H1 Essay Question 2

(a) Explain the possible causes of a country's worsening balance of payments. [10]

(b) Comment on the measures available to a government faced with a worsening balance of payments. [15]

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Synopsis

Students are required to describe structure of the BOP and its components and explain how various factors may cause unfavourable changes to components in the current and capital account leading to a worsening of the overall balance of payments.

1. Introduction – Define and explain **basic** components of BOP
   a. Current account
      i. Balance of trade - visible /invisible
      ii. Unilateral transfers
      iii. Income flows

   b. Capital account
      i. Short term capital flows – Portfolio Investments
      ii. Long term capital flows - Foreign Direct Investment

2. Cause of worsening current account
   a. Global recession - fall in global income would negatively affect domestic exports. Given everything else constant there would be a fall in net exports causing a worsening of the current account. This may have a positive effect on the BOP.

      A fall in global income also may lead to decrease in tourist arrivals leading to a fall in the invisible trade component of the current account.

   b. Domestic income level
      Sustained economic growth and rising domestic income encourages demand for locally produced goods and imports. Given a significantly high YED (YED > 1) of imports especially for higher quality luxury products, a rise in income will increase its demand. Therefore, given a constant rate of export revenue there will be a worsening of the current account and therefore the BOP.

   c. Country's stage of development
      A developing country might have the tendency to import more than it exports therefore running a trade deficit due to the need to acquire raw materials and capital goods for infrastructure development. A significant worsening of the current account may negatively impact the BOP.

3. Cause of worsening capital account
   a. Political Instability
      A poor investment outlook due to political instability, uncertainty and pessimism with respect to long term policy changes, etc. would suggest a poor environment for attracting foreign businesses. Firms might be inclined to uproot and start operations in a relatively stable economy exhibiting potential for growth. It would also deter companies intending to set up operations in the country. This movement of companies leaving an economy and companies not wanting to enter would constitute a fall in the long term flow of the capital account hence worsening the BOP.

      A politically unstable economy would also deter individuals in wanting to invest in financial assets in the affected economy. This will cause short term investors to release existing holdings of currency and financial assets held as a store of value resulting in a flight of funds to more stable offshore assets and be recorded as an outflow on the short term capital flow of the capital account.

   b. Interest rates
      Falling interest rates due to expansionary monetary policy may lead to an outflow of short term capital by foreigners in order to exploit better returns in another region. This would negatively affect the short term capital segment of the capital account.

   c. Expected changes in exchange rate
      Any expected fall in the exchange rate value of a country's currency (for instance the possibility of the monetary authority depreciating the domestic currency) may cause capital outflows and a capital account deficit in the short term capital flow segment. This is because investors may withdraw holdings of funds in the domestic currency in order to seek better options to protect the value of their currency holding.

4. Conclusion
   Therefore, a worsening of the BOP can be due to the capital or current account being negatively affected. However, very often it is not a single factor but a combination of causes negatively affecting the various components of the BOP that lead to a worsening of the BOP. Hence, policy prescription has to take a multifaceted approach addressing a range of key sources.

L1	An answer that exhibits some knowledge of factors worsening the BOP. Only provides 1 or 2 causes with inadequate explanations.	1-4
L2	An answer that provides a limited explanation of factors that negatively affect the current and capital account of the BOP. OR A thorough answer that provides an explanation of factors negatively affecting **ONLY** the current **OR** capital account of the BOP	5-7
L3	A clear and thorough answer that provides clear explanations of factors (at least 4) that worsen the current **AND** capital account thereby worsening the overall balance of payments.	8-10

(b) Comment on the measures available to a government faced with a worsening balance of payments. [15]

Synopsis
Students are required to provide measures available to a government that are geared towards the current and capital account and how it addresses a worsening balance of payments. Measures suggested should clearly explain what component/s of the balance of payments are affected and how it would improve the overall balance. Measures should also be evaluated to highlight limitations and/or negative side effects.

1. Introduction - Implications of a balance of payments deficit. A persistent BOP deficit uses up a nation’s reserves to cover money that is owed and also sends a negative signal to investors. Therefore any possible investment into an economy improving growth and creating employment would be stifled. Given the negative effects of a worsening BOP a country may employ a number of measures to reverse the net outflow. There are two such categories of policies: Expenditure Reducing and Expenditure Switching.

2. How a country may deal with a worsening BOP
   a. Expenditure reducing policies - involves reducing the level of expenditure on imports which can be attained through contractionary monetary and fiscal policies.
      - Condition of usage: Since expenditure reducing methods involve cutting back expenditure that will affect growth it would have to be employed only if the economy is functioning close to full capacity. Imposing expenditure reducing measures for an economy that has trouble improving growth would have very serious negative consequences and would not be justified in targeting a specific problem like a worsening BOP against the backdrop of the wider economy.

   i. Contractionary monetary policy
   - Explain Policy
   - How it affects overall BOP (current account and capital account):
   - Effect on current account
     Given an increase in interest rates through a contractionary monetary policy; the cost of borrowing for consumers will rise. Also higher interest rates would increase the opportunity cost of spending as money in the bank will be generating more interest income therefore discouraging spending. This reduction in spending will translate to a reduction in expenditure on imports. This improves the balance of trade in the current account if exports are unchanging. Given everything else is constant there will be an improvement in the balance of payments.

   - Effect on capital account
     The increase in interest rates will also attract ‘hot money’ into the economy which will positively affect the short term capital flow segment of the capital account thus reinforcing the improvement in the BOP.

Possible evaluation:

Effect of interest rates on the exchange rate

An increase in the inflow of short term invest ‘Hot money’ caused by an increase in interest rate will increase the demand of domestic financial assets thereby placing upward pressure on exchange rates. However, due to signed contracts for domestic importers and signed contracts of foreign importers the PED of imports and exports is inelastic in the short run. Given and the higher exchange rate and relatively steady import volume in the short term there will be lowering of the total spending on imports. And given that demand for exports is relatively price inelastic in the short run there will be an increase in export earnings in the short run. This leads to an overall improvement in the current account in the short run which may be translated to an improvement in the BOP. However, in the long run when the elasticities of demand for imports and exports are greater than one (when the Marshall-Lerner condition is met) the trade balance will worsen giving rise to a possible current account deficit negatively impacting the BOP.

ii. Contractionary Fiscal policy
   - Explain policy
   - How it affects overall BOP:
   - How it affects the current account

     A contractionary fiscal policy via the increase of personal income tax (PIT) will lead to a fall in disposable income of consumers. This will cause a fall in spending including imports. This fall in the demand for imports may improve the current account as a fall in imports given constant export figures will improve the current account and therefore the overall BOP.

   - How it affects the capital account

   An increase in corporate taxes would reduce the post-tax profits of domestic firms this would not only deter foreign firms from opening operations in Singapore but also cause existing firms to relocate to more beneficial locations. Therefore this change in FDI will register as an outflow on the long term flow on the capital account thus worsening the BOP.

   Possible Evaluation

   However, a trade off to this approach would be a contraction of the economy. A significant fall in consumption given all other components constant will have a negative effect on growth. The fall in C given all else constant may lead to a fall in AD and therefore national income and employment. There would, however, be an associated fall in the general price level if the economy is functioning close to or at the vertical section of the AS curve.

b. Expenditure-switching policy

- Involves measures to divert domestic expenditure from foreign imports to domestic goods and foreign expenditures towards the country's exports. This can be achieved by making imports relatively more expensive and exports relatively cheaper. Hence improving the current account.

i. Tariffs and subsidies

Tariffs raise the price of imported goods making them relatively more expensive. At the same time, subsidies to local producers make domestically produced goods relatively cheaper to foreign imports (tariff diagram). This improves the current account position of a country and therefore the BOP.

Possible evaluation

Imposing tariffs on imports may lead to retaliation by trading partners. This would adversely affect domestic growth especially if the trade partner is a major export destination.

– other macro problems

ii. Devaluation: Define/explain

This targets the current account making exports cheaper in terms of a foreign currency. It also makes imports more expensive due to a weaker domestic currency. This will have the effect of improving net exports (thereby improving the current account) given the Marshal – Lerner condition (where the sum of price elasticities of demand for a country's exports and imports must be greater than one) is met. The improvement in net exports would positively affect the current account and improve the BOP.

Possible Evaluation

However, Due to the price inelastic nature of the demand for imports (due to signed contracts for domestic importers) and exports (signed contracts of foreign importers) in the short run, any devaluation of the domestic exchange rate would lead to an increase in total import value and a decrease in export earnings due to the relative weakening of the domestic currency. This may have the effect of worsening the current account in the short run, thereby negatively affecting the BOP.

However, it must be noted that in long run when the demand for imports and exports become relatively elastic due to contracts being re-adjusted to reflect the changes in relative exchange rates; the combined elasticites of imports and exports must be greater than one in order for a devaluation to improve the current account which may have a positive effect on the BOP. If the the M-L condition is not met the desired effect of a devaluation will not be attained.

iii. Conclusion

There are many tools and measures available to a government in correcting or improving a worsening balance of payments. However, the consequences of embarking on some of these measures may cause more harm than good for an economy. Therefore, implementing a policy should be carefully deliberated and assessed in terms of its impacts before implementation. Moreover due to the multi-faceted nature of causes for a worsening BOP a multi-pronged approach may be needed to stem an outflow. In such a situation possible negative effects of policies may be more pronounced. Hence careful assessment of policy prescription and a re- assessment of present economic fundamentals and policies may need to be addressed prevent conditions that may lead to a worsening of the BOP in the future.

L1	An answer that comments on 1 or 2 measures available to a government with **inadequate explanations** as to how measures improve either the current or capital account in order to improve a worsening BOP	1-4
L2	An answer that provides some options available to a government that targets both the capital and current account with adequate explanations as to how it leads to an improvement in the overall BOP. OR A well explained answer that considers measures that target **ONLY** the current account **OR** the capital account in improving a worsening BOP	5-7
L3	For a thorough and well explained answer that provides options available to a government in tackling a worsening BOP clearly explaining how measures affect the relevant accounts in the BOP.	8-11

E1	For unexplained evaluative statements with no clear justification	1-2
E2	For a discussion that clearly highlights the limits and effectiveness of measures taken to improve a worsening balance of payments.	3-4