**Essay 2010 International Trade – Set A**

**Question 1**

**“America’s trade deficit is growing again. Worse, it may be extremely hard to close it without causing much economic pain – and not just for Americans.”**

**22 June 2004, The Economist Global Agenda**

**a) Explain how the US government may attempt to narrow its trade deficit.**

**b) Discuss its implications of narrowing the US trade deficit on an open economy like Singapore. (10)**

Introduction

Balance of trade is the net value of total value of physical goods sold to other countries by the producers less the total value of goods bought from the foreigner producers by the local importers. When there is balance of trade deficit, it means the total value of exports of physical goods is lesser than the total value of imports of physical goods. Under such situation, there will be a concern for the American government. The US government is likely to take measures to reduce imports and increase exports

Main body

1. The use of tariffs to decrease imports

By the imposition of tariffs, the price of imported goods at Pw will be increased to Pw + t, contributing to a fall in quantity demanded and a fall in consumer surplus. Import substitution will take place leading to a reduction in quantity of imports from Q1Q4 to Q2Q3 and at the same time, local production will increase from OQ1 to OQ2.

1. The use of quotas to decrease imports

By the imposition of quotas, the quantity of outputs will be restricted to a quantity of Q2Q3, reducing the import quantity from the original amount of Q1Q4. However, this will lead to a rise in price of imports from Pw to Pw + q, contributing to a fall in quantity demanded and a fall in consumer surplus and local production will increase from OQ1 to OQ2.

1. The provision of subsidies to local producers to increase local production so as to substitute the imports

Through the provision of subsidies, local producers are able to lower their cost of production, enabling the firm to supply the goods at a lower price level as at Pw. This measure does not contribute a decrease in quantity demanded as it remains at OQ3 but a reduction in imports as the amount of imports of Q2Q3 as it is replaced by the local production.

1. Devaluation of currency

The US government may devalue her currency to make her exports less expensive and imports more expensive. This will lead to a reduction in quantity demand of imports while increase the quantity demand of exports. However, the balance of trade deficit will only be cleared if the elasticity of demand for imports and exports satisfy the Marshall-Leiner condition (Edm + Edx > 1), the total value of exports will exceed the total value of imports.

1. Promotion of export demand

The US government can also induce its export demand by extending more trade exhibition and promotion to sell their products in other countries. The government can also engage in more free trade agreement with other countries to further facilitate the growth of export demand

1. Increase her export competitiveness

Through the introduction of cost reduction strategy such as outsourcing, the firms in US can decrease their cost of production to make them more competitive. The US government can also lower their cost of production through greater utilization of machineries and R&D. By making their products more superior, this will help them to increase their products.

Conclusion

**(b)Discuss its implications of narrowing the US trade deficit on an open economy like Singapore. (10)**

Introduction

Various measures taken by the US government may have aided the US in reducing the trade deficit but it will extensive repercussions on Singapore who relies greatly on the US for her export demand

Main body

1. Decrease in export demand

The direct impact of such measures imposed by US on Singapore would be a great fall in export demand. This will further reduce the trade surplus between Singapore and US. If the measure continues after the surplus turn into deficit for Singapore, there will be negative impact on our balance of payment. However, Singapore government has extensively aided the local firms to diversify their export market and thus its negative repercussion on BOP may be neutralized by the diversification.

1. Depreciation of the exchange rate against the US

Due to lower export demand, our exchange rate against the US dollar will depreciate and this may affect our cost of imports as most of the raw materials such as price of crude oil is paid in US$. The rise in cost of imports will increase our cost of production and thus undermining our international competitiveness. On the other hand, goods produced in Singapore that are traded in US dollar will be more expensive which will lead to a reduction the demand.

The fall in exchange will also the confidence of the investors’ in the strength of the US dollar which might lead outflow of the hot money, further undermining the financial strength in Singapore.

However, as our exchange rate system is based on a managed float system, the government can adjust the exchange rate to a more favourable level to ensure that our exchange rate is at strong and stable to ensure the country’s advantage in importing of resources

1. Fall in employment, national income and standard of living

The reduction in export demand will mean a reduction in production. This will cause a demand –deficient type of unemployment arising from the external aspect. As a result, there will be a reduction in national income via the multiplier, which will also contribute to a lower per capita income and hence a fall in the standard of living.

1. Possible advantage gained from inflow of investment

As the lower exchange rate will mean that the cost of investment is lower, the size of capital will be expanded in sing dollar value and this will lower the variable cost of production for the foreign companies’ local production base. These firms are likely to continue their production to maximize the advantage.

**Question 2**

**“Kuala Lumpur easing tariffs to woo foreign car giants.” *The Straits Times, 16/7/2004***

**Explain and evaluate the likely consequences of the removal of trade barriers on the domestic economy. (25)**

Introduction

The imposition of trade barriers is a form of protectionism that acts on giving advantages to the local producers to compete against the foreign producers. When trade protectionism is removed, the price of foreign goods will be lowered and the amount of foreign good to be imported is not no longer restricted by quotas anymore. However, the removal of trade barriers will create great impact on the economy, affecting various parties positively or negatively.

Main body

1. The local infant industries are not allowed to grow and the benefits of the growth of infant industries will be forgone when market protection is removed.
   * greater competition undermines the local infant industry from development as seen in the Malaysia’s own brand of cars, Proton. Foreign cars which are cheaper and better will replace the local brand and undermine its development.
   * The failure of the infant industry will mean that the loss of employment opportunities and tax revenue from the industry and income tax of the workers.
   * Evaluation – excessive protectionism will not help the infant industry as the local firms will rely too much on these protectionism and unable to develop their competitiveness. Infant industries of developed nation will not be affected as the nations have resources to aid the firms and do not need to use trade barriers as the solution to aid the development of the infant industry
2. Key local industries producing essential goods vital for the functioning of the economy will be affected and thus affect the efficiency of the economy.
   * For certain industries like airline services may need be to be protected at the initial stage as these local firms need to grow to support the development of the economy. The failure of the local airline services will make it difficult for the economy to develop other industries like tourism and logistics which can further generate growth.
   * Therefore, the removal of such trade barriers will have drastic consequences on the local economy.
3. Increasing competition may bring about the failure of the local business, contributing to the rise of unemployment, which undermines the interest of the workers.

The rise in unemployment will lead to more social problems and rise in the cost of government expenditure as there will be greater distribution of unemployment benefit

However, the cause of unemployment may not be due to foreign competition and such a removal of trade protectionism is not wrong. The firm’s real cause of unemployment may be due to the fact that the workers’ skills are not productive enough and therefore face retrenchment. It is therefore important to introduce re-training programmes for the workers to upgrade their skills and make them more employable.

1. It may also encourage the rise of dumping which will undermine the local firms.

The foreign firms may sell the price of their goods at cost or below cost and this will create fierce competition for the local firms and they are likely to close down their business, leading to rising unemployment. To allow such unfair trade competition will not be a wise decision for the government. Therefore the government needs to pay attention to such unfair trade competition while it removes the trade protectionism.

1. On the other hand, some may gain from this policy of free trade. One such group would be the consumers as they can enjoy greater consumer welfare.

The presence of free trade will provide consumers greater variety of goods and services at lower price level. This will mean an increase in consumer surplus. This will mean that the cost of living of the individuals and the standard of living can be raised.

These benefits will mean that the individuals can have higher disposable income and there can help to increase the available income for saving. This will led to more funds for investment and greater income security for the individuals, raising their consumption capacity for the individuals and potential capacity for the economy.

1. It will stimulate local industries to raise their productivity and efficiency.

Foreign competition will mean that the local industries must also beef up their productivity so that the produce better goods at lower price to compete against foreign competitors. This would mean that these firms must be able to reap economies of scale and improve their quality of products. It will induce governments to provide more infrastructure and institutional support to provide greater external economies of scale to help firms raise productivity and lower unit cost of production

The local firm can also enjoy lower cost of imports especially for the essential raw materials the firm needs. The firm can lower their unit cost of production and raise their competitiveness by lowering the price of their goods. This will enable for them to compete against foreign imports.

1. Local firms may also take the opportunity to diversify their business to meet the challenges of foreign competition.

The influx of foreign goods will provide the local firms new ideas and business activities for them to expand their businesses. It may lead to the rise of new industries and further promote economic growth for the country. For example, trading activities will induce the growth of logistic and insurance industry.

The presence of foreign firms will mean that the proliferation of economic activities that will induce growth of the economy but there may be rise of greater instability if the economy fails to allocate resource efficiently. There are also impacts on the external aspect of the economy, in term of exchange rate, balance of trade and balance of payment. This in turn will affect the foreign direct investment, flow of hot money and other speculative activities as removal of trade barriers will affect them and thus affect the growth of the economy.

Conclusion

The removal of trade barriers can create both positive and negative impact on the economy. This is imperative especially countries which rely a lot on foreign imports and export trade for growth. It is therefore critical for government to implement such measures with consideration of the impacts that it may create.