**Chapter**

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**1. Concept of bop**

1.1 Balance of Payment (BOP)

• A statement of a country’s trade and financial transaction with the rest of the world over a particular period of time, usually a year

(A) Current Account

i. Visible Balance (BOT) physical goods

ii. Invisible Balance (services) – tourism, insurance, logistics

iii. Income Balance (remittance of profit and dividends)

Iv.Transfer Balance (remittance- foreign workers)

• Monetary transfer for exports and imports of goods and services, income flows and net transfers in and out of the country.

 (B) Capital Account (LT term capital inflow)

• All inflows and outflows of funds due to financial activities like acquisition and disposal of fixed assets, shares, government grants for overseas project, etc.

(C) Financial Account (inflow of hot money/ equity transaction)

• Records investment overseas by local residents and the inward flow of investment funds from foreign residents. International flows of investment funds can be short term or long term.

• Short term capital flows is bank deposits (affected by interest rate)

• Long term capital flows include the holdings of securities or bonds by local or foreign residents

(D) The Balancing Item

• The balancing item is a statistical item to compensate for the errors and omissions made in recording the value of the country’s international transactions.

(E) The Overall Balance

• The sum of the current account balance, capital account balance, financial account balance and the balancing item (A+B+C+D=E)

**2. Causes of bop disequilibrium**

2.1. Current Account Deficit

2.1.1. Caused by Cyclical factors:

2.1.1.1. Relatively High Domestic Inflation

o When domestic economy experiences inflation Px rises → Xd falls or Pm falls relatively → Md rises → BOT worsen (subjected to elasticity of demand)

2.1.1.2. Relatively High Economic Growth Rate

o Increase in national income of local economy - ↑Md for local economy.

o Decrease in national income of foreign economy - ↓Xd for local economy

2.1.2. Caused by Structural Factors:

o Overvalued Domestic Currency → Px rises → XD falls or → Pm falls → MD rises → BOT worsen

o Loss in Comparative Advantage (inefficiency of local industries/change in global pattern of production) → COP rises → PX rises à XD falls or price of local goods rise → PM relatively cheaper → increase in MD

2.1.3. Caused by Ambitious Development Programme

o large increase in imports (usually happens in developing countries)

2.2 Capital and Financial Account Deficit

2.2.1. Structural Factors

2.2.1.1. Low domestic interest rates → short-term capital (or “hot” money) will flow out of the country to earn higher interest rates in other countries → financial account of a country worsen

 Contra trade – low i/r in US – will encourage US citizens and companies to save their fund in Singapore which has a higher interest rate – increase in inflow of hot money

2.2.1.2. Poor Expectation of Business Profits → if investors expect business profits to fall in the future (e.g. due to rising costs, higher corporate taxes or political and economic instability), then local investors will want to invest in other countries.

2.3 Current Account Surplus

2.3.1 Structural Factors

2.3.1.1 Undervalued domestic currency → low export prices and high import prices → quantity demanded for exports will be high and imports, low → receipts from exports will be high while payments for imports will be low assuming that the demand for exports and imports is elastic → current account improves.

2.3.1.2 High levels of domestic protection → High tariff rates will result in high prices of imports → fall in the quantity demanded of imports and thus import expenditure is reduced (assuming that the demand for imports is elastic).

2.4 Factors affecting the Balance of trade (Exports and Imports Demand)

(i) Inflation rate – affect cost of production – affect Px and Pm

(ii) relative income level

(iii) taste and preference of the products

(iv) change in exchange rate

(v) comparative advantage – affected by the change in cost of production

(vi) structural changes in the economy – economic development

2.5 Factors affecting financial account

(i) interest rate- determined the return on saving

(ii) change in the exchange rate (encouraging speculative activities)

2.6 Factors affecting capital account (FDI/resident investment)

(i) return on business

(ii) taxation policy

(iii) market demand- market sentiment – affects FDI

(iv) efficiency of the industries – return on investment

**3. Effects of bop disequilibrium on macro economic aims**

Consequences of a BOP disequilibrium

3.1 In the short-term, temporary and planned balance of payments disequilibrium does not pose a serious problem to an economy. BOP deficit may be necessary to promote economic growth, which will induce import of capital goods and resources – induce production and employment

3.2 In the long-term, persistent and unplanned disequilibrium is a serious problem and indicates a fundamental economic problem in the economy (may induce import of luxury goods –BOT deficit)

3.3 Is balance of payment deficit a concern to the country?

a) Duration of disequilibrium

A short and temporary BOP deficit will not prove serious problem as it will temporarily lower exchange rate to enhance competitiveness but a long term and persistent BOP deficit will affect the exchange rate stability which will undermine the trading activities and flow of FDI

b) Causes of the balance of payment deficit

If the cause of the BOP deficit is due to BOT deficit which will indicate a fall in production of exported goods and service, the impact on unemployment will be a serious problem for the economy.

If the BOP deficit is due to outflow of FDI into foreign country, the growth of infrastructural business will be beneficial to the economy in the long run.

Furthermore, if the deficit is due to import of resources and capital equipment, it will be beneficial for the growth of the economy. The growth of expenditure on goods and services may indicate a higher level of standard of living but it will also mean that local industries and losing out.

3.4 Effects of a Balance of Payments Deficit (Depreciation)

3.4.1 On Domestic Economy

• Inflationary impact on the economy

• Fall in national income and level of employment due to lower FDI and export demand

• Decreases in foreign reserves

• Affect the confidence of the investors

3.4.2 On External Economy

• Fall in exchange rate of a country’s currency

• Deterioration in terms of trade (TOT)

3.5 Effects of a Balance of Payment Surplus

3.5.1 On the Domestic Economy

• Increase in national income and level of employment due to higher level of FDI and surplus BOT

• Increase in foreign reserves

• Reduces the competitiveness of the export demand and in the attraction

• Worsen the trading and capital flow condition of the trading partners.

3.5.2 On the External Economy

• Rise in exchange rate of a country’s currency

• Improvement in terms of trade (TOT)

**4. Explain how trade surplus can achieve sol improvements**

Significance of Balance of payment on the indication of the state of Economy.

**Reflect the economic activiy that will affect the performance of the economy (based on the aims of government – macroeconomic goals)**

o Change in Real GDP

o Change in AD (FDI/Xd)

o Change in Md (potential growth)

o Change in production and employment

o Price stability/SOL

a) From the **current account**, the level of production of goods services can be noted as seen level of export of goods and services. We can also observe that the industries are mainly producing high valued production and there is the concentration of tertiary services. – affect output and production and employment of labour

b) The value of the **income balance** also reveals that the economy has a concentration of FDI and the increase in the flow of capital account (Long run) will also suggest that Singapore is competition enough to attract FDI. High depend of FDI and the presence of net export will substantiate that the economy is experiencing economic growth as the production capacity is increasing.

c) The **import expenditure** will indicate the level of the resource capacity the country can posses as Singapore relies greatly on import for production. It also indicates the level of standard of living as the rise in the import of services will mean that there is increase in consumption of services from abroad in the areas of tourism

d) High volume of deficit in the **transfer balance** reflects the high degree of dependency on foreign supply of labour.

e) For **financial account**, the flow of the transfer will affect the banking and finance industry which is one of critical industry in the economy and the indicator of the flow of hot money which will affect our short term exchange rate. The change in the exchange rate will affect the trading prices and of cost FDI which is affects the AD that influences production and national income.

f) The **official financing reserve** will reflect the level of stability of the external equilibrium as the amount and the distribution of reserve will affect the country’s ability to stabilize exchange rate.

5. CSQ 1

**Trend Analysis for Balance of Payment**

**Table 1: Japan and US Balance of Payments**

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
|  | 2003 | 2004 | 2005 | 2006 | 2007 |
| **JAPAN** (in billion Yen) |   |
| Current Account | 15, 766.8 | 18.618.4 | 18,259.1 | 19,848.8 | 24,793.8 |
| Capital & Financial Account | 7,734.1 | 1,737.0 | -14,006.8 | -12,466.5 | -22,538.3 |
| Net Errors & Omissions | -1,972.2 | -3,087.9 | -1,796.0 | -3,662.7 | 2,041.9 |
| Balance of Payments | 21,528.7 | 17,267.5 | 2,456.3 | 3,719.6 | 4,297.4 |
| Real Gross Domestic Product1 | 512,513.0 | 526,577.7 | 536,762.2 | 547,709.3 | 560,816.4 |
| **UNITED STATES** (in billion US Dollar) |   |
| Current Account | -521.5 | -631.1 | -748.7 | -803.5 | -726.6 |
| Capital & Financial Account 2 | 527.9 | 530.8 | 698.0 | 802.9 | 661.8 |
| Net Errors & Omissions | -7.9 | 97.5 | 36.6 | -1.7 | 64.9 |
| Balance of Payments | -1.52 | -2.80 | -14.10 | -2.38 | 0.12 |
| Real Gross Domestic Product3 | 10,301.0 | 10,675.8 | 10,989.5 | 11,924.8 | 11,523.9 |

1 In billions of chained 2000 Yen

2 Excluding change in US government official reserves

3 In billions of chained 2000 dollars

Note: “Chained dollars/yen” is a method of adjusting nominal values for inflation, thus reflecting purchasing power relative to the reference year.

*Source: US Department of Commerce, Bureau of Economic Analysis Ministry of Finance, Japan*

a) Compare the trend in Japan’s Balance of Payment with that of United States over the period 2003 to 2007 (2)

Japan has experienced BOP surplus for the period 2003 to 2007 but the BOP surplus reduced from 2003 to 2005 and it has improved again from 2005 to 2007. On the other hand, the US has experienced a BOP deficit for the period 2003 to 2007, except for 2007. US BOP deficit worsened from 2003 to 2005 and improves from 2005 to 2007 and was in surplus in 2007

 b) Account for the differences that you have identified for the cause of trend described (2)

For Japan, the cause is due to the capital account deficit as there is an extensive capital outflow due to higher interest in foreign countries and higher rate of return on investment despite improvement in current account surplus.

For US, the cause of BOP deficit is due to the worsening of the current account deficit, contributed by balance of trade deficit and income balance deficit. The BOP deficit in US is reduced by the extensive inflow of capital due to the high interest rate in US and higher rate of return on investment in US.

7. Essay Question 1

**“Against this backdrop of continuing increase in global oil, and other commodity prices, as well as increase in business costs due to tighter conditions in the labour and commercial property markets, an upward shift of the S$ exchange rate band at this point will help to moderate inflation going forward, while providing support for sustainable growth in the economy.”**

***Adapted from Monetary Authority of Singapore Policy Statement, April 2008***

**Explain how an increase in external and domestic costs mentioned above may affect the balance of payments of Singapore. [10]**

Introduction

BOP refers to the difference between the total value of goods and services exported to other nations and the total value of foreign goods and services spent by local economy. A deficit in BOP can result from a hike in internal and external cost. The increase in external cost is due to an increase in global oil and commodity pricing. Both are essential necessities that are required by producers and consumers. An increase in the external items will put inflationary pressure on the country. Inflation can also result with the increase of internal costs that are affected by rising labour cost and commercial property rents.

Main Body

**1.** **How an increase of external and internal cost out inflationary pressure on the economy**

a. An increase in external cost of raw materials will accentuate COP for producers. The increase in COP will be passed on to the consumers in the form of higher prices.

b. Hike in labour wage and property prices increases the business cost for producers. Similarly, COP increase for producers and price of consumer goods increase. The increase in price of goods will prompt workers, which are also consumers, to ask for a wage increase. The cycle manifests into a wage-price spiral of cost push inflation.

**2.** **How inflation affects BOT**

a. For export oriented producers, they must increase export prices to cover their rising cost due to climbing COP. As export prices increase relative to goods in foreign country, foreign will demand less of the export. As the demand falls, BOT to be reduced.

b. As the labour and commercial property increase in prices, the overall business cost increases. To account for rising COP and maintaining of profits, prices of goods and services will increase simultaneous. COP for exports will increase, making exports for expensive for foreign countries. Taking that BOT is initially at equilibrium, an increase in export prices will cause a fall in its demand thereby leading to a BOT deficit.

c. Besides the fall in export demand, higher COP will also increase import demand. As prices of labour and property rises, workers and capital factor owners earn more income. As income and price of local goods increases, with other things equal, there will be more demand for imports from foreign countries. Combined with the increase in prices of local goods, the demand for imports will increase. Flow of money will be outwards to foreign countries. This causes a fall in BOT.

**3.** **How inflation affects BOP**

a. BOP is a country’s trade and financial transaction with the rest of the world over a particular period of time, usually a year. It is made up of current and capital account.

b. As seen in the previous paragraph, inflation cause a fall in export demand. As export demand falls, the economic performance of a strongly export oriented Singapore economy will be compromised. Investors will be less willing to inject funds into Singapore, FDI will be reduced. Total inflow of money in Singapore will decrease. This leads to a deficit in the balance of payment.

c. Due to outflow of hot money, the government will have to borrow from foreign sources to continue funding development projects within the countries. Increasing debt payments made to foreign countries increase the outflow of money and this undermines the value of the Sing dollar relative to other currencies. This cycle will increase outflow of money and BOP falls deeper into the deficit area.

d. Service trade might benefit from the depreciation of currency as it cheapens the service goods provided by Singapore. However, Singapore’s economy is heavily dominated by the manufacturing industry and FDI. Therefore the increase in revenue from service industry is negligible when compared to the loss from export and outflow of FDI.

e. The fluctuation of ER will also encourage speculative activities. As SGD depreciates, the speculators, for fear of loss in profits, will dump SGD. This will further undermine the value of the Sing dollar and BOP deficit.

Conclusion

8. Essay Question 2

**Discuss whether protectionism is the best way to reduce a balance of trade deficit. [17]**

Introduction

Protectionism is when government implement policies to protect domestic industries from foreign competition through the setting up of barriers to trade on imports or foreign firms. Protection of local firms can be done through increasing tariffs and quota on import goods. As the price of imports increase, there will be an import substitution effect on the economy. Demand for local product increases and hence BOT deficit can be reduced.

Main Body

**1.** **How protectionism can reduce trade deficit by reducing the demand of imports.**

· Protectionism is a way to protect local firms from bigger competitors. Through tariff and quota implemented by the government, imports are made more expensive and quantity is constrained. Consumers, not wanting to pay a higher price, will consume similar goods from local industries. Consequently, the demand for imports will be reduced.

· As demand for imports dwindles, the expenditure of foreign goods is reduced. This will reduce the amount of trade deficit

**2.** **The negative effects of protectionism and why it is not the best way to reduce trade deficit**

· There is really little that is left to be desired with regards to the use of protectionism to reduce trade deficits.

· Protectionism raises many issues with foreign countries. It is viewed as an aggressive tactic used in international trade. Bigger countries might retaliate by imposing similar measures to domestic exports. This decreases the amount of trade taking place and affects the income of exporters at both ends.

· If the good import is an essential consumer product or producer’s raw material, it will be less price elastic. Increase in price due to protectionism will not reduce the demand for imports significantly. Hence it would not result in a reduction of BOT deficit.

**3.** **Import substitution to reduce import demand and improvement of export competitiveness to reduce BOT deficit**

· BOT deficit can be reduced by the increasing export demand and reducing the amount of imports incoming.

· This can be done by inducing local consumption of imports substitutes. The government can subsidize industries producing import substitutes to lower COP and, in turn, prices. This will enhance the competitiveness of substitute goods and steer consumers to consume more local goods and less of imports.

·Alternatively, the government can fund export oriented industries to increase export demand. Improvement of technology and quality of export goods will increase the foreign demand of goods

**4.** **How other policies are needed to increase export demand**

· To increase export competitiveness, producers must be able to keep prices low.

· To do that, the government can pursue supply side policies like infrastructural development and worker skill training. With the improvement in the production capacity and efficiency, COP will fall on the supply side so producers can maintain low price and competitiveness with goods from other countries.

 Conclusion