Solutions

Marking: **M1** a correct method, **A1** the correct answer, **B1** an independent mark.

Each answer shows the steps, then the **result**.

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

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

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

2.4

trade in goods $= 400 - 450 = -\$\mathbf{50}$ bn; trade in services $= +40$; current account $= -50 + 40 - 20 + 10 = -\$\mathbf{20}$ bn

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

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

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

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