Exercise walk-through

7.2
Trade, exchange rates and the balance of payments

Pearson Edexcel · International A-Level · Economics

Specialisation and comparative advantage

- When countries **specialise** , each produces the goods it makes best and trades for the rest.
- World output rises.
- But a country that specialises in a few products depends on their prices: when world copper prices fell by more than half in late 2008, Zambia's export earnings fell sharply.
- A country has an **absolute advantage** when it can produce more of a good from the same resources.

Balance of payments and exchange rates (3)

- **relative interest rates**: in 2022–2024 US interest rates rose above 5% while Japan's stayed near zero, and the yen fell to about 160 per dollar in April 2024;
- **relative inflation**: by **purchasing power parity** theory, the currency of a high-inflation country falls until a basket of goods costs the same in both countries;
- the current-account balance and the economy's strength;

Common errors (2)

- On a **tariff** diagram, counting the revenue box as a loss to society. Only the two triangles are **deadweight loss**.
- Working out a currency's fall from the change in units per dollar. 30.9 to 49.5 pounds per dollar is a 38% fall in the pound, not 60%.
- Saying a **depreciation** always improves the current account. It depends on the Marshall–Lerner condition, the time period and inflation.
- Using "devaluation" for a floating currency. Floating currencies depreciate; fixed ones are devalued.

Exercise 2.1

2.1 A country's export price index rises from 100 to 108 while its import price index rises from 100 to 112. Calculate the new terms of trade and state whether this is an improvement or a deterioration. [4]

export price index

import price index

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export price index import price index

2.1 ToT = 108 / 112 × 100 = 96.43 ≈ 96.4. A deterioration, because export prices rose more slowly than import prices: each export unit now buys about 3.6% fewer imports. Authored marking guidance (original, not an official scheme): M1 method, A1 answer, B1 judgement, B1 reason.

Exercise 2.2

2.2 Country P uses 5 worker-hours per phone and 10 per table; country Q uses 8 per phone and 8 per table. Calculate each country's opportunity cost of one phone and one table, state each comparative advantage, and judge whether trading at 1 phone for 1.2 tables benefits both. [6]

hours	phone	table
country P	5	10
country Q	8	8

Exercise 2.2

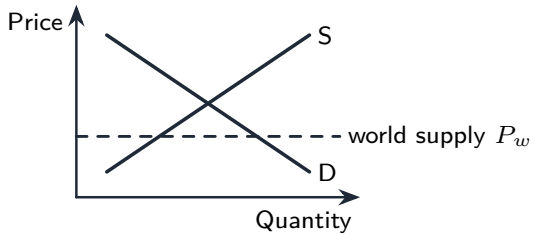
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2.2 In P, one phone costs $5/10 = 0.5$ tables and one table costs $10/5 = 2$ phones. In Q, one phone costs $8/8 = 1$ table and one table costs 1 phone. P has comparative advantage in phones, Q in tables. At 1 phone for 1.2 tables: P receives 1.2 tables for a phone that costs it 0.5 tables, so P gains; but Q pays 1.2 tables for a phone it could make for 1 table, so Q loses. The ratio must lie strictly between 0.5 and 1 table per phone for both to gain. Authored marking guidance (original): M1 method, A1 values, B1 advantages, A1 judgement, B1 condition.

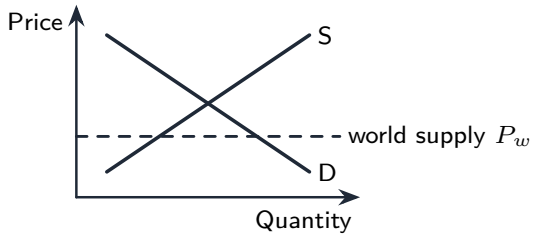
Exercise 2.3

2.3 Using a domestic supply-and-demand diagram with a horizontal world supply, explain the effect of a quota that limits imports to less than the free-trade quantity on the domestic price and on government revenue. [6]



Exercise 2.3

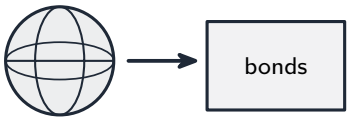
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2.3 A binding quota limits supply at the world price, so total supply turns vertical at the quota quantity: the domestic price rises above P_w until demand equals domestic supply plus the quota. Unlike a tariff, a quota raises no government revenue unless import licences are auctioned; the price gain goes to foreign exporters or licence holders. Consumers lose surplus; domestic producers gain. Authored marking guidance (original): diagram, mechanism, revenue contrast, incidence.

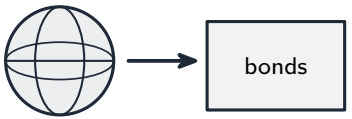
Exercise 3.1

3.1 The fictional economy of Barokia has run a current-account deficit near 6% of GDP for five years, financed by selling government bonds to foreign investors. Its currency floats freely. Evaluate measures that could be taken to reduce Barokia's current account deficit. Refer to Barokia in your answer. [20]



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3.1 Model response (original; official WEC14 essays are marked 12 for knowledge, application and analysis plus 8 for evaluation; "refer to a country" is required).

Definition and context: Barokia's current account – trade in goods and services plus income and transfers – is in deficit near 6% of GDP, financed by foreign purchases of its bonds.

Analysis of measures: expenditure-reducing policy – higher income tax or lower government spending could cut disposable income and import spending; higher interest rates

Full solution on next slide

Full solution 3.1 (1/2)

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Analysis of measures: expenditure-reducing policy – higher income tax or lower government spending could cut disposable income and import spending; higher interest rates would cut spending and also attract capital inflows that support the currency's financing side. Depreciation of Barokia's floating currency would cheapen exports and raise import prices, potentially improving the trade balance if quantity responses are sufficient. Apply the Marshall-Lerner condition within its stated benchmark assumptions; a J-curve warns of a possible initial deterioration if prices change before volumes. Supply-side measures

Full solution 3.1 (2/2)

– education, infrastructure, R&D incentives – would raise competitiveness and export value over time. Protectionism (tariffs, quotas) would cut imports directly.

Evaluation: deflation costs output and jobs, especially risky if domestic demand is already weak; a current-account deficit alone does not establish that weakness. Depreciation may fail Marshall-Lerner if Barokia's exports are raw materials with inelastic demand, and it raises imported-input costs, feeding inflation. Supply-side policies take years and need funding a deficit country may lack. Tariffs may invite retaliation and can conflict with trade commitments, depending on their design and the applicable rules. The bond financing is also fragile: if investors lose confidence, capital flight could force a crisis rather than an adjustment.

Judgement: for Barokia, a managed depreciation plus phased supply-side investment is the least damaging path; sharp fiscal deflation would turn a trade problem into a recession. (≈350 words; allow supported alternative judgements with conditions.)