

6. “One reason for the decline in traditional protectionism is that countries hit by recession are able to let their exchange rates fall.” The Economist, Oct 12, 2013
- (a) Explain why a country might get into balance of payment deficit due to a recession in another part of the world. [10]
- (b) Assess the view that in correcting balance of payment deficit, letting the exchange rate fall is a more appropriate policy than adopting traditional protectionism. [15]

Answer requirements

- (a) Briefly explain the types of balances and economic transactions in the balance of payments & what a balance of payments deficit means →briefly explain the characteristics of recession in terms of national income and unemployment →explain why the weakening of economic conditions in another part of the world can cause a country to run into balance of payments deficit. Emphasise that globalisation causes these causal effects to be both direct (with others with recession) and indirect (with others similarly affected by the recession).
- (b) Briefly explain how each policy works in correcting balance of payments deficit →use chosen criterion/criteria as basis of ‘appropriateness’ to compare the two policies in relation to the deficit correction. End with a considered response on whether depreciation is more appropriate than tariffs/non-tariff barriers.

- (a)
 - The balance of payments (BOP) –definition & balances
 - The accounts record the transactions that place between the residents of a country and the rest of the world over a given period, usually one year. These transactions take the form of trade in goods and services and investment and portfolio (financial) capital movements.
 - Trade in goods and services recorded in current account while investment and portfolio capital movements recorded in capital account.
 - The BOP position is summation of current and capital accounts. If this overall balance is in surplus or a deficit, the balance of payments is said to be in disequilibrium.
 - BOP deficit
 - When the value of payments made to other countries, from imports, outflow of investment and financial capital, exceeds the earnings made from exports and inflows of investment and financial capital.
 - The deficit can originate from current account or capital account. A country can have a current account deficit and yet having overall surplus due to a surplus in the capital account that exceeds the current account deficit.
 - Recession in another part of the world
 - Recession is an economic condition when a country experiences a decline in Gross Domestic Product (GDP) over two consecutive quarters (six months). Define GDP.

- Recession is usually accompanied with rising unemployment rate and falling or negative rate of inflation.
- How recession in another part of the world causes a deficit BOP in another country
 - Likely to be a recession in a large economy, such as US or the Eurozone.
 - Falling GDP, rising unemployment → falling imports (imports directly related to national income) + falling investment and portfolio capital outflows to other countries → falling exports and investment & capital inflows for other countries
 - Globalisation has made countries' economies internationally interconnected. The effects of recession elsewhere on a country are both direct and indirect, eg. when US goes into a recession → imports less from Singapore and other countries → Singapore will see falling exports to US and to other countries which also suffer from the decline in exports to US.
 - The widespread effects of a recession in US are significantly caused by global supply chain in today's manufacturing and trade patterns. Most goods are now produced in different countries/ parts of the world before imported to a country – the reason why a recession in US would affect more than just the country it imports goods from.
 - Accompanying the global supply chains is the significance of foreign direct investment and portfolio capital flows. Hence when US suffers a recession, American firms will also be investing less or placing less funds in other countries, thus affecting their capital accounts.

(a)	Descriptors	Marks
L3	<ul style="list-style-type: none"> ▪ Causes cover factors affecting both current and capital account ▪ Explanation with sound conceptual clarity ▪ Clear linkage of factors to external recession in a different region/ part of the world (eg. recession in US/ EU on Asian or Emerging economies) 	9-10
	<ul style="list-style-type: none"> ▪ Conceptually accurate explanation covering mainly current account only ▪ Makes links to external recession although elaboration may be lacking 	7-8
L2	<ul style="list-style-type: none"> ▪ Conceptually not sufficient, eg. key terms such as BOP deficit and recession used but not defined ▪ Linkage to recession in another part of the world minimal/incidentally mentioned 	5-6
L1	<ul style="list-style-type: none"> ▪ Very skeletal answer ▪ Many conceptual inaccuracies 	3-4
	<ul style="list-style-type: none"> ▪ Primarily irrelevant in most parts of answer 	1-2

(b)

Introduction on both policies and notion of ‘appropriateness’

- Letting the exchange rate fall (depreciation): Currency becomes cheaper in terms of foreign currencies → country's goods and services become cheaper in foreign currencies & its imports more expensive in the domestic currency. A currency may depreciate when demand for it is falling due to declining exports and inflows of capital and FDI are falling due to weakening economic performance.
- Traditional protectionism refers to trade policy of reducing imports through tariffs and non-tariff barriers (NTBs) and raising exports through government subsidy schemes on export industries.
- In the correction of current account deficit, both are expenditure switching but while traditional protectionism is mainly raising aggregate demand (AD) by switching domestic expenditure from foreign goods to domestic goods, depreciation not only reduces imports but raising exports as well. Hence depreciation has a greater expansionary effect on AD through the expansion on export demand and even inflows of FDI.
- There are a few criteria that can be considered in the notion of appropriateness in question, such as the economic characteristics of a country, its economic conditions or with respect to efficiency considerations. [answer can select one or two for discussion]

Thesis: Exchange rate depreciation can be considered more appropriate than traditional protectionism because it is caused by weakening economic fundamentals of a country and not a deliberate policy of reducing imports

Argument 1: Depreciation is more appropriate because it offers greater expansionary effects on AD, needed when country is facing both BOP deficit and slowdown in economic growth

With growth slowdown, country needs to raise AD to close deflationary gap. Depreciation has broader effects, on both exports and FDI, than tariffs NTBs. With traditional protection, government can only switch domestic expenditure whereas with depreciation, foreign markets may be more receptive to country's goods and services.

Argument 2: While depreciation helps to make domestic production more competitive at home or overseas, this happens through market forces and not deliberate protection of home market

Exchange rate depreciation is market-led, not the result of tampering of trade policy by the government. Other countries will be more receptive to weakening exchange rate than the use of tariffs and NTBs which are recognized as unfair trade practices. With depreciation it is harder for foreign governments to fault this expansionary policy.

Anti-thesis: However, depreciation becomes inappropriate when it has been caused by deliberate manipulation of the country's central bank to achieve healthy trade position and economic growth

Argument 1: Prolonged depreciation can be considered a protectionist approach too as it would have involved continual central bank's intervention to weaken currency. Depreciation should be just a short term market-led adjustment for country to improve BOP. It is not appropriate as a long term strategy because just like traditional protectionism,

domestic producers will grow reliant on depreciation for competitiveness. Depreciation cannot replace the need for restructuring measures to improve competitiveness such as upgrading of labour skills and technology.

Argument 2: Depreciation causes rising domestic inflation which will eventually weaken the country's trade position and economic condition

- Depreciation will cause rising cost-driven domestic inflation if country is import-reliant for food, raw materials and even industrial components. This import reliance will make it difficult for country to achieve the Marshall-Lerner condition (for sum of price elasticity of demand for import and export demand exceeds one).
- Rising domestic inflation due to depreciation poses similar welfare effects as tariffs and NTBs which will cause rising domestic business costs and cost of living due to higher import prices.
- Rising domestic inflation will weaken the effect of depreciation on correcting BOP deficit. For countries with highly price inelastic demand, the deficit may even worsen.

Synthesis

- While both policies offer some potential for correcting BOP deficit, each has limitations and cannot be considered to be a sound way for dealing with chronic deficits which require structural supply-side measures for improving country's competitiveness for foreign demand and foreign investment.
- Being market-led, exchange rate depreciation can be considered more appropriate than the deliberate, and internationally seen as unfair, traditional protectionist trade policy against foreign goods. However, prolonged depreciation due to central bank's manipulation becomes a deliberate protectionist policy too and cannot be considered a more appropriate policy than tariffs and NTBs.

Note to students: An answer can bring together thesis and anti-thesis on a particular core idea, for example in arguing that depreciation is appropriate because it is market-determined the answer can then counter-argue that it is possible for a central bank to engineer a prolonged depreciation by continuous buying over of foreign currencies and selling its currency (case of China during the period of undervalued yuan). In this approach, the flow could be as follows:

- Depreciation is more appropriate because it is market-led without the deliberate measures of raising import prices or reducing import access in home market. However, a prolonged depreciation is also possible due to central bank's intervention, which can be considered a protectionist economic policy.
- Depreciation is more appropriate when a country is facing both the BOP deficit and growth slowdown. However, depreciation will inject imported inflation, which will also harm trade and economic growth, especially if country is import reliant.

	Descriptors	Marks
L3	<ul style="list-style-type: none"> ▪ Compares both policies in terms of how each comes about (market-led vs deliberate), extent of expansion on AD or efficiency effects ▪ Conceptually sound and elaborated explanation using economic concepts/terms such as <ul style="list-style-type: none"> ○ Expenditure switching ○ Price elasticity of demand/ Marshall-Lerner condition 	9-11
L2	Conceptually accurate and elaborated but non-comparative : only explaining how both policies work on correcting deficit balance of payments and not attempting to consider whether and how depreciation is more appropriate than traditional protection	6-8
L1	<ul style="list-style-type: none"> ▪ Primarily descriptive, not using economic concepts/terms in reasoning ▪ Very skeletal ▪ Major errors although there is relevance to question 	3-5
	▪ Most parts irrelevant to question	1-2
E2	Uses criterion/criteria for comparative evaluation and giving a considered judgment at closure. Example: Appreciation is more appropriate than traditional protectionism because it is market-led and economic fundamentals are weak but if the depreciation is engineered through continual central bank's intervention, it will have severe economic effects just such as traditional protectionism.	3-4
E1	Random evaluation of the measures, without criterion/criteria. Leaves two sides of arguments suspended without considered judgement at the end.	1-2