

Question:

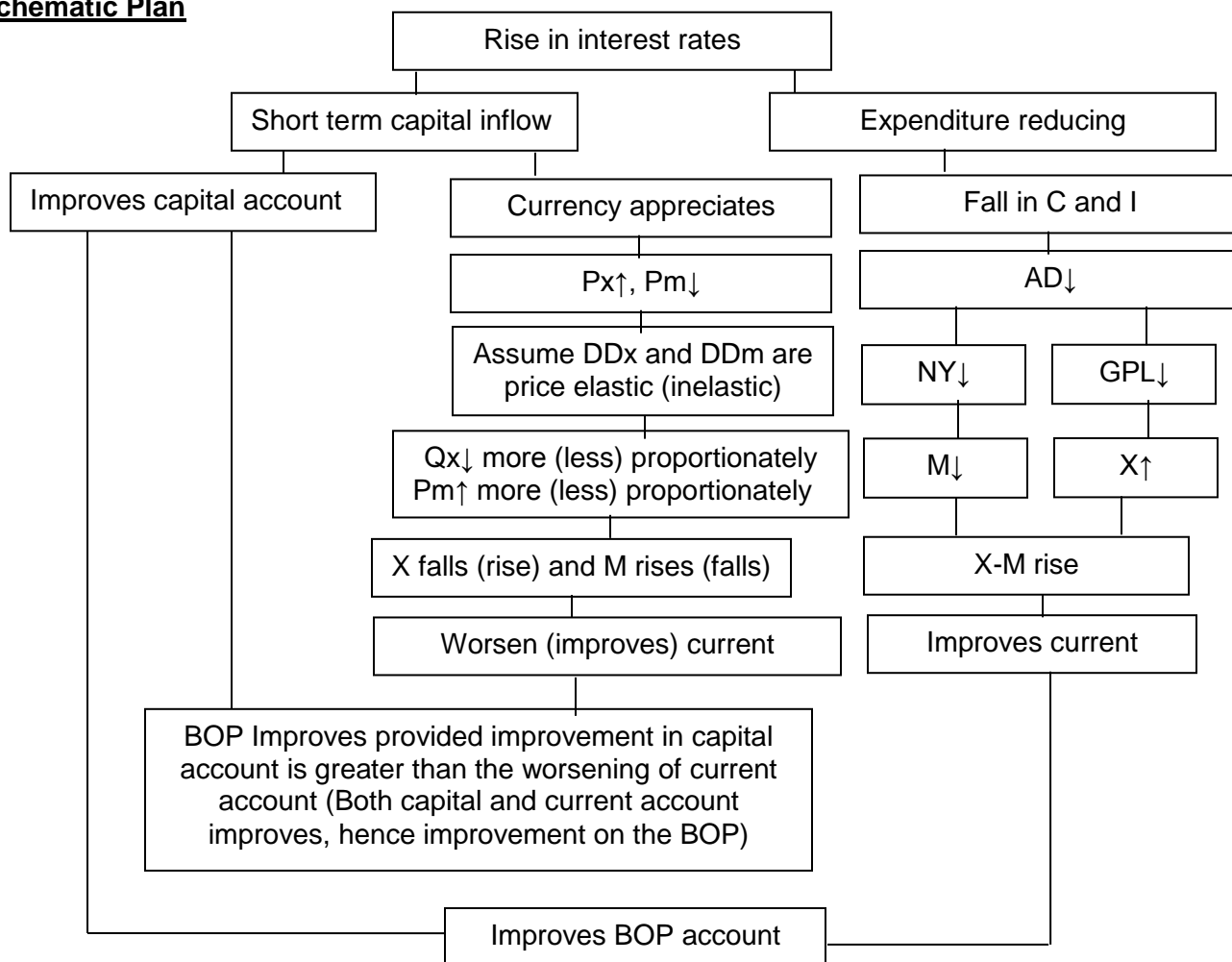
5 (a) Explain how a rise in interest rates would improve the balance of payments position of a country. [10]

(b) Assess the view that the government should focus on achieving a healthy balance of payments as its main macroeconomic goal. [15]

Interpret the Question – Part (a)

a) Explain how a rise in interest rates would improve the balance of payments position of a country. [10]

<u>What is the cue word?</u> (what are the skills required for this question?)	<u>What is the concept word?</u> (what are the concepts required to answer this question?)	<u>What is the context word?</u> (what is the context for this question?)
Explain	Interest rates Balance of payments	NA

Schematic Plan**Introduction (GIST)**

GIST	The balance of payments records the receipts and expenditure from international transactions. It is made up of the current and the capital account. The current account of the balance of payments account consists of the trade balance, services balance, income balance and balance of unilateral transfers while the capital
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	account records the inflow and outflow of capital in exchange for real and portfolio assets. Balance of payments position can be affected by various factors. One of them is interest rates. A change in interest rates can affect both the current and capital account and hence the balance of payments position.
Body (PEEL)	
What is the most important point?	
State the Point (P)	Any changes in the interest rates will have an impact on the domestic economy. Raising interest rates is a form of expenditure reducing method to improve BOP.
Explain Elaborate	<p>A rise in the interest rates raises the cost of borrowing. Borrower will borrow less for consumption due to higher cost of borrowing. At the same time, savers will save more as opportunity cost to consumer rises, hence a fall in consumption. Given the same expected rate of returns, a rise in interest rate raises the cost of borrowings for firms and cause investment to fall.</p> <p>A fall in C and I will lead to a multiple fall in AD through the multiplier process and as a result national income fall which limits the consumers' ability to consumer imported goods, hence import expenditure falls.</p> <p>The extent of the fall in NY will depend on the optimism of C and I on the economy and also the size of the multiplier, hence import expenditure may not fall substantially.</p> <p>At the same time, a fall in AD may cause general price level to fall and increase export competitiveness. This will lead to a rise in export revenue. With a rise in X and fall in M, net export rises which improves the current account.</p>
Link back to Qn	Hence, a rise in interest rates in a country will improve the current account of the country.
What is the second most important point?	
State the Point (P)	Any changes in the interest rates will have an effect on the short term capital account.
Explain Elaborate	A rise in the interest rates will attract hot money into a country. Hot money are funds or idle money that seeks for higher returns by capitalising on the difference between the interest rates of the countries provided the country does not impose capital control.
Link back to Qn	As a result, the inflow of currency will be greater than the outflow. Hence, a rise in interest rates in a country will improve the short term capital account of the country.
What is the third most important point?	
P	As hot money enters the country, the demand for the domestic currency will rise and hence will lead to an appreciation of the domestic currency.
Explain the point with clear causal links (E) Elaborate the point	An appreciation of the domestic currency of a country will cause the price of export to rise and price of imports to fall. Assume the demand for exports and imports are price elastic, a rise in price of exports will lead to a more proportionate fall in the quantity demanded for export. Likewise, a fall in the price of imports will lead to a more proportionate rise in the quantity demanded for imports. As a result, export revenue fall and imports expenditure rise and hence a fall in the net export. This will worsen the current account of a country.
Link back to Qn	Hence, in order for the balance of payments to improve, the improvement in the capital account must be more than the worsening in the current account.
What is the fourth most important point?	
P	However, in the short run, the demand for export and imports tend to be price inelastic as exporters and importers need time to adjust the expectations.

Explain the point with clear causal links (E) Elaborate the point	Hence, a rise in price of exports will lead to a less proportionate fall in the quantity demanded for export and a fall in the price of imports will lead to a less proportionate rise in the quantity demanded for imports. This will result in a rise in export revenue and a fall in imports expenditure. Hence, balance of payments improves.
Link back to Qn	Together with an improvement in the capital account due to hot money inflow, balance of payments improves.
Conclusion (SR)	
Summarise main points. Reiterate Stand	In the long run, it is important for the government to maintain a healthy balance of payments as it is one of the macroeconomics objectives of the government.

Interpret the Question – Part (b)		
(b) Assess the view that the government should focus on achieving a healthy balance of payments as its main macroeconomic goal. [15]		
<u>What is the cue word?</u> (what are the skills required for this question?) Assess	<u>What is the concept word?</u> (what are the concepts required to answer this question?) Healthy BOP Main macroeconomic goal	<u>What is the context word?</u> (what is the context for this question?) NA

Examiners' Comments

This question was not very well answered. Most scored a level 1 or 2. Students were not able to make a linkage between having a healthy balance of payments versus other macroeconomic aims. Most students presented on why other aims are important and went on to explain how fiscal, monetary, supply or trade policies were used to solve unemployment, economic growth and inflation without considering how these economic problems arise from achieving a healthy balance of payments or how achieving healthy balance of payments may sometimes conflict with the other macroeconomic aims of the country.

Schematic Plan

- 1) Explain what is considered as a healthy balance of payments
- 2) Thesis - Explain the benefits of achieving a healthy balance of payments linking to other macroeconomic aims.
- 3) Anti-thesis – Explain the costs of achieving a healthy of balance of payments which may compromise/conflict with the other macroeconomic aims.
- 4) Synthesis – Explain how the government can reconcile the conflicting aims by considering the current state of economy and the severity of the other macroeconomic problems.
- 5) Conclusion

Introduction (GIST)

GIST	<p>A healthy Balance of Payment (BOP) is one of the four macroeconomic objectives of the government. Government aims to achieve full employment, price stability, sustained economic growth and a healthy BOP.</p> <p>A BOP is considered to be healthy as long as the deficit or surplus is not huge or persistent.</p> <p>While achieving healthy BOP can bring about some macroeconomic benefits on the economy, it may also conflict with other macroeconomic aims.</p> <p>Hence, it is necessary for the government to adopt appropriate policies to achieve a</p>
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	healthy BOP to minimize these conflicts and if this is not possible, the government should consider the current situation of the economy to determine its economic priority.
Body (PEEL)	
What is the most important point?	
	<p>Thesis: A healthy BOP should be the main objective of the government. Explain how pursuing a healthy BOP should be the main objective of the government as a healthy BOP can lead to achieving other macroeconomic aims. Achieving a healthy balance of payments can ensure a more stable exchange rate of the country's currency. This will in turn promote higher volume of trade as exporters and importers are more certain of the value of the currency and thereby giving them more confidence to increase trade. This will benefit the country in terms of higher exports and higher imports. Higher exports means AD will increase and shift to the right. This will in turn cause firms to produce more output and employ more workers. As a result, there is a fall in unemployment. Higher imports means the country could possibly enjoy a higher national income and more variety of goods. A stable exchange rate due to a healthy balance of payments will also encourage higher investment in the country since firms are more certain of the returns. Higher investment will increase AD and through the multiplier process, national income will rise by multiple times. This will in turn help to create jobs as firms step up their production and reduce unemployment. In the long run, higher investments also raise the productive capacity of the country and shift the AS to the right. Achieving healthy BOP can also help to prevent the country's foreign reserves from depleting. It avoids the undesirable consequences due to a persistent and huge BOP deficit or surplus. If the current account is worsening due to the value of imports greater than its exports, it could mean that the country may be losing its export competitiveness. On the other hand, if the capital account is worsening, it could mean the country is no longer able to attract FDIs. As a result, the country needs to finance this deficit by drawing down its foreign reserves. If the country does not have enough foreign reserves, they will have to borrow from other countries or the IMF. A persistent and huge BOP deficit can lead to a devaluation of the currency and thereby worsen the SOL of the citizens as their import expenditure will rise substantially. This is especially so for countries which are highly dependent on imports for necessities such as energy and food. Hence, in order to for the country to maintain a healthy balance of payments, the country has to ensure that its export earnings are able to fund its import expenditure and avoid drawing down foreign reserves. This can be done through expenditure reducing or improve the export competitiveness through supply side policies. At the same time, the country also needs to change its policies in terms of tax and other pro-investment policies to improve the investment climate so as to attract FDIs.</p>
	<p>Anti- Thesis: A healthy BOP should not be the main objective of the government. Explain how a the pursuit of a healthy BOP may bring about conflicts with other macroeconomic goals In order to pursue a healthy BOP, a country may choose to increase its interest rate from part (a) or depreciate its currency. With an increase in interest rate, A rise in interest rates will attract hot money in the short term capital account and therefore improve the capital account and may lead to a capital account surplus. This surplus will therefore able to offset and finance the deficit in the current account. However, this will bring about a fall in consumption and investment expenditure due to higher cost of borrowing, thus leading to a fall in the level of aggregate expenditure and national income via the multiplier effect.</p>

	<p>Should the economy operates below full employment, there will be a real fall in real national income leading to negative economic growth and rising cyclical unemployment. These economic problems do not bode well for the economic performance and standard of living of the country and hence under such circumstances, the pursuit of a healthy BOP should not be the main economic objective of the government.</p> <p>Similarly, a depreciation of the currency to improve the current account balance could lead to a rise in net exports causing AD to rise. If the economy is operating at full employment output, a rise in AD may lead to demand pull inflation which is undesirable. A high inflation can cause the country to lose its export competitiveness and at the same time lowers the purchasing power of the citizens. Hence, pursuing a healthy BOP should not be the main objective of the government.</p> <p>Synthesis: How can government reconcile the conflicts?</p> <p>In order for the government to reconcile the conflicts, it is necessary for the government to adopt appropriate policies depending on its current state of economy. In the event that the country is suffering from both balance of payments deficit and high unemployment, expenditure reducing method such as increase in interest rate is not recommended as it may lead to lower national income and higher unemployment. Expenditure switching method such as depreciation may be recommended as it does not worsen the unemployment problem in the country. Demand-pull inflation due to depreciation is less of a concern during a period of high unemployment as the country will likely be operating below full employment. In this way, the pursuit of healthy BOP can remain an economic priority as it does not conflict with the other aims.</p> <p>In the event that the conflicts cannot be avoided, the government will have to prioritise its aim according to the severity of its economic problems. If the country is facing a serious problem of high unemployment but a relatively less severe problem of balance of payments deficit, it may choose to focus on reducing its interest rate to reduce unemployment instead of raising interest rate to pursue a healthier BOP as the benefits of a lower unemployment outweighs the costs of a worsening in the BOP.</p>
	<p>Conclusion:</p> <p>Whether a healthy BOP should be the main goal of the government is dependent on whether it can find the most appropriate policy to minimize conflicts with the other macroeconomic aims and the severity of the other macroeconomic problems. With the increasing flow of goods and services, direct investment and capital due to globalization, countries are facing greater challenges in maintaining a healthy BOP. This risk of unhealthy BOP, if not managed properly, can have undesirable consequences on the country's economy. Hence, maintaining a healthy BOP, as well as other macroeconomic aims, remains an important economic priority of all governments and this can be achieved by ensuring that the economy remains competitive through prudent management of the economy through effective implementation of policies.</p>