

The United States has run a large deficit on the current account of its balance of payments for several years.

Explain what might cause a persistent and large deficit on the current account of a country's balance of payments. [10]

Discuss the view that policies to deal with such a deficit can be ineffective and potentially damaging. [15]

(a)

Synopsis:

The answer would look into the different causes of current account deficit which include both **price and non-price factors**.

Introduction:

- Define Current Account:
Records receipts from the export of goods and services as well as payments for the import of goods and services during the current period.
- Explain that Current Account consists of visible trade, invisible trade, unilateral transfers and income flows.
- Explain that Current Account deficit implies export earnings of goods & services < import expenditure on goods & services

Body:

Explain 3 factors (at least 1 price and 1 non-price factor) that can cause a Current Account deficit:

- (i) **Higher price of domestic goods relative to imports** – could be due to:
- Loss of price competitiveness of goods produced as a result of higher cost of production compared to other producers in countries like China or India (due to loss of comparative advantage leading to the shift of many manufacturing industries to other countries/slower growth in productivity compared to trading partners).

⇒ Impact on the US's exports and imports:

-With a loss in export competitiveness, US might find that their trading partners who used to import from them would switch to buying relatively cheaper China or India made goods. Furthermore, Americans might also stop buying relatively more expensive domestic goods and switch to buying the cheaper imports instead. With the drop in export revenue and increase in import expenditure, the visible balance in the current account will worsen.

- Undervalued Yuan

⇒ Loss of price competitiveness of US exports and a fall in domestic price of imports from China.

⇒ US consumers may thus substitute domestic goods with cheaper China goods. If the demand for imports is price elastic, US's import expenditure will rise significantly.

⇒ China consumers may also reduce their quantity demanded of US's goods as it seems relatively more expensive in Yuan. If the China's consumers' demand for exports is price elastic, US's export revenue will fall significantly.

⇒ Thus, with the fall in export revenue and the rise in import expenditure, US may face a Current Account deficit, ceteris paribus.

- Higher rate of inflation in the U.S.
 ⇒ US's exports become more expensive. Hence, the quantity demanded of US's exports will fall and export revenue fall significantly if the demand is price elastic. US consumers may then substitute domestic goods with cheaper imports. This will raise import expenditure and it will rise significantly as well if demand is price elastic. Therefore, with a fall in export revenue and a rise in import expenditure, US may face a Current Account deficit, ceteris paribus.

(ii) **Changes in taste and preferences** of Americans in favour of foreign goods – could be due to loss of non-price competitiveness.

(iii) **Increase in income** due to continuous rate of growth in the country
 ⇒ Americans have higher disposable income → higher purchasing power → imports more
 OR
 ⇒ Americans have higher disposable income → higher purchasing power → Americans would travel more and adversely affect the invisible balance of the current account.

(iv) Other logical reasons such as the presence of FTAs (e.g. United States–Republic of Korea Free Trade Agreement, United States–Colombia Free Trade Agreement) signed between countries which in turn results in more imports (removal of tariffs – cheaper imports), fear of terrorism attacks that affects tourism (fall in exports earning from services), presence of unfair trade practices by other countries (e.g. China's government giving subsidies to the solar manufacturers) etc.

***A combination of both price and non-price factors for Current account deficit over an extended period will result in a persistent and large Current account deficit, ceteris paribus.**

Conclusion:

- There are many causes of a persistent and large current account deficit.
- Government intervention to solve the problem (should find out the root cause of the problem) is important as a persistent and large current account deficit may have undesired effects on other macro goals.

Level	Knowledge, Understanding, Application, Analysis
L3 (8 – 10)	Clear explanation of price and non-price factors causing large and persistent Current Account deficit using examples .
L2 (5 – 7)	Some attempt to explain the causes of Current Account deficit with some examples, but tends to be superficial.
L1 (1 – 4)	Smattering of points and weak in explanation.

(b) Discuss the view that government policies to deal with such a deficit can be potentially damaging and ineffective. [15]

Synopsis:

Students are required to have a two-sided argument in their answers in which the thesis will touch on how government policies to solve CA deficit can be damaging and ineffective while the anti-thesis will look at how government policies that solves CA deficit may in fact be effective. Lastly, students should make a clear and sound judgment on whether they agree or disagree with the view or that their decision depends on certain factors.

Introduction

- Briefly explain why a government should be concerned with a CA deficit and state the policies that a government can implement to solve the problem.

→ The \uparrow in trade deficit will translate into a \downarrow in AD, ceteris paribus. This will result in a fall in RNI through the multiplier effect; might cause other macro problems such as structural unemployment.

→ Policies to solve CA deficit → e.g. Expenditure-reducing measures (contractionary FP and MP), Expenditure-switching measures (Tariffs, Subsidies), SS-side policies

→ However, not all the policies mentioned above are effective to a large extent. It may be potentially damaging and ineffective.

Body:

Thesis: Government policies to deal with CA deficit can be potentially damaging and ineffective

1) Expenditure-Reducing Measures

- Explain how contractionary FP and MP work to reduce CA deficit. Illustrate with diagrams.
- AD falls → GPL falls (assuming the economy is operating at the intermediate range of AS)
- This will result in reducing the domestic inflation rate relative to those in other countries hence increasing the price competitiveness and quantity demanded for exports. Increase in export earnings assuming $PED > 1$.
- Demand for imports is also dampened as incomes are reduced. As demand for domestic goods also fall, producers are free to export more.
- Hence, export revenue rise and import expenditure falls → Improving the CA position.

However,

- The problem arises when the demand for exports and imports is price and income inelastic. The effect will be minimal and will not reduce import expenditure or raise export earnings. This will deem the policy to be ineffective.

- Furthermore, when AD falls (intermediate range of AS), RNI falls as well (conflicting macro goals). If CA deficit continues to rise, it will lead to a further fall in AD and hence RNI which is potentially damaging to the economic growth of the country. Unemployment may also rise in the country (labour being a derived demand).

Evaluation: However, if the country is operating at the classical range of the AS curve, contractionary policies may not necessarily reduce RNI. Instead, it will only reduce GPL and hence lower the domestic inflation rate. This will increase the country's price competitiveness without conflicting with the other macro goals of achieving sustainable economic growth and low unemployment.

2) Expenditure-Switching Measures

- This involves measures to switch domestic expenditures from foreign imports to domestic goods and foreign expenditures towards the country's exports. This can be achieved by making imports relatively expensive and exports relatively cheaper.
- E.g. Tariffs, Subsidies, Quotas, Devaluation (Choose one to explain how it can solve CA deficit)

Devaluation:

→ This is the deliberate lowering of the exchange rate of the home currency in terms of other countries' currencies. Exports will be encouraged and this leads to an increase in export revenue. Meanwhile imports will be discouraged, which leads to a fall in import expenditure. Assuming Marshall Lerner condition holds, $(X - M)$ will ↑.

However,

- It can be potentially damaging and ineffective if there is retaliation from other countries. The country devaluing its currency gains at the expense of trading partners. The latter's exports earnings fall and import expenditure rise. They may retaliate by implementing various protectionist measures e.g. tariffs and quotas and may even counter-devalue their currency.
- Also, if exports contain a large proportion of imported raw materials, the price advantage of devaluation over other foreign goods would be eliminated i.e. the price of exports will not fall due to the more costly import content.
- While devaluation can be effective in correcting a CA deficit, it may be interpreted as a sign of a weakening economy, causing foreign investors to lose confidence in the economy. Devaluation leads to a fall in price of exports and a rise in price of imports and this may cause a serious deterioration in the terms of trade as more exports have to be exchanged for the same amount of imports.
- The burden of overseas indebtedness also increases as more local currency has to be exchanged to obtain foreign currency to repay foreign loans.

Evaluation: May not necessarily be damaging if the country chooses to implement it only for a short period of time and if the country's exports do not contain a large proportion of imported raw materials.

Anti-thesis: Government policies to deal with CA deficit may not be damaging and ineffective

1) Supply-side Policies (To increase both SRAS and LRAS)

- Businesses need to be more competitive in domestic and overseas markets by reducing costs (increasing SRAS). Investment in new growth sectors or in industries with large exporting potential should be encouraged and research and development promoted to increase productivity as this will reduce the productivity gap with other countries (increasing LRAS). Illustrate with diagrams.
- Increase in both SRAS and LRAS will reduce GPL or lower the rate of increase in GPL which will raise the country's price competitiveness (Does not conflict with other macro goals. Both RNI and employment will rise) → Raise export earnings
- Investing in R&D may also lead to improvement in quality of the goods produced → Increase in demand for exports and domestic consumers may also prefer the better quality domestically produced goods than imported goods → Raise export earnings and decrease in import expenditure → Reducing CA deficit

Limitations:

- Governments may not have sufficient funds to subsidize investments in R&D due to a large budget deficit.
- Opportunity costs incurred → Funds used for subsidizing R&D can be used for other areas such as the health and education sectors.
- Time period → For long-run supply-side policies, the effects can only be seen in the LR. CA deficit may continue to rise in the short-run.
- Effects are not guaranteed as R&D may fail.

2) Signing FTAs with other countries

- FTA is a legally binding agreement between two or more countries to liberalise trade and bring about closer economic integration.
- FTAs aim to remove the barriers to trade and investment. They create a freer flow of goods, services, investment and people. FTAs allow the partners to give each other preferential market access.
- With removal of trade barriers, exports may now seem cheaper and there will be an increase in quantity demanded of exports, raising export earnings. Assuming import expenditure remains constant or the rise in import expenditure is less than the rise in export revenue, $(X-M)$ will increase and hence CA deficit will be reduced.
- No retaliation by other countries and this may also seek to achieve other macro goals such as increasing in RNI and employment.

Limitations:

- This policy will only be effective if there is no dumping by participating countries.
- As imports may also be cheaper as a result of the FTA, the rise in import expenditure may exceed the rise in export revenue which may not necessary reduce the CA deficit to a large extent.

Conclusion

- Government policies to deal with CA deficit can be potentially damaging and ineffective but this will depend on several factors.
- These factors include:
 - Which policy the government is implementing?
 - Where is the economy operating at on the LRAS?
 - Does the government have sufficient funds to encourage and subsidize R&D?
 - Time period (Short-run → may not be damaging)
 - Does the government have plans to implement both short run and long run policies?
 - Is the government addressing the root causes of why the country is facing such a large and persistent CA deficit?
- Important for a government to find out the root cause/s before implementing any policy. The government also has to ensure that there will be no conflicting macro goals when implementing these policies and that they should have short-run, long-run, demand and supply-side policies in place.

Level	Knowledge, Understanding, Application, Analysis
L3 (8 – 10)	For a good analytical assessment of how some policies to solve CA deficit can be potentially damaging and ineffective while other policies may be effective and not conflict with other macro goals.
L2 (5 – 7)	For a correct but underdeveloped explanation. Adequate explanation on how some policies to solve CA deficit can be potentially damaging and ineffective while other policies may be effective and not conflict with other macro goals.
L1 (1 – 4)	Ability to identify one or two policies that seek to solve Current Account deficit. Answer lacks depth and content.
E3 (4 - 5)	Clear and sound justification on whether the view holds or does it depend on other factors.
E2 (2 – 3)	Some justification on whether the view holds or does it depend on other factors.
E1 (1)	Mainly unexplained judgments.