Governments typically use data on unemployment and inflation to assess the performance of an economy.

(a) Explain how the above-mentioned indicators of economic performance determine the choice of policy to deal with a deficit on a country's balance of payments. [10]

(b) Discuss the view that supply-side policy is the best option available to any government to ensure a satisfactory balance of payments. [15]

Suggested Answer:

When a country is facing a deficit on her balance of payments (BOP), it would mean that there is more currency outflows than inflows as a country's BOP is a record of the money value of all economic transactions between residents of one country and the rest of the world over a period of time. There are two main types of policies which can reduce a BOP deficit, namely the expenditure reducing policies and the expenditure switching policies. While both types of policies could potentially reduce the BOP deficit, there would be some conflicts with other macroeconomic aims under different economic conditions as indicated by the data on unemployment and inflation. Hence these indicators play an important role in determining which of the 2 policies would be more appropriate in correcting the BOP deficit.

Data on unemployment is an important piece of information for the government to consider when they are implementing expenditure reducing policies. When the government adopts expenditure reducing policies, like contractionary monetary and fiscal policies, they aim at reducing aggregate demand which will then reduce the national income through the multiplier process. As import is a function of income, import expenditure will fall and this will help to improve the BOP deficit. For example, in Singapore, the government can cut its government expenditure by stopping the recruitment of more civil servants and stop the construction of national projects like lift upgrading and expressways etc. However, as a result of this, unemployment will rise if the country is on the Keynesian range of the long run aggregate supply curve. With reference to Figure 1 below, when ADo falls to AD1, national income falls from Yo to Y1 and unemployment rates will increase. On the other hand, if the country was experiencing high inflation at first, the fall in aggregate demand from AD2 to AD3 might not cause unemployment if the extent of the fall in AD is manageable and within the classical range of LRAS. Therefore, the indicators of economic performance as seen from inflation and unemployment statistics will determine the suitability of implementing expenditure reducing policies.

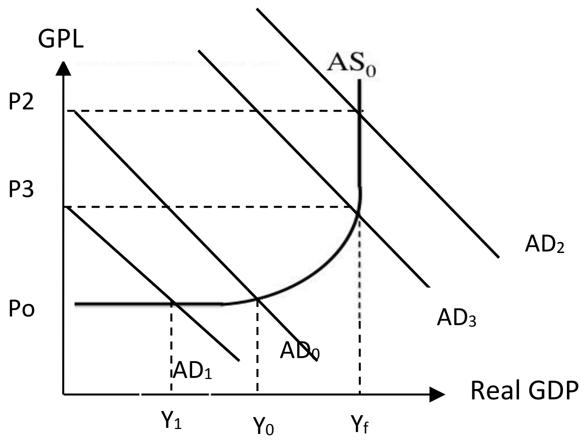
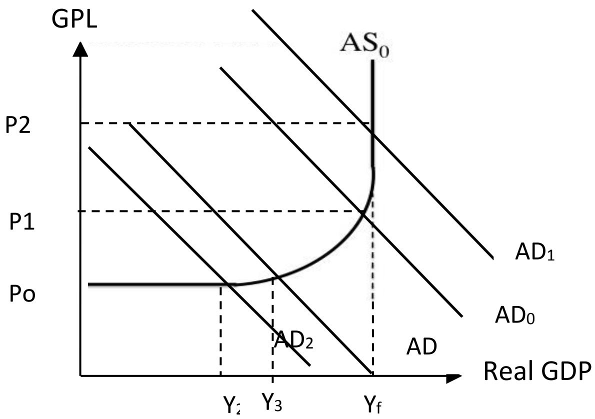


Figure 1

In determining the relevance of implementing expenditure switching policies, which are policies which switch import expenditure to domestically produced goods, inflation data have to be considered as well. When countries implement a depreciation of the exchange rate to enhance export competitiveness to correct a BOP deficit, demand-pull inflation might occur as a trade-off, especially if the economy was already experiencing high inflation. For import reliant countries, they become more vulnerable to imported inflation too, which might cause the cost of production to rise and fuel cost-push inflation. When a country depreciates the external value of their currencies, prices of exports in foreign currency becomes relatively lower while prices of imports in local currency becomes relatively higher. Assuming Marshall Lerner condition is satisfied, net exports will increase and this reduces the BOP deficit. At the same time, this results in an increase in aggregate demand too and national income will then increase via the multiplier process, depending on the state of the economy it is in. If the country had already been experiencing high inflation, the devaluation of the currency would cause AD to increase from ADo to AD1 and result in demand-pull inflation if there is no corresponding increase in productive capacity of the country. From Figure 2, prices will increase significantly from P1 to P2. On the other hand, if inflation rates or the risk of inflation has been low, then the country would have fewer concerns to implement expenditure switching policies to correct the BOP deficit. With reference to Figure 2, if AD2 increases to AD3, there will be an increase in national income from Y2 to Y3 with no increase in prices because of the spare capacity. Therefore, it is clear that both unemployment and inflation statistics are important factors to consider so that policy conflicts can be avoided as they help determine the suitability and relevance of policies to fight BOP deficit.



Level 3	For a developed explanation of how economic performance (given by indicators of inflation and unemployment) determines how BOP deficit can be reduced without tradeoff in policy objectives.	8-10
Level 2	For a developed explanation of how expenditure reducing OR expenditure switching policies can cause policy conflict with unemployment and inflation. For an undeveloped explanation of how policies to reduce BOP deficit can affect unemployment or inflation.	4-7
Level 1	Smattering of valid points	1-3

Suggest answer for “b”,

Most governments would implement supply-side policies to ensure a satisfactory balance of payments. A satisfactory balance of payments would mean a healthy BOP and it is in a surplus. This would mean that the main accounts of BOP, namely current and financial account, would be mainly in a surplus position as well. In comparison with a surplus, if BOP had been in a deficit, that would mean that the country might be importing more than it is exporting or even facing a dearth of investments from overseas, implying an uncompetitive investment market and this would usually require intervention to correct the BOP deficit. If it is a persistent deficit, the country would lose foreign reserves or be pushed to take up international loans to pay off their external debts, which would cause the future generations of the country to be in debt. Therefore, most countries would adopt an array of economic policies to reduce a BOP deficit and which policy is the best would depend on several factors like economic conditions and the root cause of the deficit etc.

One of the policies that government would adopt can be supply-side policy. The aim of the policy is to increase the quantity and quality of the resources in the economy so that costs of production can be reduced in the long run, which will then enhance export competitiveness. For example, governments can roll out training subsidies and research incentives which can help offload the producers financially when they send their employees for training and incentivise automation. Upon completion of training and a successful research and development, the employees and the production line become more productive. This will allow the prices of exports to be more competitive and if demand for exports is price elastic, quantity demanded of exports will increase more than proportionately, increasing export revenue and reduces the BOT deficit at the same time. With a more productive workforce and consistent attempts by the government to improve the infrastructure for investments, foreign investors would be attracted to the country to invest and the influx of FDI would improve the financial account, helping to reduce the overall BOP deficit. For example, in Singapore, corporate income tax rates have remained competitive and favourable tax exemptions and incentives are given to pioneering investors, so that FDI can continue to stream into Singapore to boost our financial account.

However, supply-side policy are costly and the results can be uncertain. For instance, the training courses which are heavily subsidised by the government would take up a significant portion of government’s fiscal budget and they would then have less to spend on other areas like healthcare and defence**.** Workers might also be reluctant to go for training as they might be resistant to more work and studies and the success rate of training amongst the workers also vary. Ultimately, given these limitations in reality, the effectiveness of supply-side policy would depend on the mindsets and receptiveness of the employees when they go for training. If they are willing and open-minded about going for training, then they can pick up the essence of the courses and apply them at work to enhance productivity. Also, if the government does not have a budget surplus all these years to finance the subsidies and incentives to enhance research and development, then the extent of the effectiveness of the programs would also be limited.

If the country was facing a BOP deficit due to excessive spending on imports by the citizens, then a more appropriate policy might be contractionary demand management policies like fiscal and monetary policies. Besides cutting down government expenditure as illustrated in part a, they can also increase income and corporate taxes to reduce disposable income and after tax profits so that consumption and investment expenditure would be reduced. As a result, aggregate demand will decrease and national income will fall via the multiplier process, bringing about lower import expenditure, which will reduce the BOP deficit.

The effectiveness of contractionary FP and MP to reduce AD might be limited too if the market sentiments about the future is optimistic. When there had been high economic growth recorded by the country in recent years, the level of expectations towards the future would be relatively positive, so the **consumers and investors might want to continue to consume and invest despite the higher direct taxes since they might believe they would be able to finance the higher taxes without adjusting their spending patterns too much. Also, these policies are immensely unpopular as it is generally difficult to raise taxes on the people as it will reduce economic growth and lower the standard of living quantitatively.** In addition, the effectiveness also hinges on whether the **demand for the imports is income elastic. If the demand for imports is income elastic, demand for imports will then drop more than proportionately when income falls**. It also depends on how strong the government is and the degree of the macroeconomic goals like unemployment rates and inflation, as mentioned in part a. If the government is strong and popular enough most of the time among the electorate, it would not need to implement populist policies to gain votes and would thus be more willing to increase taxes to correct a BOP deficit if necessary.

Lastly, the government can also adopt protectionist measures to restrict imports into the country. For example, they might impose import tariffs which would then cause the prices of imports to rise and assuming the demand for imports to be price elastic, quantity demanded for imports would fall more than proportionately and import expenditure would decrease, reducing the BOP deficit. However, protectionist measures might invite **retaliation from other countries and they would also do tit-for tat** and this can result in a fall in export revenue, which would limit the improvement of BOP position. In addition, there would be **deadweight loss to the society** when import tariffs are imposed as the consumers are forced to pay higher prices for goods and services when they could have been able to pay less. Ultimately, **protectionist measures should only be for the short term if the deficit is huge and requires fixing immediately. In the long term, countries should embrace free trade as the benefits of trade are immense and more withstanding while the benefits of protectionism can only be temporary.**

In conclusion, it is important to examine the root cause of the BOP deficit so that the appropriate policy can be implemented. If there had been a trade deficit due to the fundamental loss of comparative advantage, then supply-side policy would be more useful to build up a new area of specialisation and to regain export competitiveness. Yet it is also crucial to consider the magnitude of the deficit and if it is huge, then it would be imperative to reduce it immediately, then short term measures like protectionism would have been useful.

Level 3	For a developed discussion of how supply-side and 2 other policies can maintain a satisfactory BOP and a thorough consideration of the limitations of each policy. Also important to consider the appropriateness of each policy given different possible contexts to deem whether it is the ‘best’.	9-11
Level 2	For an undeveloped discussion of how supply-side policy and	5-8

	expenditure reducing policies can maintain healthy BOP. For a developed discussion of how supply-side policy OR expenditure reducing policies can maintain a satisfactory BOP	
Level 1	Smattering of valid points	1-4

Evaluation		
E2	For an evaluative assessment based on economic analysis. Thorough discussion about the suitability of supply-side policy for countries in various contexts. Deep consideration of the relevance of other proposed policies too.	3 – 4
E1	For an unexplained assessment, or one that is not supported economic analysis.	1 - 2