Lesson 29 International Trade

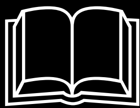
Aims

The aims of this lesson are to enable you to

- grasp the principle of comparative advantage
- calculate the terms of trade
- look at different exchange rate policies
- analyse the factors affecting levels of imports and exports.

Context

This lesson introduces the final section of your course in which an understanding of international trading objectives will be applied to an extended case study of the European Union.



Powell, ch. 10, sections 10.2 – 10.4.

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The Principle of Comparative Advantage

Before going into detail on the UK balance of payments, it is necessary to look at the basic theory and principles of international trade. Trade occurs for a number of reasons but the most important reason was suggested by **David Ricardo**. He argued that trade took place because of:

"The differences in opportunity cost or comparative advantage".

Countries will produce and sell those goods and services in which they have a relative (comparative) advantage and buy those goods and services in which they have a relative (comparative) disadvantage.

The table following illustrates a possible situation, where both countries are splitting their productive resources equally between the only two goods they can produce:

	U.K.	France	Total
Wheat	600	1100	1700
Shoes	600	600	1200

The UK can produce any combination of food and shoes so long as it is prepared to give up six units of wheat for six units of shoes (its opportunity cost). France can produce either 1100 units of wheat or 600 units of shoes or any other combination of wheat and shoes providing it is willing to give up eleven units of wheat for each six units of shoes.

Although France has an *absolute* advantage in producing wheat and neither country has an advantage in producing shoes, France has a *relative* advantage only in wheat production.

Note that it costs France 0.54 units of shoes to produce one unit of wheat.

But in the UK it takes 1 unit of shoes to produce the same unit of wheat.

However France sacrifices 1.83 units of wheat to produce one unit of shoes.

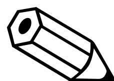
But the UK only sacrifices 1 unit of wheat to produce one unit of shoes.

So the existence of different opportunity costs within each country means that it is possible for each country to gain through trade. If

the UK switches all its production to shoes, it could produce 1200 units of shoes, while France could produce 2200 units of wheat. If the UK trades shoes with France at a rate which gives more than 5 units of wheat for each 5 units of shoes, and if France trades wheat with the UK at a rate which gives more than .6 units of shoes for each 11 units of wheat, e.g. if the UK trades 600 units of shoes for 900 units of wheat, then both countries would be better off and so gain from trade.

Thinking point

One of the issues with comparative advantage is that it can change over time. For example, the UK used to be one of the main manufacturing economies, but its comparative advantage has reduced significantly, as other economies have taken its place, such as China and India. Think about how the comparative advantage of an economy can change over time, and the impact this can have on the economy.

Activity 1	Think about the factors which can influence a country's comparative advantage over another. Write these in the box below.
	Issues include:

Problems with Comparative Advantage

The above theory has made a number of important assumptions which (as usual) do not normally occur in real life:

1. **Relative costs were presumed to remain unchanged** as a country increases its specialisation in one commodity or the other. This is not realistic. It is not always possible to switch

factors of production between different products and still gain maximum productivity. So as the quantity of wheat produced increases, its opportunity cost also goes up.

2. The theory so far **has not considered the actual demand** for the product. Consumers may not require more than a specific amount of wheat or shoes.

The above points would help to explain why the UK imports and exports both food and manufactured products.

Example: China has a lower labour cost than many other countries, so is able to produce goods at a lower price than it competitors. This provides Chinese firms with a comparative price advantage over firms in other countries.

Terms of Trade

Students always find difficulty with this term. In its simplest form it refers to the rate of exchange which must exist between two countries. The key point is how this rate is fixed. Ignoring governmental agreements and international conventions, the terms of trade will normally be based on the relative opportunity costs of the two countries.

Case study example from above - As you should realise by now, if France is to find it beneficial to trade with the UK, the Terms of Trade must be greater than the amount of shoes it could obtain domestically with the resources used to produce a unit of wheat. In this case, it will trade, providing the exchange rate means it costs less than 1.83 units.

Terms of Trade Index

The exact Terms of Trade within the opportunity cost limits set by the differing factor costs of production in two countries depends on many influences. Most important are the demand and supply conditions and their elasticities in both countries.

In real life, trade occurs in a multilateral way and so involves many countries and different products. In practice, therefore, the Terms of Trade are measured by the relationship between the price for imports and exports.

This relationship is then expressed as an index number which helps subsequent comparisons. Hence:

$$\text{Index number for Terms of Trade} = \frac{\text{Index of export prices}}{\text{Index of import prices}} \times 100$$

An increase in the index number – called an improvement in the Terms of Trade – shows that export prices have increased relative to import prices. In this situation if the UK Terms of Trade improved it will need to sell fewer goods in order to purchase the same quantity of imports.

A decrease in the index number – a deterioration in the Terms of Trade – means exports have become relatively cheaper than imports. So more goods must be exported in exchange for the same amount of imports.

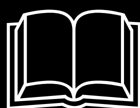
Interpretations of Terms of Trade

You should not jump to the conclusion that an improvement in the UK Terms of Trade means that the UK is better off! The key to any improvement remains the elasticities of demand for import and exports.

An improvement in the Terms of Trade caused by an increase in export prices but constant import prices could be disastrous. UK exports tend to be price elastic so an increase in price will mean a fall in total revenue from exports and hence, as imports have remained constant, the UK is in a worse situation!

The repercussions can in fact be quite complicated. If export prices remain constant while import prices fall, the UK would import more luxury items (cars), but many of the commodities we purchase from the 'Third World' are price inelastic, e.g. sugar purchases will not increase very much. So these countries have less money to buy our exports of machinery and once again an improvement in the UK Terms of Trade will not be beneficial to the UK economy.

It is worth stressing that the above two examples were chosen to illustrate possible bad effects – you should be able to work out possible beneficial examples for yourself.



Read Powell, sections 10.2 - 10.3.

Activity 2

Watch the video at www.ool.co.uk/2907ea, an overview of how exchange rates work.

Activity 3

Watch this on sterling and households: www.ool.co.uk/2907ea2.

Exchange Rate Policies

It should be clear, from what was said in the first part of this lesson, that International Trade will only occur when the exchange rate between countries allows them to benefit from specialisation.

As these rates are so important governments rarely permit them to be fixed by pure market forces. It is true that a great deal of the control of international exchange is linked to the systems used to establish the inter-change of national currencies. The three main methods of establishing exchange rates, prior to European Monetary Union, were (1) freely fluctuating rates, (2) the gold standard and (3) fixed exchange rates.

A brief note follows on each of these systems, but you need to study these in more detail by reading the relevant sections of your textbooks. The first test question at the end of the chapter is on this topic.

1. Freely Fluctuating Exchange Rates

In this case the government places no restrictions on the conversion of its currency into any other. One country's currency may be freely bought or sold for other currencies.

The only influence a government has is over the quantity of its currency available. So the value of a currency depends on the demand for it, compared with the demand for all other currencies, and on the supply of it, compared with the supply of all other currencies. The demand for a currency will of course be a function of the demand for its services and products.

Now think about the advantages that a freely fluctuating exchange rate can have for an economy. For example, it can benefit the balance of payments, it is flexible and countries need hold smaller reserves. Do you think these outweigh the disadvantages?

2. Fixed Exchange Rates

Under a system of fixed exchange rates, a country's currency is given a par value in terms of other currencies. The government of the countries concerned will agree to maintain the value of their currencies within fairly narrow limits by artificially maintaining demand or supply. This is done by selling up a reserve fund of convertible currencies and gold, which can be used to bolster its currency (in the UK, sterling) in the world currency market.

The UK fund is called the Exchange Equalisation Account. When there is too much pressure on the pound funds from the account are used to purchase sterling and so maintain its value. If the pound is in great demand then the Bank of England sells sterling and so adds to its reserves of foreign currencies.

If long-term imbalances occur, it becomes impossible for a country to continue to support its currency – hence devaluation or revaluation occurs.

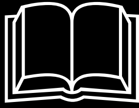
3. Managed Flexibility

Since the entry of the UK into the EU, the UK government, via the Bank of England, has operated a policy of managed flexibility in relation to exchange rates. Their objective has been to create a stable exchange rate in foreign currency markets around the world.

They allow the market to operate to find its own level. If the rate is falling or rising too fast the Bank of England enters international money markets, buying or selling pounds sterling.

Demand and supply factors operate to equalise the exchange rate compared to other currencies. At the same time other central banks in, for instance, France, Germany and America are trying to maintain exchange rate levels in their currencies. Exchange rate

stability allows firms to manage prices, control costs and plan future profits.



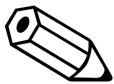
Read Powell, section 10.4.

Activity 4

For 2 years, the UK was part of the European Exchange Rate Mechanism (ERM) before withdrawing in 1992 following a dramatic fall in the value of the £, and "Black Wednesday".

This is a useful example of a managed exchange rate, and demonstrates when this arrangement works well, but also the pitfalls.

Put together a diary of key dates working up to the UKs withdrawal, noting the key events in the run up to the UK's withdrawal.

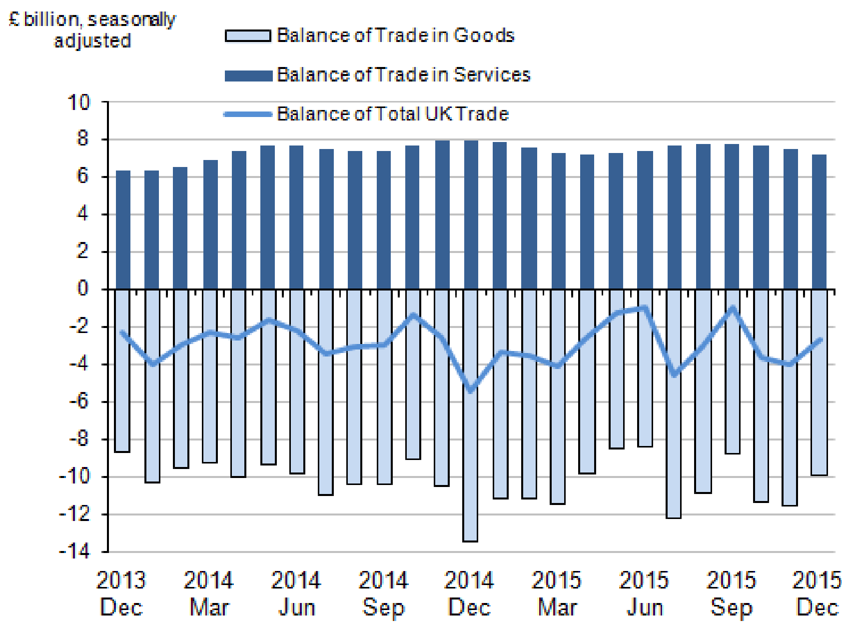


Dates include:

UK Trade

It is important to keep up to date with recent trading figures. These may take the following form:

Figure 1: Balance of UK trade, December 2013 to December 2015

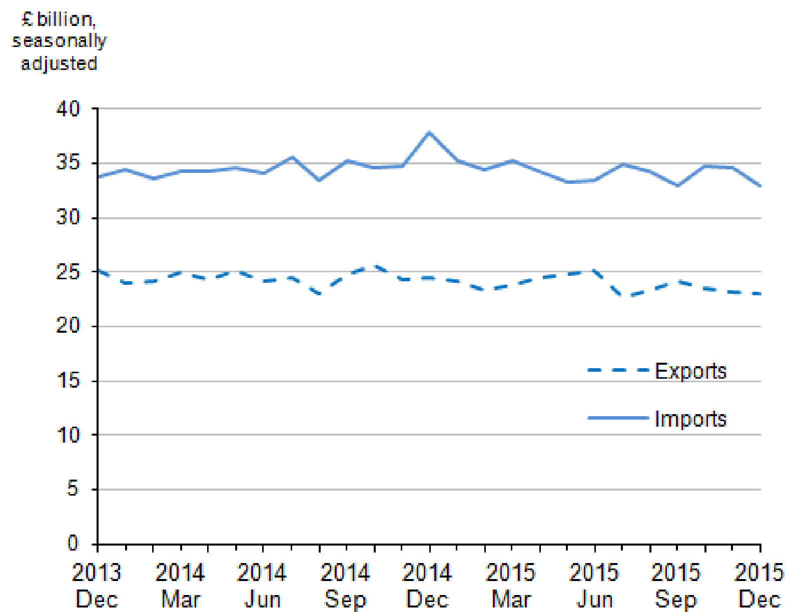


Source: Office for National Statistics

UK imports

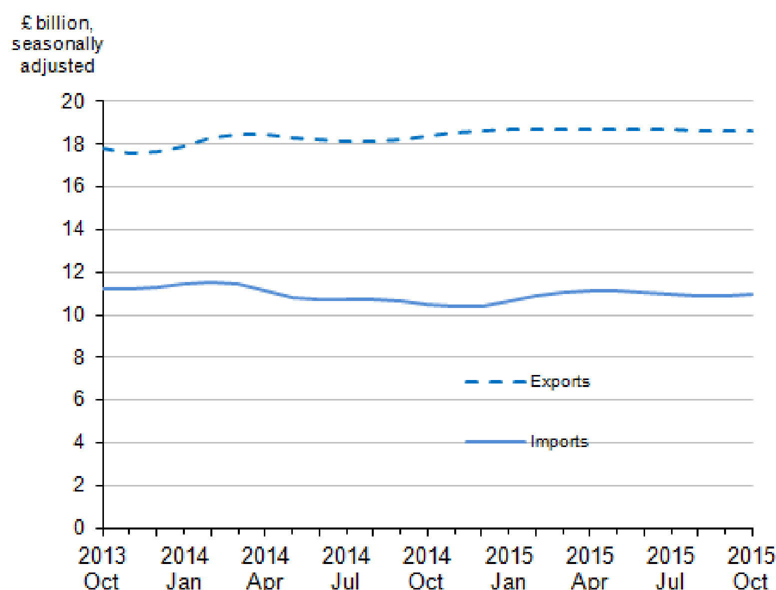
The UK imports a very broad spectrum of products, but it is more important to know the *relative* amounts than absolute totals, and how the composition changes.

Figure 2: Value of UK Trade in Goods, December 2013 to December 2015



(source: Office for National Statistics)

Figure 3: Value of UK Trade in Services, October 2013 to October 2015



(source: Office for National Statistics)

The UK imports of **services** (invisible imports) were mainly sea transport, civil aviation and government imports. Britain's trade in services has been in credit for over 200 years, excluding war periods.

As is to be expected, the EU share in the UK imports has risen quite dramatically since 1970, more than doubling by 1980, and constituting 53% of visible imports by 1992. Imports have also risen considerably from the oil-exporting countries and from Japan, while remaining relatively stable from the rest of the world.

Example: there was an overall increase of imports into the UK economy from 18% of GNP (Gross National Product) in 1967-70 to 27% of GNP in 1991-94, indicating the growing openness of the U.K. economy.

Why does the Level of Imports Vary?

1. The most obvious factor is the **total level of demand** – as overall spending increases so do imports by about $^{1}/3$ rd of total rise in expenditure.

2. **The relative price level** of domestically produced to imported products is also vital. Inflation in the UK has tended to be faster than most of our competitors, hence imports have

become more attractive. When the value of sterling fell, a similar situation occurred. However, these factors tend to work only in the long term as the elasticity of demand for foodstuffs and raw materials is quite low while, although manufactured products are elastic in demand, it is not always possible to build up the service to back-up facilities required by most manufactured goods overnight!

3. **Trade policies** are also significant – the UK entry to the EU in 1973 saw a major change in UK import patterns. This enabled companies in the UK to trade freely with other European companies.

4. **Technical progress** affects imports, since countries have to import new and improved goods that they do not have the technical skill to make for themselves. This applies particularly in very research-intensive industries such as computers, aircraft and pharmaceuticals.

Remember these as:

UK Exports

The largest group of visible exports are manufactures and semi-manufactures. These include a very wide range of engineering and other industrial products. You should compare the figures below with the import figures:

Visible exports are often divided into the following categories:

1. Foods, beverages and tobacco
2. Basic raw materials
3. Oil and non-oil fuels
4. Finished Manufactures
5. Semi-manufactured
6. Unclassified

Invisible exports of services are more important among exports than among imports, now comprising more than 25% of the total of all exports. These include earnings from sea transport, civil aviation, travel expenditure by foreigners in the UK and financial services especially banking and insurance.

The amount of exports have expanded with the increase being almost entirely on trade with Western Europe, North America, and the oil-exporting countries. This again has been a result of EU membership. Why do you think EU membership has had such a significant effect?

Where do our exports go to?

The UK exports goods and services to most of the world's countries, as may be seen from the following table:

Table 1: England - Top five export partners, year ending June 2015

	Country	Year ending June 2015 Total £ millions	Year ending June 2014 Total £ millions	% Change from June 2014	% Total Exports in year ending June 2015
Top 5	USA	33,812.4	29,241.5	15.6	15.9
	Germany	22,685.1	22,922.2	-1.0	10.7
	France	13,979.7	15,417.5	-9.3	6.6
	Netherlands	11,637.7	14,355.6	-18.9	5.5
	China	11,309.7	11,326.7	-0.1	5.3
	Others	119,124.3	121,871.5	-2.3	56.0
	Total EU	99,758.1	106,695.5	-6.5	46.9
	Total Non-EU	112,790.9	108,439.3	4.0	53.1
	Grand Total	212,548.9	215,134.9	-1.2	100.0

Note: 2015 data is provisional
Source: HM Revenue & Customs Regional Trade Statistics

Why Does the Level of UK Exports Vary?

1. The overall level of demand in foreign markets explains part but not all of the variations in UK export performance.

2. As with imports, the relative inflation rates of the UK and its customers' countries affect the price and relative competitiveness of our exports compared to those of our competitors.

3. Two theories attempt to relate UK export performance to the pressure of UK domestic demand:

    (a) A domestic boom means goods are diverted to home markets and/or exports decline because of too lengthy delivery dates.

    or the opposite:

(b) A boom in the home market is good for exports as it leads to long production runs and low unit costs, so that firms can export profitably at competitive prices.

Unfortunately, the actual data does not really support either of these two theories!

The Balance of Payments

The balance of payments records financial transactions made between consumers, businesses and the government in one country with those in other countries. It shows how much is being spent by consumers and firms on import, and how successful firms have been in exporting goods and services.

The balance of payments is made up of:

- The current account
- The capital account
- Official financing account

Activity 5	For an overview of the balance of payments please watch the video at www.ool.co.uk/2913.

Components

Trade in services

Trade in services is very important to the UK and represents about 30% of our exports. In 1999, the UK was the second largest exporter of services in the world. The strengths are in financial and business services, hi-tech knowledge services, creative services such as film and television programmes, books, advertising and marketing services and architecture and design.

However, the UK has a deficit in international travel and transportation as UK citizens enjoy their overseas holidays and low budget airlines help them to get there more cheaply.

Transfers

A significant amount of money leaves the UK every year in transfers. Some of this is the large contribution that we currently make to the EU (this is likely to reduce with Brexit) but also the large amount of money that the UK gives in foreign aid to poorer countries.

Finance

London is one of the main three financial centres in the world. Many large overseas banks can be found in London. HSBC (the Hong Kong and Shanghai Banking Corporation) is headquartered in London. Much of the world's currency transactions take place in London. The financial sector is a huge asset to the UK's Balance of Payments. At the time of writing, it remains to be seen how London's financial position will be affected by our decision to exit the European Union.

The Current Account

The UK runs a current account deficit and has done for many years. The deficit in goods is huge and growing. The surplus in services helps to offset that deficit but the staggering size of our imports of goods overshadows our export of services.

Measuring the current account

The current account of the balance of payments comprises:

- The balance of trade in goods
- The balance of trade in services
- Net investment incomes from overseas assets
- Net transfers

Running a deficit on the current account means more money is leaving the UK than coming in – this represents an increase in withdrawals from the circular flow of income.

The UK is not the only country to run a deficit as Portugal, South Africa and India, for example, also run deficits on their current account. One country's deficit is another country's surplus – countries that run a surplus on their current account include Norway, Germany and China.

What causes a deficit?

(a) In the UK we have a high-income elasticity of demand for imports. When our incomes rise we buy a lot more imports As our economy grows, so does our demand for imports.

(b) Deindustrialization and the emergence of lower cost countries has brought a long-term decline of UK manufacturing industry. In the 19th century the UK was the workshop of the world but today we import far more goods than we export. We only have to look at the steel industry and the future of the

Port Talbot steel works to see this in action – simply put, China makes steel at much lower cost than it is made in the UK. [They have also overproduced it and so are 'dumping' it, i.e. selling it below cost on world markets to reduce their stock]. Many UK businesses outsource their production – many Dyson products are made outside the UK.

(c) The UK is a net importer of food and drink and imports increasing amounts of oil as North Sea production is in decline.

(d) Changing exchange rates and volatile movements in commodity prices (oil, gas, coffee etc.) can have quite an impact on our import costs.

Problems caused by a persistent deficit

- Loss of AD leading to a fall in GDP and lower living standards
- Loss of jobs in domestic industries leading to structural unemployment
- Can lead to currency weakness and higher inflation
- May reflect a lack of competitiveness or supply side problems

Surpluses can cause difficulties too:

- If GDP is close to capacity, it can lead to demand pull inflation
- Threat of protectionist measures by other countries

How to reduce a deficit

1. Contractionary fiscal or monetary policy will reduce AD and therefore the demand for imports and potentially lead to recession (Expenditure reducing policy).
2. Improve productivity – this is an issue in the UK economy.
3. Lower the exchange rate, however, the exchange rate is freely floating so this is not as easy to accomplish (expenditure switching policy).
4. Invest in training to boost productive capacity and competitiveness.
5. Protectionist measures – tariffs, quotas etc. However, we cannot impose protectionist measures while we are still a member of the EU and, even after we leave, we have to abide by international agreements made with the WTO. (Expenditure switching policy).

Note the definition of expenditure switching and expenditure reducing policies (e.g. at p. 328 of the textbook).

Currency Depreciation and the Balance of Payments

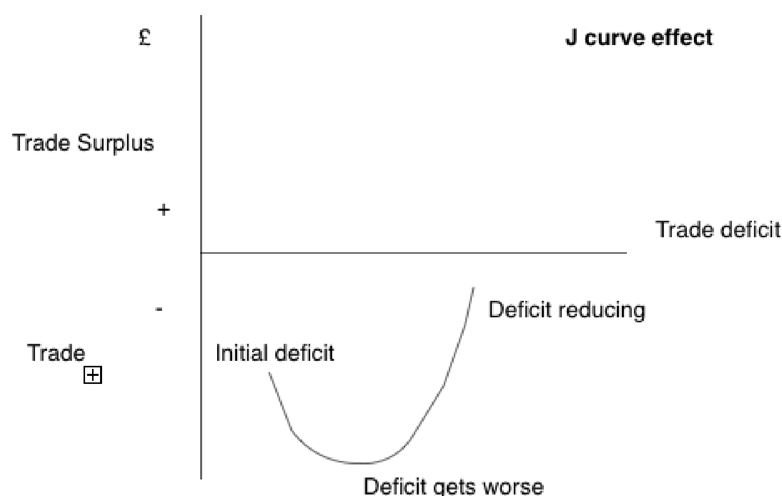
When the pound depreciates, it makes exports cheaper and imports more expensive. In theory this should lead to a lower volume of imports and a higher volume of exports improving the balance of payments.

However, in practice it might not quite happen like this. This is because in the short run there is a low price elasticity of demand for imports and exports. People cannot just alter their positions overnight in response to exchange rate changes. Businesses will have entered contracts and need to fulfill the terms of the contract until it ends.

People and firms in other countries may not see that UK goods are cheaper immediately. In effect there are time lags between the moment the change takes place and when the effects are seen.

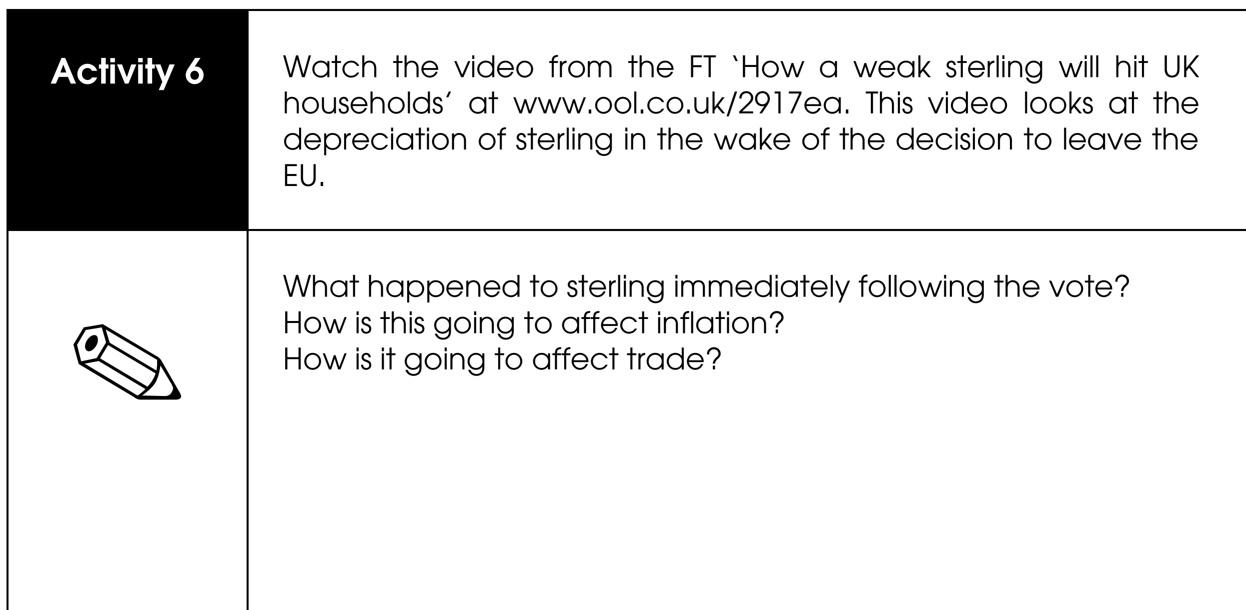
If we continue to buy the same level of imports at the new (higher) prices and our export volumes stay the same. But at the new (lower) prices the balance of payments could actually get worse in the short term; this is called the **J curve effect**.

The J curve effect can be illustrated on a diagram:



The Marshall-Lerner condition states that provided the sum of the PEDs for imports and exports are greater than one, then the trade balance will improve over time.

As we have seen, changes in the exchange rate can have a big effect on the balance of payments, although the effects depend on time lags and the PED for imports and exports.



Activity 6

Watch the video from the FT 'How a weak sterling will hit UK households' at www.ool.co.uk/2917ea. This video looks at the depreciation of sterling in the wake of the decision to leave the EU.

What happened to sterling immediately following the vote?
How is this going to affect inflation?
How is it going to affect trade?

The balance of payments and the standard of living

A Balance of Payments deficit is not always bad for the economy. It means that a country must rely on foreign direct investment or borrow money to make up the difference.

Foreign direct investment is overseas firms (multinationals) and governments investing in the UK. It is very important to our economy to attract this investment. It will be interesting to see what the impact of our decision to leave the EU will have on FDI.

If we have a deficit we may need to borrow to finance it. Like people countries have a credit rating and the better the rating the easier and cheaper it is to borrow money, hence the interest in the UK's international credit rating.

In the short term increasing imports can increase the standard of living as it allows consumer to buy more and a wider choice of goods and services.

Interest rates and exchange rates

When interest rates increase in the UK, foreign investors are attracted by the higher rates and invest in the UK. This leads to an increase in the demand for sterling and increases exchange rates. When interest rates fall, the opposite happens. These 'hot money flows', as they are called, can have significant effects on the exchange rate.

The exchange rate and inflation

If the exchange rate falls, it increases the prices of imported goods and services – this has a direct effect on the consumer price index. Many commodities, e.g. oil, are priced in dollars – so a change in the sterling-dollar exchange rate has a direct impact on the UK price of oil. A stronger dollar makes it more expensive for Britain to import these items.

The Bank of England has suggested that 10% depreciation in the exchange rate can add up to 3% to the level of consumer prices three years after the initial change in the exchange rate. However, the impact on inflation depends on what else is going on in the economy.

The exchange rate and unemployment

Exchange rate depreciation causes a faster growth of real GDP because of an increase in net exports (increased injection) and a fall in the demand for imports (a reduced leakage in the circular flow).

An increase in demand and output may create jobs as businesses seek to meet the increased demand. A lower exchange rate can have a positive multiplier effect on the economy.

Some industries are more exposed than others to currency fluctuations – e.g. sectors where a high percentage of total output is exported and where demand is highly price sensitive (price elastic)

Macroeconomic benefits of a weaker currency

A fall in the exchange rate is an expansionary monetary policy and can be used as a measure to stimulate demand, profits, output and jobs when an economy is in recession or slowdown.

It should lead to an improvement in the **balance of trade** and, as exports rise, lead to an expansion of output in industries that serve export businesses – which is called the **'supply-chain' effect**.

Goldman Sachs have estimated that a 1% fall in the exchange rate has the same effect on UK output as a 0.2 percentage-point cut in interest rates. In 2008 there was a 25% decline in sterling, which was equivalent to a cut in interest rates of between 4 and 5%. Had this not happened, the recession in the UK would have been much worse.

Lower exchange rates provide a **competitive boost** and can lead to positive **multiplier** and **accelerator effects** within the economy.

Depreciation also increases the value of profits and income for UK multinationals with investments overseas. It is a boost to tourism,

as the UK becomes a relatively cheap destination for overseas tourists.

CAP payments made to farmers are made in Euros, so a lower sterling/Euro exchange rate increases the sterling value of farm subsidies for farmers in Britain. CAP payments will end when the UK exits the EU.

Limitations of currency depreciation to solve economic problems

Not all of the effects of a lower exchange rate are positive. Overseas investors may lose confidence in investing in the UK and this can make it more difficult for the government to borrow to finance its deficit. If a lot of overseas investors take their money out, this is called 'capital flight'. If the exchange rate falls, we effectively owe more to foreign investors or banks.

Depreciation increases the cost of imports, which can cause an inward shift of short run aggregate supply and might also affect long-run productive potential.

The benefits of a lower exchange rate in attracting grater exports are limited if there is weak global demand.

Also remember the J curve effect things can get worse before they get better.

Activity 7	Watch the video at www.ool.co.uk/2919 and consider the various models – WTO model, Canada Model, Norway model. Liechtenstein model. Which model do you prefer? What might you be willing to compromise to get your preferred model?

Summary

Comparative advantage is the relative advantage or opportunity costs a country may have compared to another.

Terms of trade refer to the rate of exchange that exists between two countries.

Exchange rate policies can influence a country's economy.

Suggested Answer to Activity One

You may have considered the following influences:

- Access to primary raw materials
- Labour costs
- Other fixed and variable costs, such as transport
- Expertise and knowledge levels (skills)
- Scale of production

Suggested Answer to Activity Four

You will have researched what happened and the key dates leading up to the UK joining the ERM, what happened during this time, when the UK left the ERM and the impact this had on the economy.

Suggested Answer to Activity Six

What happened to sterling immediately following the vote?

Following that decision, the value of sterling fell to a 30 year low against the dollar and about an 11% fall in the countries the UK trades with.

How is this going to affect inflation?

The bank of England estimated that a 10% drop in sterling will lead to a 2-3% increase in prices but this effect may be bigger. However, with uncertainty and lower business confidence, companies may have to pass on the effects of rising import prices to consumers.

How is it going at affect trade?

Normally following a fall in the value of a currency leads to an increase in exports, as they are cheaper. However with lower interest rates and high employment there is not a lot of capacity for growth. Also FDI may not increase significantly as if the UK will no longer be operating inside the EU, it may be less attractive to foreign investment.

Syllabus Review

Topics relating to trade are covered in many lessons of this course, including the lessons that follow on the EU.

4.2.6.2 Trade

- The model of comparative advantage.
- The distinction between comparative and absolute advantage.
- The model shows that specialisation and trade can increase total output.
- Other economic benefits of trade, such as the ability to exploit economies of scale and increased competition.
- The costs of international trade.
- The reasons for changes in the pattern of trade between the UK and the rest of the world.
- The nature of protectionist policies, such as: tariffs, quotas and export subsidies.
- The causes and consequences of countries adopting protectionist policies.
- The main features of a customs union.
- The main characteristics of the Single European Market (SEM).
- The consequences for the UK of its membership of the European Union (EU).
- The role of the World Trade Organisation (WTO).

Students should be able to use a simple numerical example to illustrate the principle of comparative advantage and the associated benefits of trade.

Students should be able to use a diagram to illustrate the effects of imposing a tariff on imports.

Students should be able to discuss the arguments for and against the UK's membership of the EU.

4.2.6.3 The balance of payments

- The difference between the current, capital and financial accounts on the balance of payments.

- The current account comprises trade in goods, trade in services, income flows and transfers.
- The meaning of a deficit and a surplus on the current account.
- The factors that influence a country's current account balance such as productivity, inflation and the exchange rate.
- The consequences of investment flows between countries.
- The policies that might be used to correct a balance of payments deficit or surplus.
- Expenditure-switching and expenditure-reducing policies.
- The effect policies used to correct a deficit or surplus may have upon other macroeconomic policy objectives.
- The significance of deficits and surpluses for an individual economy.
- The implications for the global economy of a major economy or economies with imbalances deciding to take corrective action.

Students should have a detailed knowledge of the structure of the current account of the balance of payments but only need a general appreciation of the other sections of the balance of payments account.

Students should appreciate the difference between foreign direct investment (FDI) and portfolio investment.

4.2.6.4 Exchange rate systems

- How exchange rates are determined in freely floating exchange rate systems.
- How governments can intervene to influence the exchange rate.
- The advantages and disadvantages of fixed and floating exchange rate systems.
- Advantages and disadvantages for a country of joining a currency union, e.g. the eurozone.