CIE Economics A-level

Topic 4: The Macroeconomy

i) Policies towards developing economies; policies of trade and aid

Notes

Types of aid; nature of dependency

Humanitarian aid is provided after disasters, such as the 2015 Nepal earthquake, or the 2004 tsunami. It aims to save lives and reduce suffering.

Tied aid is when aid is donated with conditions. For example, a developed country might donate aid in return for a trade deal.

Charitable aid is given from organisations, such as OXFAM and it is funded by donations from the public.

Development or long term aid aims to provide education to local communities to enhance their skills and aim for sustainable development.

Multilateral aid is provided by international organisations rather than individual countries. For example, it could be aid from the World Bank.

One of the main problems of aid is that countries can become dependent on it. It is particularly a problem if the aid is a loan and not a grant, since the recipient might struggle to pay it back.

Africa has been a top recipient of Chinese aid. By the end of 2009, it received 45.7% of China's cumulative foreign aid. It is important as a policy instrument for China with engagement with Africa.

Consumers in LEDCs have a higher propensity to consume than save, due to their limited incomes. Capital inflows, including those in the form of aid, can help fill this savings gap.

Aid provides temporary assistance to a country, such as humanitarian aid offered to countries after conflicts or natural disasters. Aid could also be a grant for a project that a country might not have the funds for.

Aid could be used to reduce human capital inadequacies or to pay off debt. It can improve infrastructure, which can help make the country more productive.

However, the benefits of aid are limited by corrupt leaders, the size of the aid payment and the potential for the recipient country to become dependent on aid.

Dambisa Moyo and Jeffrey Sachs are two prominent economists who have looked at the effects of foreign aid. Dambisa Moyo is generally against aid, whilst Jeffrey Sachs is generally pro-aid. It is worthwhile to have a look at some of their research and ideas. To briefly summarise, two of Moyo's arguments are that corruption means aid does not go where it is intended and that dumping goods, such as mosquito nets, into a country means private firms cannot compete and are forced out of business. Sachs suggests that it is possible for rich countries to meet the UN MDG of investing 0.7% of GDP into developing countries, which can help them improve infrastructure, yet this target is not being met.

Trade and investment, role of multinationals and Foreign Direct Investment (FDI)

Free trade is the act of trading between nations without protectionist barriers, such as tariffs, quotas or regulations.

Free trade provides the following benefits:

- Countries can exploit their comparative advantage, which leads to a higher output using fewer resources and increases world GDP. This improves living standards.
- Free trade increases economic efficiency by establishing a competitive market. This lowers the cost of production and increases output.
- By freely trading goods, there is trade creation because there are fewer barriers. This means there is more consumption and large increases in economic welfare.
- More exports could lead to higher rates of economic growth.
- Specialising means countries can exploit economies of scale, which will lower their average costs.

The following costs could be considered:

- Free trade has resulted in some job losses, since countries with lower labour costs have entered the market.
- Free trade might have contributed to some environmental damage. This is especially from the increase in manufacturing.

FDI is the flow of capital from one country to another, in order to gain a lasting interest in an enterprise in the foreign country.

FDI can help create employment, encourage the innovation of technology and help promote long term sustainable growth. It provides LEDCs with funds to invest and develop.

Multinational companies (MNCs) are organisations which own or control the production of goods and services in multiple countries. They have used marketing to become global, and by growing, they have been able to take advantage of economies of scale, such as risk-bearing economies of scale. The spread of technological knowledge and economies of scale has resulted in lower costs of production.

External debt, role of IMF and World Bank

The World Bank and IMF are sometimes called the Bretton Woods Institutions. They aim to provide structure and stability to the world's economic and financial systems.

Almost every country is a member of both institutions. The governments of each member nations own and direct the institutions.

The World Bank mainly focuses on development. The IMF tries to keep payments and receipts between countries logical and ordered.

World Bank

The World Bank can loan funds to member countries, and its aim is to promote economic and social progress by raising productivity and reducing poverty.

The World Bank is involved in several projects globally, such as providing microcredit, supporting education, and helping the rebuilding of countries after earthquakes.

International Monetary Fund (IMF)

The IMF aims to promote monetary cooperation between nations, and monetary problems can be consulted in the institution.

It also aims to help free trade globally, so jobs are supported. The IMF promotes exchange rate stability, and tries to avoid competitive depreciations in the currency.

Members can also borrow from the IMF, such as if they need to correct an imbalance in the balance of payments.

External debt is the amount of money owed to foreign lenders. Governments, firms and consumers could be borrowing money. Money is owed to commercial banks, governments and international institutions, such as the IMF and World Bank.

Impact of corruption, and importance of the legal framework in an economy

Countries with corrupt leaders might have higher levels of poverty. There is likely to be relative poverty since the leaders might keep most of the wealth.

In sub-Saharan Africa, the money lost from corruption could pay for the education of 10 million children per year in developing countries.

Without a safe, secure and stable banking system, there is unlikely to be a lot of saving in a country. This could cause a savings gap to emerge.

In many developing countries, there is only limited wealth, which means money cannot be put aside for the future, and they can only afford to spend in the short run. Consumers have to focus on their immediate needs, including food and safe water, to ensure they can survive. Without sufficient savings, there is inadequate capital accumulation.

Africa's saving rate is around 17%, whilst the average for middle income countries is around 31%. This makes it more expensive for the African public and private sectors to get funds since they have higher borrowing costs. This impedes capital investment.

The Harrod-Domar model states that investment, saving and technological change are required in an economy for economic growth. The rate of growth increases if the savings ratio increases. This leads to increased investment and technological progress, which leads to higher productivity.

The rate of growth is calculated by the savings ratio / capital output ratio in the Harrod-Domar model. Growth increases with more saving or a small capital output ratio.

The limitations of the model are that there is a low marginal propensity to save in some countries, or that there might be a poor financial system. Funds might not lead to borrowing and investment. There could also be inefficiency in the workforce.

Moreover, the paradox of thrift could be considered. An increase in savings could lead to an increase in investment. However, an increase in savings means there is a reduction in spending, which leads to a fall AD.

Weak or absent property rights mean entrepreneurs cannot protect their ideas, so do not have an incentive to innovate.