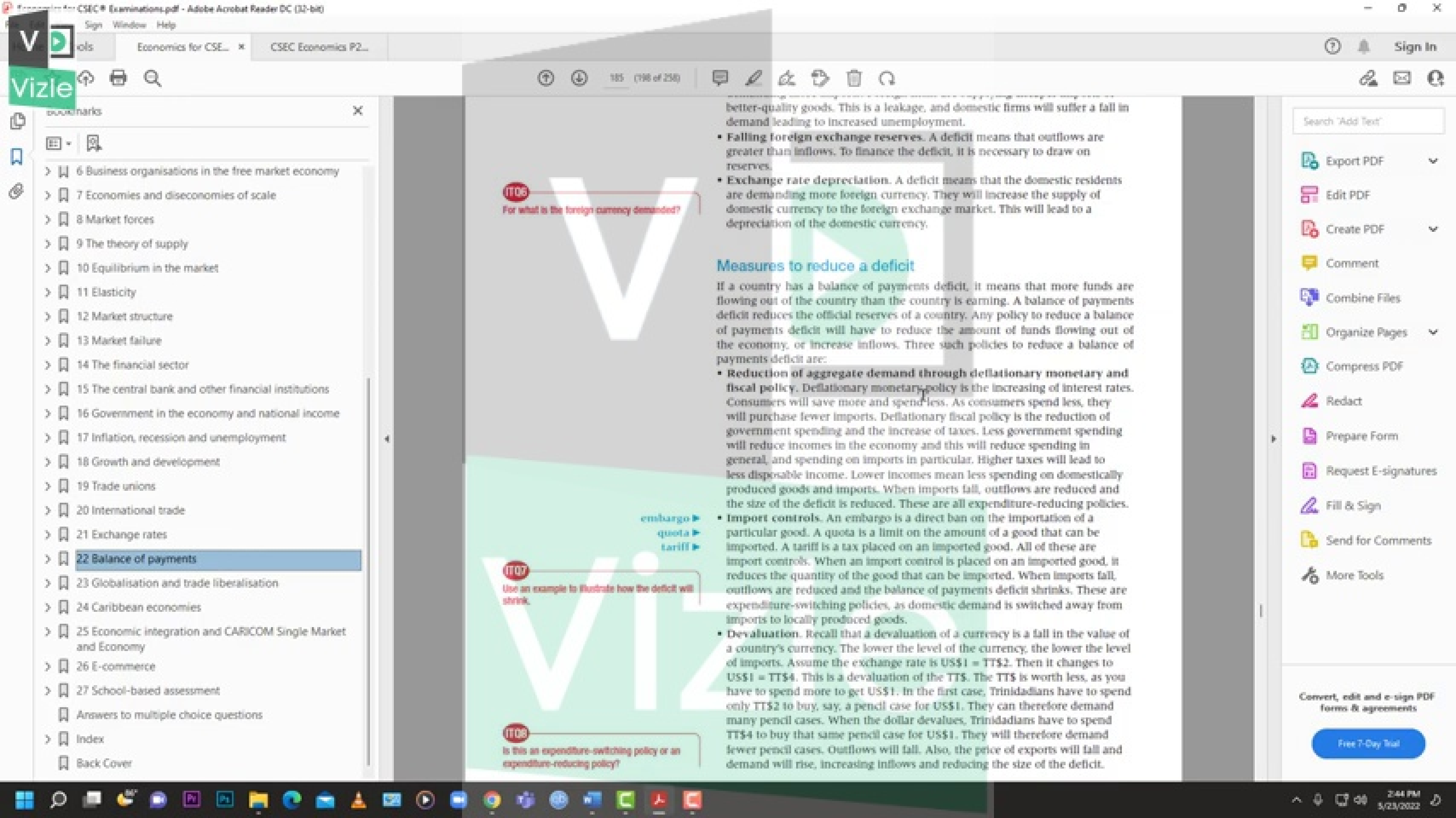

better-quality goods. This is a leakage, and domestic firms will suffer a fall in demand leading to increased unemployment.

- **Falling foreign exchange reserves.** A deficit means that outflows are greater than inflows. To finance the deficit, it is necessary to draw on reserves.
- **Exchange rate depreciation.** A deficit means that the domestic residents are demanding more foreign currency. They will increase the supply of domestic currency to the foreign exchange market. This will lead to a depreciation of the domestic currency.

IT06 For what is the foreign currency demanded?

Measures to reduce a deficit

If a country has a balance of payments deficit, it means that more funds are flowing out of the country than the country is earning. A balance of payments deficit reduces the official reserves of a country. Any policy to reduce a balance of payments deficit will have to reduce the amount of funds flowing out of the economy, or increase inflows. Three such policies to reduce a balance of payments deficit are:

- **Reduction of aggregate demand through deflationary monetary and fiscal policy.** Deflationary monetary policy is the increasing of interest rates. Consumers will save more and spend less. As consumers spend less, they will purchase fewer imports. Deflationary fiscal policy is the reduction of government spending and the increase of taxes. Less government spending will reduce incomes in the economy and this will reduce spending in general, and spending on imports in particular. Higher taxes will lead to less disposable income. Lower incomes mean less spending on domestically produced goods and imports. When imports fall, outflows are reduced and the size of the deficit is reduced. These are all expenditure-reducing policies.
- **Import controls.** An embargo is a direct ban on the importation of a particular good. A quota is a limit on the amount of a good that can be imported. A tariff is a tax placed on an imported good. All of these are import controls. When an import control is placed on an imported good, it reduces the quantity of the good that can be imported. When imports fall, outflows are reduced and the balance of payments deficit shrinks. These are expenditure-switching policies, as domestic demand is switched away from imports to locally produced goods.
- **Devaluation.** Recall that a devaluation of a currency is a fall in the value of a country's currency. The lower the level of the currency, the lower the level of imports. Assume the exchange rate is US$1 = TT$2. Then it changes to US$1 = TT$4. This is a devaluation of the TT$. The TT$ is worth less, as you have to spend more to get US$1. In the first case, Trinidadians have to spend only TT$2 to buy, say, a pencil case for US$1. They can therefore demand many pencil cases. When the dollar devalues, Trinidadians have to spend TT$4 to buy that same pencil case for US$1. They will therefore demand fewer pencil cases. Outflows will fall. Also, the price of exports will fall and demand will rise, increasing inflows and reducing the size of the deficit.

embargo ►
quota ►
tariff ►

IT07 Use an example to illustrate how the deficit will shrink.

IT08 Is this an expenditure-switching policy or an expenditure-reducing policy?

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