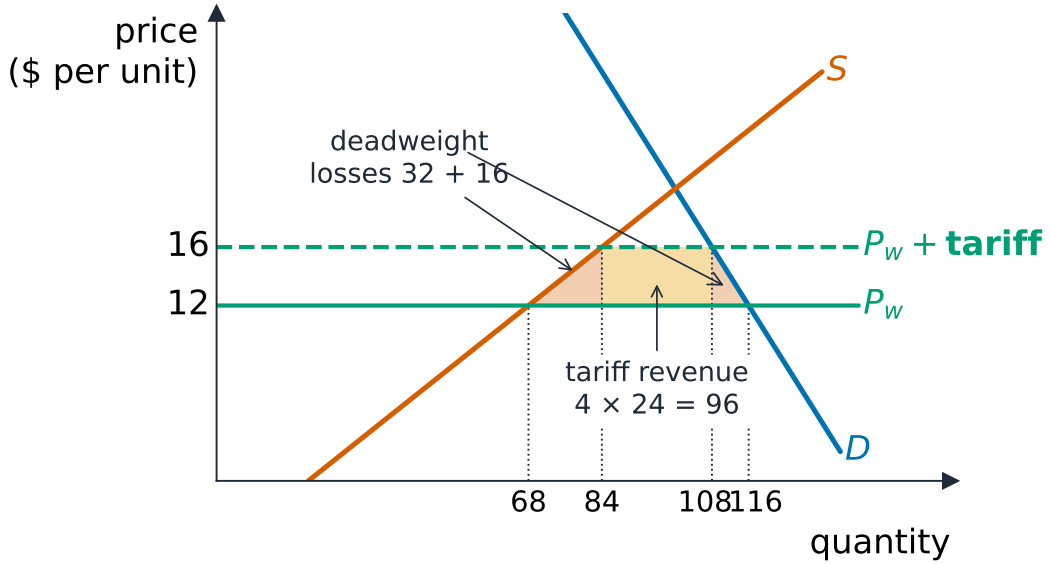
Exercise walk-through

# 6.5
# Balance of payments

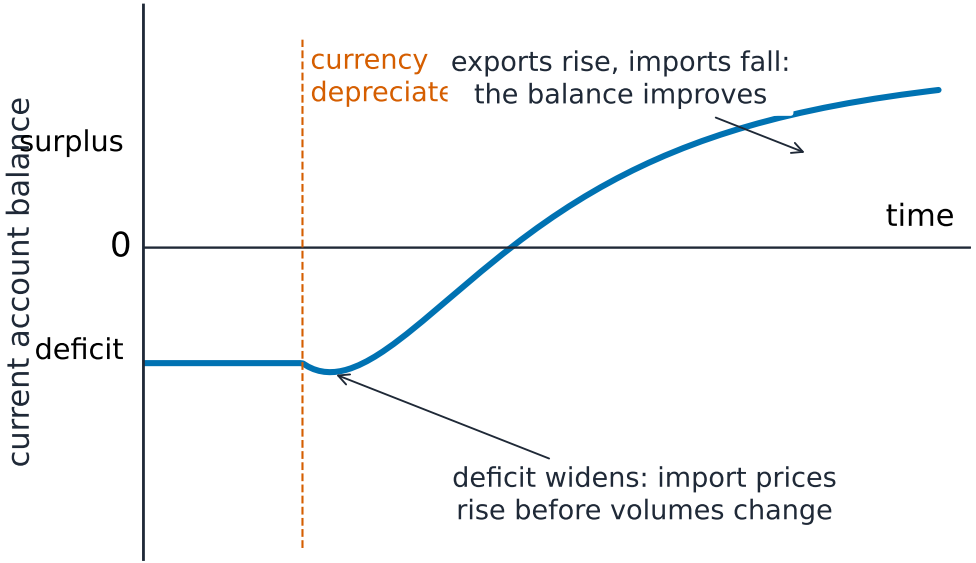
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# Figure: Trade protection



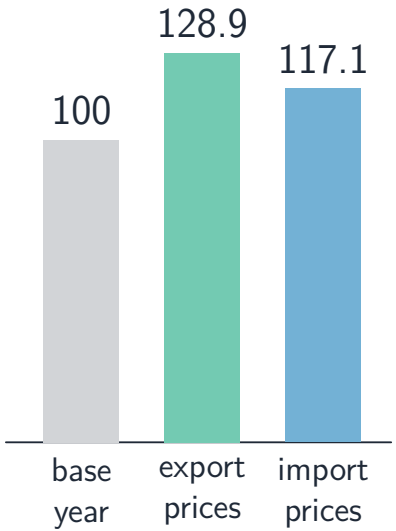

- A **tariff** of 4 halves imports, raises 96 for the government and wastes 48
- Match each part of the diagram to the text.

# Figure: The balance of payments ·




- After a **depreciation** the **current account** gets worse before it gets better
- Read the axes and units first.

# Figure: The balance of payments · ·




$$\frac{128.9}{117.1} \times 100 \approx 110.1$$

each unit of exports buys about 10% more imports

but dearer exports from domestic inflation may sell less

- **Terms of trade** from two indices
- Match each part of the diagram to the text.

# Exercises 2.1·2.2

**2.1** State **two** items recorded in the current account. [2]

goods services $ income

**2.2** Explain why a current account deficit must be matched by a surplus on the capital and financial accounts. [2]

current + capital and financial $= 0$

# Exercises 2.1·2.2

**2.1** State **two** items recorded in the current account. [2]




**2.1**

any two: trade in goods; trade in services; primary income such as profits, interest or wages from abroad; secondary income such as remittances or aid

**2.2** Explain why a current account deficit must be matched by a surplus on the capital and financial accounts. [2]

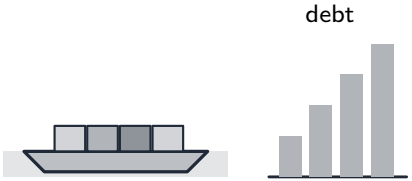



**2.2**

the balance of payments must sum to zero; a country paying out more on its current account must finance it by borrowing or selling assets abroad, which are inflows on the financial account

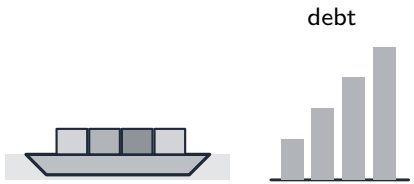
# Exercise 2.3

**2.3** Explain **two** possible consequences of a persistent current account deficit. [4]



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**2.3** Explain **two** possible consequences of a persistent current account deficit. [4]




**2.3**

any two, explained: rising foreign debt, so more income goes on interest payments abroad; downward pressure on the exchange rate, which may raise import prices and inflation; more foreign ownership of domestic firms and assets; interest rates may have to rise to attract capital, slowing growth

# Exercise 2.4

**2.4** A country's data ($ bn): exports of goods 400, imports of goods 450, exports of services 120, imports of services 80, net primary income −20, net secondary income +10. Calculate the balance of trade in goods and the current account balance. [3]

| | exports | imports |
|---|---|---|
| goods | 400 | 450 |
| services | 120 | 80 |
| net income | −20, +10 | |

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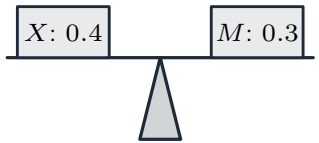
| | exports | imports |
|---|---|---|
| goods | 400 | 450 |
| services | 120 | 80 |
| net income | −20, +10 | |

**2.4**

trade in goods = 400 − 450 = −$**50** bn; trade in services = +40; current account = −50 + 40 − 20 + 10 = −$**20** bn

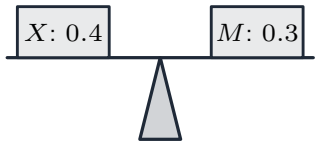
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**2.5** A country's PED for exports is 0.4 and its PED for imports is 0.3 (absolute values). Using the Marshall–Lerner condition, explain the likely effect of a depreciation on its current account. [3]



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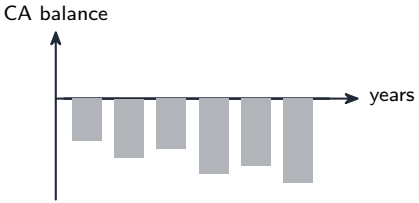

**2.5**

the condition needs $|\text{PED}_X| + |\text{PED}_M| > 1$; here $0.4 + 0.3 = 0.7 < 1$; so export and import volumes change too little to offset the price changes, and the current account worsens

# Exercise 3.1

**3.1** A country has had a large current account deficit for many years.

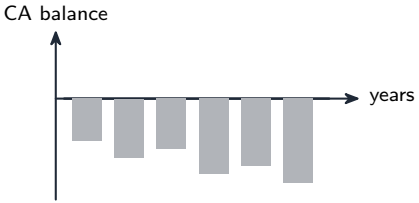
Evaluate the policies that the government could use to reduce the deficit. [10]



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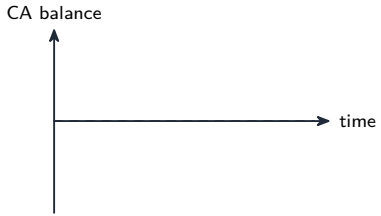



**3.1**

award up to [10]: expenditure-switching: a depreciation makes exports cheaper and imports dearer; but imported inflation; and it depends on elasticities; protection reduces imports, but risks retaliation and inefficiency, and may break WTO rules; expenditure-reducing: higher taxes, lower government spending or higher interest rates cut AD and so imports; but they also cut growth and raise unemployment; supply-side policies (education, infrastructure, productivity) raise competitiveness; but they take a long time and are costly; a deficit may not be harmful if it finances investment that raises future exports; the best mix depends on the cause of the deficit; reasoned conclusion

# Exercise 3.2

**3.2** After its currency depreciated, a country's current account deficit grew for a year before it began to shrink.

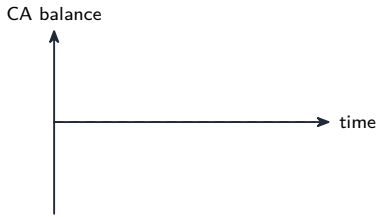



Using a J-curve diagram, explain this pattern. [6]

[[drawlines:6]]

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**3.2**

diagram: current account balance against time, falling after the depreciation, then rising above the starting level; short run: export and import volumes respond slowly because of contracts and habits, so demand is inelastic; imports cost more in domestic currency and exports earn less foreign currency, so the deficit worsens; long run: buyers switch, demand becomes more elastic; once the Marshall–Lerner condition holds, the current account improves