RVHS Prelims II Qn5

(a) Explain the role investments play in maintaining a healthy balance of payments account. [10]

- Inflow and outflow of investments are categorised under the Financial Account → increase in long term investment → improve the Financial Account position → improves the overall BOP position.

- Increase in investment in the country → increase the productive capacity of an economy
- Diagram
- NY increases and P falls → lower prices boost a country's export competitiveness → increase net exports increase → improve the BOT position →improvement in the overall BOP position.

- increase in investment in the form of form of research and development (R&D) → increase in the quality of goods → increase export competitiveness of a country and result in an improvement in the Balance of Trade (BOT) which is a component of the Current Account

- domestic firms who invest abroad can bring about an improvement in the Current Account when they repatriate profits back into the country

L3	Developed explanation of how investments help to maintain a healthy BOP account through both the Current Account and the Financial Account.	8-10
L2	Undeveloped explanation of how investments help to maintain a healthy BOP account through the Current Account and/or the Financial Account.	4-7
L1	Smattering of valid points	1-3

(b) Countries are increasingly worried about their increasing trade deficits. Discuss appropriate policy options that are available to an open economy to correct its trade deficit. [15]

The discussion of appropriate policies to correct a trade deficit depends on the causes of the trade deficit. A country could be running a trade deficit because its goods have lost competitiveness. To correct the trade deficit resulting from a loss in competitiveness, a country can implement expenditure switching or expenditure reducing policies to increase exports and decrease imports.

There are many reasons for a loss of competitiveness. One of the reasons is changing comparative advantage. If other countries are able to gain comparative advantage in the production of a good which used to be exported by the domestic country, this will mean that substitutes produced by other countries are now cheaper than that produced by the domestic country. Assuming a high degree of substitutability between the exports of the two countries, then the domestic country will likely see a loss of export competitiveness and a fall in demand for their exports. This will lead to a fall in net exports and a worsening of the balance of trade.

One type of expenditure switching policy that can be implemented by an open economy is supply side policies. Supply side policies can be implemented to regain a country's comparative advantage or to seek out new areas of comparative advantage. Supply side policies that include measures to encourage firms to invest and engage in research and development can increase the competitiveness of a country's goods as mentioned in part (a). The resultant lowering of cost of production or increase in quality of goods produced could help the country regain comparative advantage, thus boosting its export revenue and reducing its import expenditure and enabling it to correct its trade deficit. However, one limitation of supply side policies is that the results of R&D is not always guaranteed. Furthermore, the results of such policies can only be seen in the long term.

Another reason for a loss in competitiveness could be relatively high inflation occurring in the domestic economy. High prices in the domestic economy would mean that exports are more expensive in foreign currency and imports are relatively cheaper compared to domestically produced goods. This could lead to a fall in export revenue as foreigners buy fewer exports, and a rise in import expenditure as domestic consumers switch to relatively cheaper imports. As a result, net exports fall and the balance of trade position worsens.

To address inflationary pressures in the domestic economy, several policies can be implemented. One of which is supply side policies that aim to increase the productive capacity of the economy and shift the long run aggregate supply curve to the right. This can include measures to encourage investment as mentioned in part (a). However, as mentioned above, the effects of supply side policies often only take place in the long run. For a short term solution to the problem of inflation, expenditure reducing policies such as policies to reduce aggregate demand (AD) can be implemented. This can take the form of a contractionary fiscal. The economy could raise corporate and personal income taxes or reduce government spending (G). A rise in corporate taxes reduces the after tax profits and discourages investment (I) while a rise in personal income taxes reduces consumption (C). I and C being components of AD will cause AD to fall, resulting in a fall in prices thus easing inflationary pressures and improving the balance of trade position. A fall in AD will also result in a fall in national income (NY), which tends to reduce consumer's demand for imports as their purchasing power has decreased. As import expenditure falls, net exports rise, improving the balance of trade position.

Thus, it can be seen that both supply side policies and demand management policies work together to improve the balance of trade position and correct the trade deficit arising from inflationary pressures in the domestic economy.

Another potential cause of a loss in competitiveness is an overvalued domestic currency. A solution to this problem would be to implement expenditure switching policies like devaluing the exchange rate to increase the price competitiveness of exports and reduce import expenditure. One of the limitations of devaluing the currency is that it will only work if the Marshal-Lerner condition is satisfied. Also, countries that depend on imports for factors of production and consumption goods may not be able to implement a devaluation of their currency as it may lead to imported inflation.

Lastly, a trade deficit could arise if a country embarks on an ambitious development programme. Large scale imports of factors of production, e.g. machinery, equipment, raw materials and technology are required for industrialisation to take place. Over the period of industrial development, there may be a drastic increase in import expenditure leading to a worsening of the country's balance of trade position. This cause of a trade deficit mainly applies to developing countries as they embark on ambitious industrialisation programmes. As such, there is no great need to address a trade deficit arising from an ambitious development programme.

In conclusion, there are many approaches that an open economy can take to correct its trade deficit. It needs to first assess the root cause of the trade deficit before implementing policies to correct it.

L3	Developed discussion of the causes of a balance of trade deficit and the policies that are available to an open economy to correct its trade deficit.	9-11
L2	Developed explanation of the causes of a balance of trade deficit and the policies that are available to an open economy to correct its trade deficit. OR	4-8

	Undeveloped discussion of the policies that are available to an open economy to correct its trade deficit.	
L1	Smattering of valid points	1-3