Past-paper walk-through

Policies to correct disequilibrium in the balance of payments ▪ 11.1

eXercise

Questions in this set

- 9708/31 N25 Q25 ▪ 1 mark
- 9708/31 N25 Q29 ▪ 1 mark
- 9708/32 N25 Q18 ▪ 1 mark
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Question 25

9708/31 N25 ▪ Q25 ▪ 1 mark

25 Which statement about the components of the balance of payments is correct?

A The current account consists of transactions in goods, services, investment income and remittances between countries.

B The current account consists of transactions in goods, services, and portfolio investment between countries.

C The financial account consists of transactions in financial assets, investment income and remittances between countries.

D The financial account consists of transactions in fixed assets, investment income and the balancing item between countries.

Solution 25

Answer: **A**

Why

- The current account covers trade in goods and services, primary income and secondary income.
- Investment income and remittances therefore belong there.
- Purchases of assets belong to the financial account, and capital transfers to the capital account.

Question 29

9708/31 N25 ▪ Q29 ▪ 1 mark

29 There is a rise in the domestic rate of interest in an economy. This economy has a fixed exchange rate.

What would be the impact on the current and financial accounts of the balance of payments?

	current account	financial account
A	improves	improves
B	improves	worsens
C	worsens	improves
D	worsens	worsens

Solution 29

Answer: **A**

Why

- A higher domestic interest rate attracts financial inflows, so the financial account improves.
- It also reduces domestic spending, so imports fall and the current account improves.
- With a *fixed* rate the central bank must intervene to stop the currency appreciating.

Question 18

9708/32 N25 ▪ Q18 ▪ 1 mark

18 A country with a managed exchange rate has a persistent deficit on the current account of the balance of payments. It devalues its currency to reduce this deficit.

Under which conditions will a devaluation help the government to achieve its four main macroeconomic objectives?

	Marshall–Lerner condition satisfied	level of employment
A	no	below full employment
B	no	full employment
C	yes	below full employment
D	yes	full employment

Solution 18

Answer: **C**

Why

- A devaluation makes exports cheaper and imports dearer, so it should improve the current account.
- But it only works if trade volumes respond enough – the Marshall–Lerner condition.
- The sum of the export and import demand elasticities must exceed one.

Question 29

9708/34 N25 ▪ Q29 ▪ 1 mark

29 A country with fixed exchange rates faces a surplus on its current account.

Which policy is most desirable to maintain the fixed exchange rate?

A an increase in subsidies given to exporters

B the imposition of trade barriers on the import of non-essential goods

C the sale of foreign currencies in the foreign exchange market

D the use of expansionary monetary policy

Solution 29

Answer: **D**

Why

- A current account surplus creates excess demand for the currency, pushing the fixed rate up.
- To hold the rate the authorities must reduce that pressure.
- So they should encourage imports or capital outflows – an export subsidy would make the surplus worse.