

Exercise walk-through

6.5

Policies to correct imbalances in the current account of the balance of payments

A-Level Economics

Trace fiscal and monetary policies through imports and exports

Expenditure-reducing policies lower domestic demand; imports may fall as part of that response.

Illustrative tool	Mechanism and possible offset
Higher income taxes or lower government purchases	Lower domestic spending may reduce imports. Output and jobs can fall if demand is already weak.
Higher interest rates	Dearer borrowing may reduce spending and imports. Capital inflows may appreciate the currency, weakening exports and making imports cheaper.

A lower import bill is not the same as an improved whole current account. Check other components, demand responses and competing objectives.

Compare switching expenditure with reducing expenditure

A government considers a tariff or an export subsidy

How could each change trade? Which directly raises public spending, potentially worsening the budget balance if other flows do not change?

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Expenditure-switching changes relative prices to favour domestic goods. A tariff may reduce imports; an export subsidy may support foreign sales and directly costs public funds. Tariff receipts and subsidy costs are different budget effects.

A depreciation can also change relative prices, but a floating rate is not simply set lower by government command. Monetary measures may influence it with uncertain responses. Higher import costs, **retaliation**, limited capacity and weak demand responses can offset gains.

Choose a supply-side response that addresses the constraint

Two exporters lose sales for different reasons

Firm A cannot deliver reliably because the port is congested. Firm B has spare capacity but sells products foreign buyers no longer want. Would the same training programme solve both problems?

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Firm A cannot deliver reliably because the port is congested. Firm B has spare capacity but sells products foreign buyers no longer want. Would the same training programme solve both problems?

Supply-side policy can improve **competitiveness** through productivity, reliability, quality and costs. Port investment may address A's delivery problem; B may need product development or a different market.

Skills, infrastructure and technology take resources and can have lags. Capacity does not guarantee sales. Compare the actual constraint, opportunity cost and foreign demand before predicting higher exports.

Exercises 2.1-2.3

2.1 Define the term *expenditure-switching policy*.

[2]

2.2 State one expenditure-reducing policy.

[1]

2.3 State one drawback of using expenditure-reducing policy to cut a deficit.

[1]

Exercises 2.1·2.3

2.1 Define the term *expenditure-switching policy*. [2]

2.1

- a policy that moves spending away from imports towards domestically produced goods, e.g. a tariff or a lower exchange rate (2 for a clear definition; 1 for a partial idea)
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2.2 State one expenditure-reducing policy. [1]

2.2

- any one of: higher taxes; higher interest rates (1)
-

2.3 State one drawback of using expenditure-reducing policy to cut a deficit. [1]

2.3

- any one of: slower economic growth; higher unemployment (1)

Exercises 3.1·3.2

3.1 A **depreciation** of the currency to reduce a current account deficit is an example of: [1]

☐

A an expenditure-reducing policy

B an expenditure-switching policy

C a supply-side policy

D a contractionary monetary policy

3.2 Explain how an expenditure-switching policy could reduce a current account deficit. [6]

Exercises 3.1-3.2

3.1 A **depreciation** of the currency to reduce a current account deficit is an example of: [1]

- ☐ **A** an expenditure-reducing policy
B an expenditure-switching policy
C a supply-side policy
D a contractionary monetary policy

3.1 B

- A depreciation switches spending to home goods, so it is expenditure-switching
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3.2 Explain how an expenditure-switching policy could reduce a current account deficit. [6]

3.2

- [6] AO1 1 + AO3 up to 5 – a depreciation (or tariff) makes imports dearer and exports cheaper
- consumers switch from imports to home goods and foreigners buy more exports
- imports fall and exports rise
- the deficit narrows (if demand is elastic enough)

Exercise 3.3

3.3 Discuss the best way for a government to reduce a large current account deficit. [12]

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3.3

- [12] AO1/AO2/AO3 up to 8 + AO4 up to 4. **Expenditure-reducing:** cuts imports fast but harms growth and jobs. **Expenditure-switching:** a depreciation or tariff helps if demand is elastic but risks inflation/retaliation. **Supply-side:** raises competitiveness for a lasting fix but is slow and costly. Judgement: the best mix depends on the cause and size of the deficit and the time available – supply-side measures give the most durable solution, but short-run support may be needed first