

Suggested Response for Essay Question 6

6. To ensure that international trade remains smooth, open and reliable, one must resist the temptation to turn inwards, protectionism is not viable, especially for small states.
- (a) Explain how a country's balance of trade may worsen over time. [10]
- (b) Discuss the view that the pursuit of a healthy trade balance leaves no room for the use of protectionism. [15]

(a) Explain how a country's balance of trade may worsen over time. [10]

Command word	Explain – use economic reasoning Start point: factors affecting X and M End point: worsen BOT
Concepts	Macroeconomic concepts
Context	Open context

Introduction:

- Defining balance of trade: X-revenue minus M-spending on all goods and services (visible and invisible trade balances)
- Worsen BOT: falling X-revenue and rising M-spending
- Causes of the worsening can be internal or externally driven.

Students are expected to give at least 2 factors, of which at least one factor must link to both X-revenue reduction and M-spending increasing. The factors can include either of the following:

1) Poorer foreign economic growth or national income

The changes in relative economic growth rates across countries may lead to changes in demand for the country's exports or its demand for imports.

For example, a fall in national income of a trading partner's economy, relative to domestic would lower the foreign residents' purchasing power, hence **reducing their demand for imports**. This could **reduce the X-revenue of the domestic country**. **The fall will be more significant if the trading volume is larger and the country is a close trading partner**. Therefore, with the fall in X-revenue relative to the import-spending, this may worsen a country's BOT.

2) Exchange rate

Appreciation of the country's exchange rate will make the **country's exports become more expensive in its trading partner's currency**. At the same time, its imports are relatively cheaper in its own domestic currency. **If demand for both export and import are price elastic**, the higher price of the country's exports (in foreign currency) will **lower the country's export revenue** while its cheaper imports (in its domestic currency) will increase its import expenditure, leading to worsening of BOT.

3) Relative inflation rates

If domestic costs of a country rise faster than costs abroad, its **exports will be relatively more expensive than before and imports relatively cheaper**. Assuming that demand for exports and imports are both price elastic, the increase in domestic costs will lead to a more than proportionate fall in the quantity demanded for exports, hence, reducing X-revenue. At the same time, its **domestic residents may turn towards cheaper imports, leading to higher demand for imports, increasing M-spending**. The fall in X and rise in M will lead to a worsening of the BOT.

4) **Loss of comparative advantage due to lack of technological progression**

Countries which do not invest in expanding its production capacity may face higher production costs, especially if domestic resources are tight (e.g. labour market). This could mean **losing our relatively lower opportunity cost** in the production of some goods. This will worsen when other countries invest in building their infrastructures and R&D capabilities → allowing them to enjoy relatively lower opp cost (than us) in the production of **the same good**.

Therefore, the domestic country loses its CA → becomes an importer rather than exports.

Foreign households buy less from the domestic country (due to more expensive prices) and local households also buy more from cheaper import sources → X-revenue falls due to weaker DD and higher M-spending due to higher demand.

(X -- M) drops and worsens.

Conclusion

Causes of BOT worsening can be due to many domestic or external factors or both. BOT worsening can lead to other macroeconomic implications such as economic growth and unemployment issues. Hence, it is important that government put in place policies to improve the BOT.

Level	Knowledge, Application, Understanding and Analysis	Marks
L3	<ul style="list-style-type: none">• 2 factors are well-analysed to account for the worsening of BOT• Must explain the impact on <u>both</u> X-revenue and M-spending to qualify for 9m and 10m<ul style="list-style-type: none">- Good use of economic concepts and tools of analysis (e.g. AD-AS)- No major inaccuracies- Content is relevant- Start and end point is clearly explained, no missing elaboration.	8-10
L2	<ul style="list-style-type: none">• Developed but one-sided explanation on either X-revenue or M-spending can worsen the BOTOr• Under-developed analysis on both the X-revenue and M-spending factors:<ul style="list-style-type: none">- Use of economic concepts but contains several inaccuracies	5-7

	- start and end point not entirely clear, some incoherence in the answers	
L1	<ul style="list-style-type: none"> • Descriptive answer without any conceptual framework • Answer contains many inaccuracies. 	1-4

(b) Discuss the view that the pursuit of a healthy trade balance leaves no room for the use of protectionism. [15]

Command word	Discuss – balanced argument Req 1: how the use of protectionism can help to improve a country's trade balance Req 2: How the use of protectionism may not help Start point: protectionistic tools End point: Balance of Trade
Concepts	Protectionism, BOT
Context	Open context – contextualise by considering different economies' characteristics

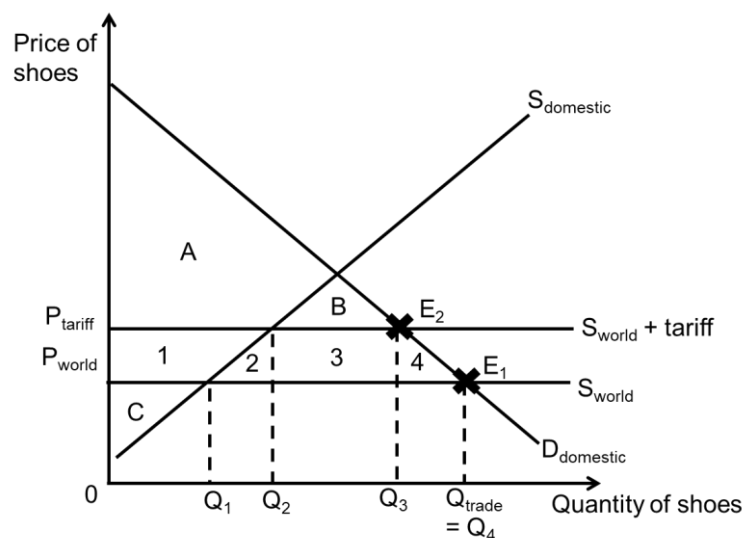
Introduction

- Defining protectionism: use of tariffs, export subsidies, import quota
- Aim: to switch spending on imports to domestic goods and increase competitiveness of domestic exports → Improve balance of trade
- **Whether there is room for the use depends on 1) causes of worsening BOT and 2) country's characteristics and 3) time.**

Requirement 1: How the use of protectionism can help to improve a country's trade balance

Protectionism such as a tariff may help to raise import prices and hence, reducing the spending on foreign imports and hence, improving balance of trade. Tariffs is a tax that is imposed on imported goods. The imported good will now face a higher selling price due to the imported tax, as seen from how the supply curve shifted upwards by the amount of the tax, from S_{world} to $S_{world} + \text{tariffs}$.

Figure 4: Market for Shoes with Tariffs



After the tariff is imposed, the imported good prices will therefore increase from P_{world} to P_{tariff} . **Importers will now pay a higher price of P_{tariff} for imports.** At this higher price, **domestic quantity demanded for shoes falls from Q_4 to Q_3 .** At the same time, **more domestic firms are willing and able to sell shoes, and domestic production increases from Q_1 to Q_2 .** As a result, the **volume of imports will fall from Q_1 - Q_4 to Q_2 - Q_3 .** So, assuming that the **PED for imports is more than 1**, the higher price of imports lead to a **more than proportionate fall** in qty demanded for M → **M spending will fall.** Ceteris paribus, **BOT improved** with the fall in M-spending.

The use of import tariffs, coupled with exports subsidies can further improve a country's BOT. The government collects the tax revenue from tariffs to use to subsidise the exports' production.

Export subsidies → **reduce the cost of production** for the exported goods and services → **price of these exports fall** → assuming **$PED_x > 1$** , the rise in Qty demanded for these X is **more than proportionate** → X-revenue increase

Higher X and lower M improves BOT position.

Requirement 2: How the use of protectionism may not be able to improve a country's trade balance and/or bring about unintended consequences & hence no room for the use of protectionism

(Note to markers: Should students interpret R2 to be the use of other policy tools such as Supply-side policies / FTAs to improve BOT, WITHOUT addressing why there is no room for use of protectionism → this is counted as a Knowledge Answer (L1), max of L2 5m)

Imposing protectionism such as import tariffs may bring about unintended consequences to the domestic economy:

The tariffs have also resulted in a welfare loss to society.

- With tariffs imposed, domestic consumers now consume fewer shoes than before (Q_3 instead of Q_4), so there is a welfare loss of area 4 due to the loss of consumer surplus from lower consumption.
- Although domestic producers are able to produce and sell more shoes as seen from Q_1 - Q_2 pairs of shoes, these domestic firms are likely to be **relatively more inefficient** since they **do not have the comparative advantage** in the specialization of this good in the first place. Therefore, there is a welfare loss of area 2 due to this inefficiency.

Protectionism may not be effective when the reason for worsening BOT is the loss in comparative advantage:

- A worsening BOT position can be due to a loss in CA either from higher X price or poorer quality of X (e.g. shrinking labour force results in higher wages and hence, higher prices).
- Hence, even with import tariffs and exports subsidies → it may not be enough to bring down the price of domestic goods and X sufficiently enough and so, domestic consumers may not find domestic products cheaper or foreigners may not be attracted to our exports → does not necessarily improve the competitiveness of the exports and BOT position.
- Hence **in the long term, protectionism is at best a symptomatic relief but not a cure.**

For countries like Singapore that rely on imported FOPs, protectionism can worsen our BOT position instead.

- **PED_m < 1**, tariffs will in fact **increase M-spending** as the qty demanded fall with a price increase is **less** than proportionate.
- Since M-spending increases, assuming that the X-revenue cannot increase enough to offset the higher M-spending, it could **worsen BOT** instead. It is likely that our X prices can increase as well since our COP is now higher with the use of more expensive FOPs.
- Furthermore, higher COP translates to higher cost of living for these countries, SRAS falls, lower RNY coupled with higher GPL → **slower economic growth & cost-push inflation as the negative unintended consequence.**

When protectionism invites retaliation from the foreign trading partners:

- Trading partners can also impose similar tariffs on goods and services
- Our exports can also become more expensive when tariffs are imposed
- The X-revenue may not increase, and could fall **even more than the fall in import spending** → BOT does not necessarily improve and could in fact worsen.

When the effect of beggar-thy-neighbour takes place:

- By reducing the import-spending to improve our BOT position also means that trading partners' BOT position worsens → reduce in their national income → less ability to spend on our exports → X-revenue could fall **even more than the fall in import spending** → BOT does not necessarily improve and could in fact worsen.

(Part of Evaluation) **Overall conclusion (to include the possible use of other more effective policy to improve BOT):**

Protectionism is likely **only useful for the short term and for bigger countries** with the capacity to produce self-sufficiently. With less demand for imports, the **domestic production can be increased** to make up for the shortages caused by fewer imports. At the same time, cheaper X prices can attract more foreigners to buy the exports. However, using subsidies to lower X prices does not always guarantee higher X-revenue, especially if the government budget is tight and if the quality of X is poorer than competitors.

Therefore, for countries like Singapore that **rely heavily on trade for growth and resources**, protectionism **will not** work. Instead, to ensure **sustained competitiveness** in the globalized world, these governments should focus on **long term strategy** such as spending on **improving labour productivity**, so as to **lower unit cost of production and ensure a more sustainable improvement in the exports' competitiveness**. At the same time, smaller nations should always **embrace free trade and diversifying import sources**, so as to ensure continuous growth in X-revenue and competitive import prices. **Resorting to protectionism will bring more harm than good to most economies, hence there is indeed little room for the use of protectionism to improve a country's balance of trade.**

Level	Descriptors	Marks
L3	<p>Both requirements are well analysed:</p> <ol style="list-style-type: none"> 1. how protectionism can help with trade balance and 2. how protectionism may worsen trade balance and/or have unintended economic consequences <p><i>(Other acceptable response include:</i> <i>Req 1: how protectionism can reduce M spending</i> <i>Req 2: how protectionism can increase X-revenue</i> <i>Evaluation: how protectionism can worsen M-spending and/or X-revenue for some)</i></p> <p>Well-analysed includes:</p> <ul style="list-style-type: none"> - Correct start and end point (protectionism solving trade imbalances) - Correct use of AD-AS framework - Diagram(s) is/are used in explanation - No major conceptual errors 	8-10
L2	<p>Only one requirement is well-analysed or Both requirements are somewhat explained but <u>not</u> well-analysed</p> <p>Explanation includes:</p> <ul style="list-style-type: none"> - Some gaps in explanations - Inconsistent / inaccurate use of concepts - Diagrams drawn but are not used in explanation 	5-7
L1	<p>Major conceptual inaccuracies Irrelevant use of concepts</p>	1-4
Evaluation		
E3	Both requirements are considered and evaluated AND a summative conclusion is provided, considering the context of different economies and hence, the role protectionism plays.	4-5
E2	Both requirements are considered and evaluated (the degree / extent) but <u>no</u> overall summative conclusion / recommendation provided (e.g. on whether there is any room for the use of protectionism)	2-3
E1	A brief attempt at considering the effectiveness of protectionism in pursuing healthy BOT	1