Trade, exchange rates and the global economy

Pearson Edexcel · International A-Level · Economics

Scope and prerequisites

This package now covers the full IA2 targets of specification sections 4.3.1–4.3.3 (36 objectives), grounded in specification pages 44–48 and WEC14 January 2025, June 2025 and October 2023 papers and mark schemes. Read the native introduction first.

Key terms

comparative advantage ; **opportunity cost** ; **globalisation** ; **foreign direct investment** ; **terms of trade** ; **tariff** ; **quota** ; **current account** ; **exchange rate** ; **Marshall-Lerner condition** - ; **J-curve** J .

Supported explanation

Comparative advantage means lower opportunity cost, not being absolutely faster. Calculate each country's forgone alternative in the same units. A feasible exchange between the two opportunity costs can make specialization and exchange attractive in a simplified model. Transport, adjustment, distribution and productive assumptions matter; the model does not guarantee benefits for every worker.

Protection can support a named industry, but tariffs also raise some consumer or input costs and can provoke retaliation. An infant-industry argument requires a plausible learning mechanism, a credible temporary plan and review; permanent protection is not established by the label. In a currency quotation of domestic units per foreign unit, an increase means domestic depreciation. Import costs can rise before quantities adjust; the current account also includes income and transfers, so it is not simply the goods balance. Integration can lower barriers within a group while affecting outside suppliers differently. Evaluate the actual rule and source conditions rather than treating every agreement as identical.

Original introductory case: Trade and exchange: introductory reasoning

Country	Hours/cloth	Hours/grain	OC cloth	OC grain
A	3	6	0.5 grain	2 cloth
B	4	4	1 grain	1 cloth

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Worked case

Country A uses three worker-hours per cloth unit and six per grain unit. Country B uses four per cloth and four per grain. Calculate opportunity costs, then consider exchange of one grain unit for 1.5 cloth units, assuming constant costs and no trade costs.

In A, one cloth costs $3/6 = 0.5$ grain and one grain costs $6/3 = 2$ cloth. In B, one cloth costs $4/4 = 1$ grain and one grain costs 1 cloth. A has comparative advantage in cloth; B in grain. A obtains one grain for 1.5 cloth instead of producing it at a cost of two cloth. B receives 1.5 cloth for grain costing it one cloth. The stated trade ratio lies between one and two cloth per grain. Feasible production and transport costs must still be checked; no distribution claim follows automatically.

Independent transfer

After depreciation, import expenditure rises. A commentator calls the comparative-advantage model false and recommends a permanent tariff. Assess both leaps.

Checked original model

Depreciation can raise domestic-currency import prices while contracts and limited substitutes slow quantity adjustment. Import spending alone does not establish the whole current account or refute an opportunity-cost model. A tariff recommendation needs a specific objective, effect on consumers and input users, adjustment and retaliation evidence, and a comparison with feasible alternatives. Set a review condition rather than infer permanent protection from one observation. The detailed IA2 trade, integration and exchange-rate analysis is now taught in the sections below.

Globalisation: characteristics, causes and effects

Globalisation is the growing integration of national economies. Its three measured characteristics are: trade rising as a share of GDP; the growing importance of **transnational companies** (TNCs) and **foreign direct investment** (FDI) – investment that sets up or buys lasting control of productive capacity abroad; and increased migration.

Causes over the last 50 years: trade liberalisation (falling tariffs and quotas through successive WTO rounds), more and larger trading blocs, political change (the breakdown of the Soviet system and the opening up of China), cheaper transport and communications (container shipping, the internet), and the growing significance of TNCs themselves.

TNC motives for FDI: access to cheaper labour or raw materials, access to markets behind trade barriers, lower taxes, and spreading risk across countries. Effects on recipient countries can run both ways: FDI can bring capital, jobs, technology transfer

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and tax revenue, but profits may be repatriated and large TNCs can influence domestic policy. **Transfer pricing** means setting prices for transactions between related companies. Misuse of those prices can shift profits to lower-tax locations and erode tax revenue.

Evaluating globalisation: possible benefits include faster growth, higher tax revenue, economies of scale, lower prices and higher consumer surplus, more choice and higher living standards. Possible costs include displaced workers in declining industries, exploitation where labour standards are weak, the environmental damage of longer supply chains, revenue loss from transfer-pricing misuse, widening income inequality within countries, and TNC influence over domestic policy. A good evaluation asks who gains, who loses, and under which conditions.

Specialisation, comparative advantage and the terms of trade

The worked case above shows the method: compute each country's **opportunity cost** per good in the same units; the lower opportunity cost identifies the **comparative advantage**; any exchange ratio between the two opportunity costs can benefit both. The theory assumes two countries, two goods, constant costs, full employment, no transport costs and free mobility of factors within countries; its limitations – transport costs, adjustment unemployment, demand patterns and increasing returns – are exactly where evaluation earns marks.

Patterns of world trade change with emerging economies, shifts in comparative advantage, new trading blocs and bilateral agreements, relative exchange-rate movements and changing protectionism.

The **terms of trade** measure export prices against import prices: ToT = (index of export prices / index of import prices) $\times$ 100. Worked example matching the June 2025 WEC14 question: export prices fell 4.8% and import prices fell 3.1% from a base of 100, so ToT = 95.2 / 96.9 $\times$ 100 = 98.25 – a deterioration, because export prices fell faster. Influences include relative inflation, relative productivity and labour costs, the exchange rate and world commodity prices. Effects depend on elasticities: a ToT improvement raises revenue per export unit, but export *revenue* rises only if demand is not too price-elastic; living standards move with the buying power of exports; the trade balance follows prices times volumes.

Trading blocs and the WTO

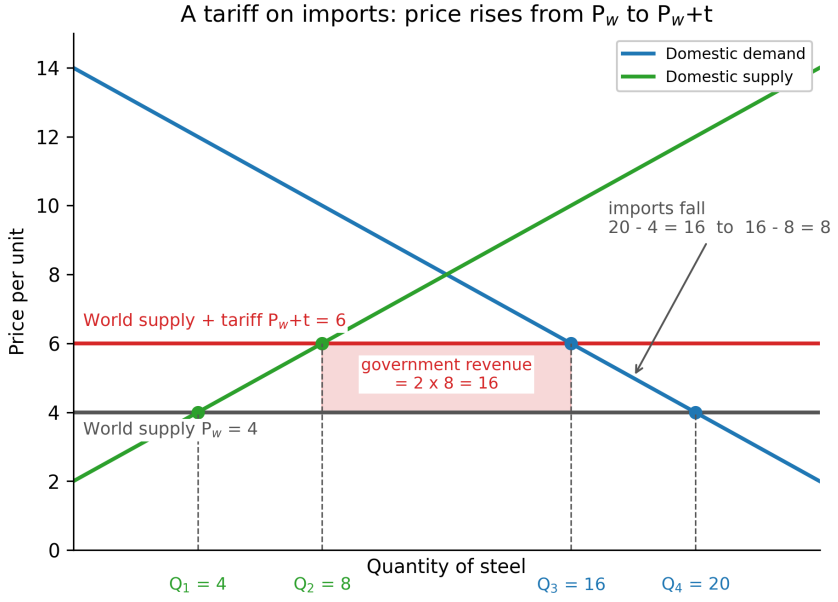
The **World Trade Organization** negotiates trade-liberalisation rounds, sets rules (national treatment, most-favoured-nation) and runs dispute settlement. Bloc types form a ladder: a **free-trade area** removes tariffs between members only; a **customs union** adds a common external tariff; a **common market** adds free movement of labour and capital; an **economic and monetary union** adds coordinated policy and often a single currency. Membership brings trade creation (buying from cheaper partners), scale

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economies and lower transaction costs, but also trade diversion (switching from cheaper outside suppliers to dearer members), and possible conflict with WTO non-discrimination rules.

Protectionism

Reasons for restricting free trade: protecting infant industries while they learn, geriatric industries while they decline, domestic jobs, and national security; preventing dumping; correcting a current-account deficit; and raising revenue. Types: **tariffs** (import taxes), **quotas** (quantity limits), non-tariff barriers (standards, red tape) and subsidies to domestic producers.



In the diagram's numbers (domestic supply $P = 2 + 0.5Q$, demand $P = 14 - 0.5Q$, world price 4, tariff 2): the price rises to 6, domestic output rises from 4 to 8, consumption falls from 20 to 16, imports fall from 16 to 8, and government revenue is $2 \times 8 = 16$. Consumers lose surplus and pay more; domestic producers gain; the government gains revenue but risks retaliation; living standards and equality can fall because tariffs hit low-income consumers hardest.

Balance of payments

The balance of payments records transactions with the rest of the world: the **current account** (trade in goods and services, primary income, secondary transfers), the capital account (capital transfers and non-produced assets), and the **financial account** (investment flows and reserves). A current-account deficit means the combined balance of goods, services, primary income and secondary income is negative. A trade deficit can contribute, but income and transfer flows can offset it. Weak com-

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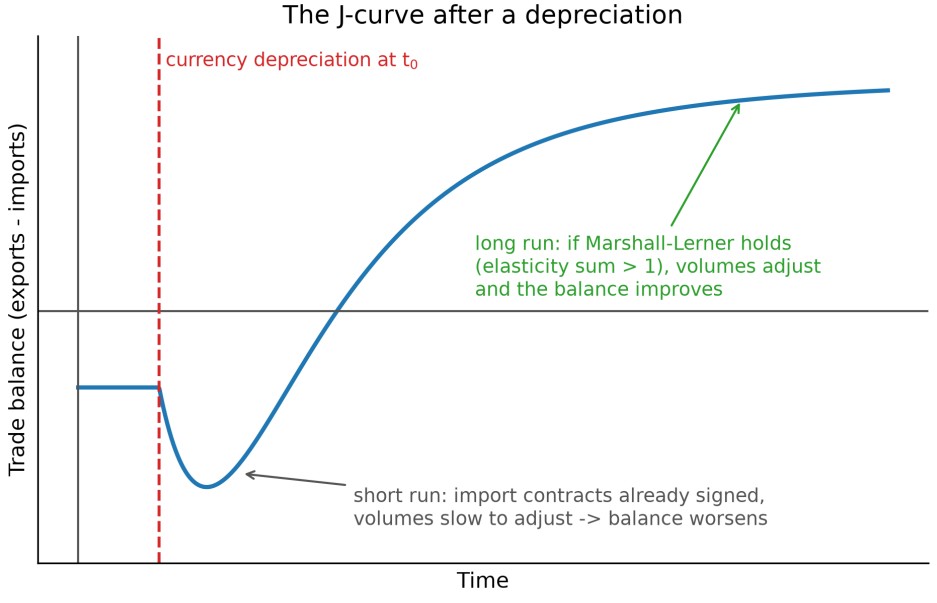
petitiveness or strong import demand may contribute; distinguish these mechanisms from the accounting definition.

Measures to reduce a deficit (the June 2025 WEC14 essay demand): expenditure-reducing deflationary policy (higher income tax or lower government spending to cut the marginal propensity to import; higher interest rates to cut spending); supply-side policy (education, infrastructure, R&D tax relief to raise competitiveness); a lower exchange rate; and protectionism (tariffs and quotas). Evaluation: deflation costs growth and jobs, supply-side policies take years, depreciation works only when the Marshall-Lerner condition holds, and tariffs invite retaliation. Global imbalances matter because one country's deficit is another's surplus: persistent gaps build debts, fuel capital-flow instability and can trigger protectionist pressure.

Exchange rates

A **floating exchange rate** is set by currency markets; a **fixed** rate is held by the central bank; a managed rate lies between. Governments influence currency markets through foreign-currency transactions (buying or selling reserves), interest rates, and quantitative easing (which increases money supply and tends to lower the currency).

Floating rates respond to relative interest rates (higher rates attract "hot money"), relative inflation (the purchasing-power-parity idea: high inflation erodes a currency's value), the current account, economic strength, capital flight, speculation and global factors such as commodity-price falls. Distinguish the words precisely: under a fixed regime the government devalues or revalues; under floating, the market drives depreciation or appreciation. A fixed-rate reduction is a **devaluation** – as the January 2025 WEC14 MCQ tested with the UAE dirham.



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A cheaper currency can lower foreign-currency export prices and raise local import prices, depending on pass-through. In the traditional benchmark of initially balanced trade, perfectly elastic supply and full pass-through, the **Marshall-Lerner condition** requires the magnitudes of export and import demand elasticities to sum to more than 1 for a trade-balance improvement. A **J-curve** can arise if prices change before quantities: the balance initially worsens, then improves if later quantity responses are sufficient. It is not an inevitable path. Exchange-rate changes also move the financial account (capital follows expected returns), growth, employment, inflation (dearer imported inputs) and FDI flows. Competitive depreciations – each country cheapening its currency to steal demand – invite retaliation and can shrink world trade, as in the 1930s.

International competitiveness

Competitiveness is measured by relative productivity, relative **unit labour costs** (labour cost per unit of output) and relative export prices. It depends on productivity, human-capital quality, the exchange rate, wage and non-wage costs (such as employer contributions), regulation, infrastructure and non-price factors such as design and reliability. Policies to raise it: education and training, investment incentives, privatisation and deregulation, a lower exchange rate, and trade liberalisation. A competitive economy sells more abroad and attracts investment; an uncompetitive one faces rising imports, weak export industries and pressure on jobs.

WEC14 assessment demand for this topic

WEC14 is an IA2 unit: 120 minutes, six Section A MCQs (6 marks), a 34-mark Section B source question, and two 20-mark Section C essays chosen from three; it may draw on Units 1–3. Section A has tested the devaluation/depreciation distinction, comparative-advantage outcomes, index numbers, customs-union definition and the tariff diagram's areas. Section C essays on this topic's ground include terms-of-trade causes (October 2023), current-account-deficit measures with a named country (June 2025), and FDI benefits (October 2023); "refer to a country of your choice" is a standing requirement, so prepare two or three revised country examples. The essay rubric (12 + 8) is the same as certified for WEC13.

Source boundary

XEC11/YEC11, 2018 specification, Issue 2. Evidence: specification pages 44–48 (sections 4.3.1–4.3.3), WEC14 January 2025 QP/MS (Section A Q1–6), June 2025 QP/MS (Section A Q3, Q5; Section C Q8) and October 2023 QP/MS (Section C Q8, Q10). Local authored marking guidance is not an official qualification scheme.

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