Exercise walk-through

Policies to correct imbalances in the current account of the balance of payments ▪ 6.5

eXercise

You must be able to

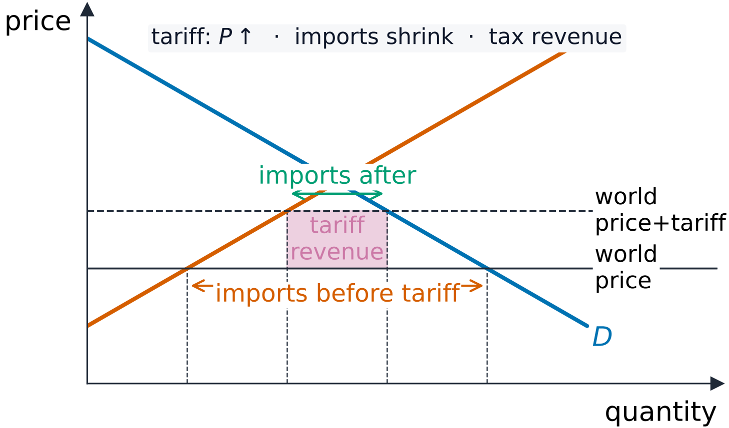
- describe the three types of policy to correct a deficit
- explain how each one works and its side effects
- analyse and evaluate the best policy for a deficit

Method — Correcting a deficit

- **Expenditure-reducing 支出减少**: higher taxes/interest rates lower demand → fewer imports — **but** slows growth, raises unemployment.
- **Expenditure-switching 支出转换**: a tariff or lower exchange rate moves spending to home goods — **but** risks retaliation or inflation.
- **Supply-side 供给侧**: raise **competitiveness 竞争力** (skills, technology) so exports rise — best long-run, but slow.

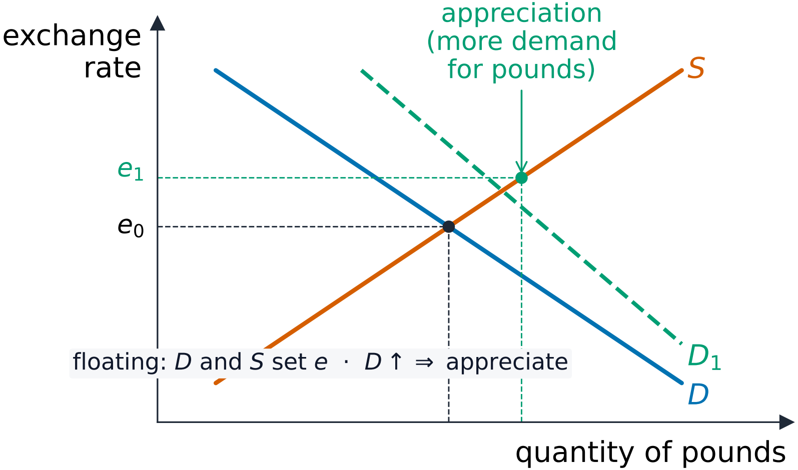
Answer shapes: AO1 + AO2 + AO3 (analysis) + AO4 (a supported judgement *in context*).

Method — Correcting a deficit



A tariff is an expenditure-switching tool that shifts spending to home goods

Method — Correcting a deficit



Practice 2.1 ▪ 2 marks

Define the term *expenditure-switching policy*.

Solution 2.1

Method: Correcting a deficit

Worked steps

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).

Practice 2.2 ▪ 1 mark

State one expenditure-reducing policy.

Solution 2.2

Method: Correcting a deficit

Worked steps

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

Practice 2.3 ▪ 1 mark

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

Solution 2.3

Method: Correcting a deficit

Worked steps

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

Exam-style 3.1 ▪ 1 mark

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

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

Solution 3.1

Method: Correcting a deficit

A an expenditure-reducing policy

B an expenditure-switching policy ✓

C a supply-side policy

D a contractionary monetary policy

Worked steps

B. A depreciation switches spending to home goods, so it is expenditure-switching.

Exam-style 3.2 ▪ 6 marks

Explain how an expenditure-switching policy could reduce a current account deficit.

Solution 3.2

Method: Correcting a deficit

Worked steps

[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).

Exam-style 3.3 ▪ 12 marks

Discuss the best way for a government to reduce a large current account deficit.

Solution 3.3

Method: Correcting a deficit

Worked steps

[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.