J2 June Intensive Revision 2015

**L10 – Essays – Foreign Exchange/Balance of Payment**

**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]

**Essay Question 2**

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

**Essay Question 3**

Explain why the value of the Singapore dollar against foreign currencies has been appreciating in recent months and discuss whether changes in the exchange rate are of economic significance. [25]

**Essay Question 4**

"Unlike Singapore which chooses exchange rate for its monetary policy and free capital flows, USA chooses interest rate monetary policy and free capital flows to manage the economy."

(a) Compare how exchange rates are determined in Singapore and USA. [10]

(b) Discuss the usefulness of interest rate monetary policy and free capital flows for stimulating growth in the economy of the USA. [15]

**Essay Question 5**

Discuss the extent to which the trend toward globalization, rather than domestic factors, contributes to a persistent balance of payment deficit in an economy. [25]

**Essay Question 6**

In 2013, the Japanese economy grew on the back of fiscal stimulus and a weaker yen. Singapore and Japan are major trade partners.

Explain how each of the Japanese policy might affect Singapore’s balance of payments. [10]

**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**
   1. 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.
   2. 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**
   1. 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.
   2. 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.
   3. Beside 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**
   1. 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.
   2. 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.
   3. 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 Sing dollar relative to other currencies. This cycle will increase outflow of money and BOP falls deeper into deficit area.
   4. 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 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.
   5. 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 Sing dollar and BOP deficit.

Conclusion

**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 consumer similar goods from local industries. Consequently, the demand for imports will be reduced.
* As demand for imports dwindle, the expenditure of foreign goods is reduced. This will reduce the amount of trade deficit

1. **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 desire 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.

1. **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 consumer 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
2. **How other policies are needed to increase export demand**

* To increase export competitiveness, producers must be able to keep prices low.
* To do that, 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

**Essay Question 3**

**Explain why the value of the Singapore dollar against foreign currencies has been appreciating in recent months and discuss whether changes in the exchange rate are of economic significance. [25]**

Introduction

The appreciation of SGD against other currencies can be cause by an increase for demand of SGD and/or decrease in supply of SGD in the ER market. The appreciation of ER affects the economy of Singapore significantly because she depends heavily on the manufacturing export market for income.

Main Body

1. **Factors affect the rise in demand and fall in supply of SGD**

* A rise in demand of SGD could be due to increase in export demand and increase capital inflow.
* Increase in export demand will increase the amount of domestic currency demanded to pay for our exports.
* On the other hand, a decrease in supply of SGD is due to a fall in import demand. When import demand is low, Singaporeans would not release SGD in return for foreign currencies to complete the transaction.
* On the other hand, a spike in inflow of capital will cause a rise in demand for SGD and the reverse for an outflow of capital.
* Capital inflow, in the short term, is affected by the change in interest rates. When rates are higher, return to capital is higher and more capital flows in. When rates are low, returns are also low and capital flows out.
* In the long run, the expected profitability of business opportunities within Singapore attracts funds from external investor. When sentiments are positive, more funds will flow in; vice versa.

1. **Impact of appreciation on export and BOT**

* When there is an appreciation of SGD, relative price of exports will increase in foreign countries and price of imports in Singapore will decrease. This will decrease quantity demanded of export and increase in quantity demanded of import.
* Since quantity of exports is reduced and quantity of import increases, the expenditure of import will rise and revenue from export falls. In the short run, ED(M) + ED(X) is less than 1 (elastic). Therefore BOT will worsen.

1. **Impact of appreciation on FDI and BOP**

* The cost of the value of FDI will be higher due to the appreciation of exchange rate. The cost of foreign business operation locally will be higher. Depending on the degree of appreciation, FDI will remain the same or fall.
* If FDI falls as funds are being pulled out of the Singapore, BOP will enter into deficit.

1. **Impacts of appreciation on local production and employment**

* As both the decrease in export demand and increase in imports will lead to a lower local production, the employment level in the economy will be reduced.

1. **Impacts of appreciation on economic growth/AD/NY**

* Appreciation will increase import of capital equipment from other countries at a lower cost. This will enable the economy to expand its production capacity and raise its technological development to attain higher level of economic growth.

1. **Impacts of appreciation on cost of living and standard of living**

* Appreciation will make imports cheaper, local consumers are able to buy more foreign products and standard of living is improved.
* For Singaporean consumer which buys many foreign products, cost of living dwindles and they can enjoy more imported goods for a given level of income. Hence standard of living improves.

1. **Impact of appreciation on distribution of income**

* As appreciation cause the export demand to fall, owners of export oriented production factors will earn less than before.
* On the other hand, increase in import demand will cause a fall in consumption of domestic goods. Domestic producers will earn less than before.
* Depending on the degree that affects export factor owners and domestic producers, distribution of income will be more equitable.

Conclusion

**Essay Question 4**

**"Unlike Singapore which chooses exchange rate for its monetary policy and free capital flows, USA chooses interest rate monetary policy and free capital flows to manage the economy."**

**(a) Compare how exchange rates are determined in Singapore and USA. [10]**

Introduction

* Definition of exchange rate
* State that the exchange rate policies for USA and Singapore differ as USA adopts a flexible exchange rate system while the Singapore adopts a managed-float exchange rate system.

Main Body

**1) Explain how the exchange rate system is determined under US (Flexible exchange rate system)**

The flexible exchange rate system determines the exchange rate based on the demand and supply of currency in local or foreign currency in the foreign exchange market.

*(State that the intersection of DD & SS of SGD in the forex market will determine exchange rate)*

For demand side, the main factors affecting the demand for currency would be the export demand, inflow of hot money and inflow of investment. As for the supply side, the main factors affecting the supply of currency would be the import demand, outflow of hot money and outflow of investment. Therefore, for economic variables like interest rate and inflation rate would affect exchange rate indirectly as they affect the factors affecting the demand and supply of the local currency in the forex market.

As seen from the diagram, the exchange rate is determined at R0, where demand and supply will intersect.

**2) Explain how the exchange rate system is determined under Singapore (Managed-float exchange rate system)**

As for the managed-float exchange rate, the central bank (MAS) will set a range for the exchange rate to fluctuate within and will only intervene to manipulate the exchange rate if the rate rise above the upper band or falls below the lower band. If the government decides not intervene, it will adopt a neutral stance to allow the exchange to rise or fall. In doing so, the central bank will raise or lower the band.

It may take a neutral stance on the direction of change in the exchange, allowing it to appreciate or depreciate if the rate of change in the exchange rate is favourable to the economy and thus, allowing the market forces to influence exchange rate. It will let the market forces decide as the extreme depreciation of S$ may mean that excessive amount of S$$ is needed to uphold exchange rate.

To appreciate the exchange rate so as to dampen the imported inflation, the MAS needs to increase the demand for S$ by buying S$ and selling of foreign currency. To depreciate the exchange rate so as to lower down the cost of FDI and price of export, the MAS needs to increase the supply of the S$ by selling S$ and buying of foreign currency.

**3) Identify and evaluate the differences between US and Singapore exchange rate systems**

* Both allow the market forces of demand and supply of the economy to determine the exchange rate but Singapore’s system needs to be regulated occasionally to maintain the exchange rate within a range
* Singapore exchange rate system is determined on a **basket of currency** while US exchange rate is determined as a singular currency
* The focus of Singapore’s exchange rate system is **to ensure the stability of trading prices to stabilize trading and production activities** while the US adopts the floating exchange rate system to **reflect the economic and trading activities** on the exchange rate so that they will **self-adjust independently to attain external stability**.
* Singapore managed-float exchange rate system requires a **large pool of foreign currency reserves** to ensure the stability of the exchange rate, thus incurring high opportunity cost on maintaining reserve seen in term of other economic uses. On the other hand, US exchange rate system will require a large pool of foreign currency reserve but it is destabilizing to allow autonomous correction.

Conclusion

In conclusion, both exchange rate systems have their strengths and weaknesses and they serve their aims to ensure that there is greater external stability for their economies.

**Essay Question 4**

**"Unlike Singapore which chooses exchange rate for its monetary policy and free capital flows, USA chooses interest rate monetary policy and free capital flows to manage the economy."**

**(b) Discuss the usefulness of interest rate monetary policy and free capital flows for stimulating growth in the economy of the USA. [15]**

Introduction

* Explain the notion of interest rate monetary policy and the meaning of free capital flows
* State that it will stimulate economic growth as it will influence economic activities as seen from its impact on the aggregate demand (AD) components

Main Body

**1) Explain how the expansionary monetary policy or lowering of interest rate will lead to actual growth of the economy**

* The **monetary policy** involves the **variation of money supply** and **interest rates** by the central bank to **affect the level of economic activity** in an economy to achieve certain macro-economic objectives.
* When **expansionary monetary policy** is conducted, the government will increase the money supply through the buying of government bonds which will lower interest rate. This will lower the cost of credit consumption and reduces the reward for saving which will encourage more consumption and reduce willingness to save. Also, the level of investment will be raised as the level of profitability is raised since the cost of investment is lowered as lowering interest rates lowered the cost of borrowing. Consequently, there will be a rise in consumption and investment which will raise the aggregate demand, via the multiplier effect and thus raises the real GDP, production and employment.
* **In the multiplier process**, the initial increase in the aggregate expenditure expands the circular flow of income and then increasing the income of the factor earners which will further expand the circular flow of income with new consumption activities. As long as more consumption activities are take place, the circular flow of income will continue to expand at the respective level of economic activities until the withdrawal effect is equal to the initial injections which will cease the expansion of the circular flow of income. Consequently, the national income will increase by several folds, depending on the value of the multiplier which is determined by the sum of the MPW (Marginal Propensity to withdraw - MPS + MPT +MPM)
* Diagram and description of diagram

Y1

Real GDP

GPL

AS0

AD1

AD0

Y0

P1

P0

As seen from the diagram, the rise in aggregate demand from AD0 to AD1 due to the expansionary monetary policy will contribute to a rise in real GDP from Y0 to Y1, leading to higher degree of employment.

**2) Explain how free capital flow would lead to the expansion of the resource capacity or potential capacity**

* Process on how FDI and flow of hot money would contribute to how the resource capacity expands the economy’s production capacity which will lead to sustainable economic growth

**3) Evaluate the effectiveness of the monetary policy and capital flow in stimulating the economy**

* Size of the multiplier process is large
* Consumption and Investment are significant AD components – the influence of interest rate on these components is significant since **credit consumption is impactful**
* **Private consumption and investment** will **create permanent impact** on the growth of the economy as items like hosing is spread over a long-term payment
* Free capital flow allows the US **to extend their investment activities beyond the local economy**. This will allow the economy to **attain more resources at cheaper rates** from other countries, as seen from the outsourcing activities by Nike and General Motors (GM) to tap the cheap labour and resources in China. As such, the capital flow will enable the US firms to **raise their profitability** as they are able to **access larger markets** and **lower the cost of production**

**4) Evaluate the limitations of the monetary policy and capital flow in stimulating the economic growth**

**Low market confidence** will undermine US firms and consumers from investing as seen from the impact of the sub-prime market – If the consumers do not have confidence in the future economic development, they will be unwilling to borrow for consumption and investment. Even with a lowered interest rate, it will not induce consumption and investment to generate growth in US.

**Rising cost condition** is another factor that will undermine the effect of the expansionary monetary policy on stimulating actual growth. The wage cost in US is much higher than her neighbouring countries like Mexico and the trading partners like China. This will mean that local investment may not increase despite the low interest rate policy as the US firms may divert investment to foreign countries. Also, goods are produced abroad and exported back to US to meet market demand. Consequently, local investment may not increase and the stimulating effects on economic growth may not occur.

**High MPM** in the US economy also suggests that credit consumption induced by the low interest rate policy may not benefit the local economy. Instead, it will encourage trade which will stimulate the growth of their trading partners and not the US economy.

**Flow of capital** may encourage local US firms to locate their production to the overseas consumer market to lower the cost of production and cost of trade. This implies that the rise in demand for US goods in foreign market may not lead to actual growth as there is no local production due to free flow of capital.

**Free flow of capital in term of hot money** will undermine the expansionary monetary policy where the borrowing of funds by US firms is used for financial gains through saving in foreign banks or purchase of foreign assets instead of investing in US business activities. Consequently, low interest rate policy fails to stimulate the growth of local investment and consumption.

Conclusion

In sum, the rise in interest rate monetary policy and the encouragement of capital flow may help the US economy to grow but these policies have their shortcomings. The failure to control the weaknesses of the policies will make economic recovery for the current ailing American economy an uphill task.

**Essay Question 5**

**Discuss the extent to which the trend toward globalization, rather than domestic factors, contributes to a persistent balance of payment deficit in an economy. [25]**

Introduction

Globalization involves the integration of economic activities among different economic activities in the areas of trades, flow of investment, flow of fund and mobility of resources. As for balance of payment deficit, it occurs when the outflow of currency due to trade, investment and flow of funds exceeds the inflow. Although globalization has an influence on the balance of payment deficit, domestic factors will also contribute to the balance of payment deficit.

Main Body

**1) Explain why balance of payment deficit will occur due to domestic factors**

**Lack of resources** inducing a high degree of reliance on imports or failure to actualize local production to replace imports (e.g. Philippines)

**Acceleration of economic development** inducing the need of extensive import of resources and capital equipment, which will further lead to higher rate of economic growth 🡪 import of more luxury goods which are high-valued, contributing to current account deficit and then balance of payment deficit(The reliance on foreign workers will induce the outflow of transfer balance).

**Inflation rate** will make local goods more expensive and imported goods become relatively cheaper 🡪 inducing current account deficit

**Low interest rate** will make it less attractive to save in the country, contributing to outflow of fund and reduction in the inflow of fund. Interest rate reduction by the Bank of England was the main cause of the balance of payment deficit since 2008 as the need to induce local economy contributes to the exodus of fund from England, resulting in the persistent balance of payment deficit.

**Political instability** will also lead to extensive redistribution in local economic activities, prompting the local economy to rely more on the import of goods and services. At the same time, there is a reduction in the flow of FDI due to the lack of confidence in the economy. Consequently, balance of payment deficit occurs persistently as political instability is difficult to resolve

Given the extensive influence of the local economy, it is quite logical to attribute the local economy for the cause of the persistent balance of payment deficit. However, with the threat of globalization, balance of payment deficit may not be that persistent and difficult to eradicate.

**Mobility of fund** made possible for speculators to move fund out of the country to reap higher returns on fund due to interest rate and exchange rate differences. The extent of ease in transferring fund and lack of restriction encourages the mobility of fund as globalization seals the integration of the banking system among countries. Such countries may face extensive exodus of fund which will lead to balance of payment deficit when the local economy becomes less attractive for keeping funds.

Trade encouraged by the **formation of FTAand trade network systems** brought about by globalization will encourage countries like US to shift their production overseas to foreign countries like China with cheaper resources and labour to produce and then export back to US, which means that there will be higher degree of imports and outflow of investment, contributing to greater outflow that will lead to persistent balance of payment deficit as such impact of globalization is prolonged and impactful

**Flow of investment** made possible by the integration of economies through globalization will mean that some countries’ production bases would be influenced to move out of the country; cutting down the export of the countries as the local MNCs choose to produce their goods in foreign markets and sell directly in these markets. This will reduce the export revenue of the local economy and encourage the outflow of investment, which will worsen the balance of payment. Furthermore, as flow of investment is feasible, production may also be outsourced or relocated to other countries and re-import for fund accessibility for export again. This will bring down the value-added of the local economy’s production with the facilitation by globalization. This development can be absurd in US with firms like Nike, Apple and GM which are now relocating their production bases to different parts of the world.

**Free mobility of resources** would contribute to the growth of certain economies to gain more from trade and investment which will undermine the balance of payment deficit with these countries. Singapore’s efficiency of production will enable it to tap resources form countries like New Zealand to add value to her production while New Zealand will experience balance of trade and balance of payment deficit as she needs to import more high-valued manufactured goods

Conclusion

In conclusion, the internal factors of the economy will cause balance of payment deficit but the trade of globalization will exacerbate the effect of the balance of payment deficit, making it more persistent and difficult to curb.