

4a. Explain what might cause a current account deficit in the balance of payment. [10]

4b. When faced with a deteriorating trade balance, some countries turn to protectionism. However, countries like Singapore do not engage in protectionism. Discuss why governments use different policies to achieve healthy trade balance. [15]

Outline

a) The Balance of Payments (BOP) for a country is a summary statement of the money value of all economic transactions between the residents of the country with the rest of the world during a specified period of time, usually one year. The Current Account in the BOP shows the flow of goods and services, plus incomes flowing into and out of the country, plus net transfer of money into and out of the country. A deficit in the current account is mainly due to $M > X$.

Explain causes of $X < M$ (any 3 but must include mixture of explanations on X & M , candidates may also give other reasons not stated here)

- **↓X - Loss of comparative advantage** due to competition from emerging economies or depletion of resources

The law of comparative advantage states that countries should specialize in the production of goods for which it has a lower opportunity cost.

Many developed countries have lost their comparative advantage in the production of low-end manufacturing goods with the emergence of low-cost economies like China. Her abundance in cheap labour, vast land and other resources, resulted in a lower opportunity cost than the developed countries when it comes to production of such goods.

This results in a loss in export competitiveness of the developed countries as the Chinese products are preferred due to their lower price. When price of China's export is cheaper, importers will import from China and their demand for the developed economies' exports will fall assuming a high degree of substitutability between these exports.

- **↓X ↑M - Higher relative inflation rate**

A rise in a country's inflation rate will cause her exports to be more expensive and imports to be cheaper. Assume demand for exports is price-elastic due to the availability of substitutes, a rise in price of exports will cause quantity demanded to fall more than proportionate and the export revenue will fall.

And if the rise in inflation rate is higher than other trading partners, the demand for exports will fall and so will revenue.

Assume domestic goods and imports are substitutes that deemed by consumers to be alternatives to satisfy similar wants. Thus with a higher inflation rate, a rise in price of domestic goods will cause demand for imports to rise, leading to a higher import expenditure.

As a result, a fall in export revenue together with a rise in import expenditure will worsen the balance of trade.

- **↓X - Unfair trade practices** by trading partners e.g. undervaluation of currency, protectionism
Countries like US have accused its trading partners, particularly China of keeping Yuan undervalued. For example, by lowering the value of the Yuan, US citizens find Chinese goods cheaper in terms of the US dollar, while the Chinese will find that the US goods are more expensive in terms of Yuan as long as the

Marshall-Lerner condition holds, where the sum of price elasticity of demand for imports and exports is greater than one, net exports for US will fall, leading to a worsening of the trade balance.

To protect the home industry, the government levies a specific tariff on imports, raising the price of imports. As a result, the locals may switch back to the domestic goods.

↑M - Affluence leading to High Imports for Consumption + Industrialisation leading to Higher Imports for Machines and Raw Material

Higher growth rate and together with an increasing consumerism will result in a larger import expenditure on consumer goods. Emerging economies like China and India have been enjoying high growth rates and resulted in a growing middle class for goods such as cars and air-conditioner units. These countries which are undergoing the industrialization phase have a huge appetite for imports especially in capital goods and raw materials to support production.

Assuming most of the imports they purchase are positive income elastic, the demand will increase more than proportionate when income increases. This higher demand for imports will worsen the trade balance, *ceteris paribus*.

Note: net income flow and net current transfers are not required

L3	Ability to give excellent explanation of the causes with some attempt at exemplification 2 causes with good explanation, covered both X & M and with exemplification – low L3	7-10
L2	Ability to elaborate on the causes	5-6
L1	Major conceptual errors Listing of causes	1-4

4b) When faced with a deteriorating trade balance, some countries turn to protectionism. However, countries like Singapore do not engage in protectionism. Discuss why governments use different policies to achieve healthy trade balance. [15]

Why countries use protectionism with worsening BOT	Why countries like SG do not use protectionism
<p>Explain how protectionism helps countries when BOT is deteriorating using tariff diagram -</p> <ul style="list-style-type: none"> Assume D_d represents the domestic demand for steel and S_d represents the domestic supply of steel. In the absence of trade, the domestic equilibrium price and quantity of steel are P_E 	<p>Characteristic – small, lack resource, hence dependency on trade</p> <p>Need export market as engine of growth, engaging in protectionism might invite retaliation and affect X</p> <p>Need import for necessities and raw materials, engaging in protectionism will only cause inflation</p>

<p>and Q_E respectively.</p> <ul style="list-style-type: none"> • When the country is open to foreign trade, it faces a perfectly price elastic world supply for steel S_W. That is, the country can import as many steel as she wants at the prevailing world price P_W. • With free trade and at the price P_W, domestic consumers will demand OQ_2 of steel, of which OQ_1 is supplied by domestic producers and the remainder Q_1Q_2 imported from other countries. Free trade thus lowers the domestic price of steel from P_E to P_W. • To protect the home industry, the government levies a specific tariff on steel imports, thus raising the supply curve from S_W to $(S_W + \text{tariff})$. The price now increases from P_W to P_2. • At P_2, domestic production increases from OQ_1 to OQ_3; domestic buyers are buying less steel – from OQ_2 to OQ_4. The tariff has caused a fall in the amount of imports from Q_1Q_2 to Q_3Q_4. <p>Hence with protectionism, it helps to reduce M and improves BOT</p> <p>Limitations</p> <p>Such protectionist measures will undoubtedly harm the trade position of her major trading partners as their exports will fall. It is deemed to be a ‘beggar-thy-neighbour’ measure. Hence, if these trading partners retaliate with their own set of protectionist measures, the country that initiated the tariff, will also experience a fall in exports and this might offset any prior improvement in her trade deficit.</p> <p>By resorting to protectionism, the deficit country forgoes the benefits that come with free trade, i.e. a higher standard of living, cheaper and greater variety of imports.</p>	
<p>Reasons to practice protectionism at least in the SR given the limitations</p>	<p>Ways to ensure BOT is healthy (candidates may use other measures):</p>
<p>1. May be necessary at least in the SR if the cause of deterioration of BOT is industries losing CA (sunset industry) and new industries are not able to build CA given the intense competition (infant industry). Temporary protectionism gives time for</p>	<p>1. Use supply side policies instead to constantly build new areas of CA to ensure the country stays ahead of competitors. Price and non-price competitiveness of exports are enhanced to ensure BOT is healthy</p>

<p>industries to restructure and develop CA. Protectionism can then be removed when restructuring has been completed.</p>	<p>Examples of SSP - government spending on R&D or training of workers to increase their productivity will reduce the unit cost of production and improve export competitiveness. R&D will also result in the production of a wider range of high quality goods and in turn help to further improve export competitiveness and expand the export market share. This will help to reverse the decline in their export performance and increase export revenues, reducing the trade deficit.</p> <p>Besides, a more productive workforce will also attract more inflow of FDIs of high capital intensive manufacturing and high value added services and even improves the financial account.</p> <p>Limitation</p> <p>However supply-side policies take a long time to bear fruit and their success is relatively less certain. For example, the retraining of structurally unemployed workers to redeploy them in industries in which they have a comparative advantage in, requires a change in mindset. If these workers remain resistant to the idea of switching from an industry that they can be used to for many years and refuse to pick up the training in hope of getting back their previous job, it will reduce the effectiveness of such supply-side measures.</p>
<p>2. May be necessary if the deterioration of BOT is a result of unfair trade practices by trading partners.</p> <p>One example is the practice of dumping. Dumping refers to the selling of the same good to a foreign country at a lower price than that charged to the domestic buyers and often below the marginal cost of production.</p> <ul style="list-style-type: none"> • The objective is to drive out rival producers in the importing country and eventually monopolize the market. Import-substituting industries in the receiving market may not be able to compete against such foreign exporters and hence may not be able to develop. • Also, production is often subsidized by the government, this leads to unfair competition with producers in the importing countries. • Hence, domestic producers of particular products often argue that they are unfairly 	<p>2. Establishing Free Trade agreements with major trade partners so as to guarantee the country will not be a victim of unfair trade practices.</p> <p>An FTA is an agreement whereby member countries agree to remove tariff and non-tariff barriers among themselves but each can retain whatever restrictions she wants for non-member countries. Usually, it also includes better terms for investment in foreign countries.</p> <p>As legally binding arrangements between willing member countries, FTAs enhance trade and investment flows by providing lower tariffs for exports of goods, hassle-free custom procedures, improved market access for various commercial and professional services, easier entry for businessmen into other countries, better terms for investment in foreign countries etc. FTAs will set a framework for a small country like Singapore to export more easily and hence maintaining a</p>

<p>victimized by competing foreign imports that are “dumped” in domestic markets.</p> <ul style="list-style-type: none"> • In the long run, the consequence may be the destruction of local producers, which produces a competing product. The biggest concern is that, after the competitors are destroyed, the monopolist will now charge a higher price to its overseas consumers, making consumers worse off. • Protectionism such as tariffs is thus often used to reduce imports and increase domestic production. 	<p>healthy BOT.</p> <p>Limitation and evaluation</p> <p>Although signing an FTA may lead to trade diversion, Singapore has established a varied network of FTAs. This minimizes the negative consequences of trade diversion.</p>
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L3	Excellent ability to explain relevant reasons for protectionism and ability to explain why some countries do not turn to protectionism	9-11
L2	Ability to explain relevant reasons for protectionism and some ability to recognize why some countries do not turn to protectionism Or Rehearsed arguments for and against protectionism	6-8
L1	Listing of reasons for protectionism Major errors	1-5
E2	Substantiated judgement	3-4
E1	Unsubstantiated judgement	1-2

To achieve L3, candidates must cover 3 aspects:

- a) Why & how protectionism helps improve X-M
- b) Why some countries don't use protectionism
- c) What alternative solutions are used to improve X-M

If candidates only cover 1 aspect – L1

If candidates only cover 2 aspect – L2

Examiner's comments

Common errors / missing analysis / AFIs	Explanation