

Exercise walk-through

6.4

Current account of the balance of payments

IGCSE Economics

Exchange rates

Appreciation (a stronger currency) makes exports **dearer** & imports **cheaper**.
Depreciation does the reverse.

Appreciation

(currency rises in value)

exports dearer,
imports cheaper →
exports fall, imports rise

Depreciation

(currency falls in value)

exports cheaper,
imports dearer →
exports rise, imports fall

Exam: appreciation hurts export competitiveness; depreciation can boost net exports (SPICED)

Balance of payments

The **balance of payments** records money in & out.

- exports $>$ imports – a **surplus**
- imports $>$ exports – a **deficit**

exports (money in) $>$ imports (money out)
= a surplus

imports $>$ exports = a deficit

The four parts of the current account, and free trade's cost

trade in goods

visible exports minus visible imports

trade in services

exports and imports of services – tourism, banking, shipping

primary income

wages, interest and profit **earned from abroad**

secondary income

money sent **with nothing given in return** – aid, and remittances

a surplus

the total is positive; a deficit means the country buys more from abroad than it sells

free trade's cost

new, small industries may never grow if they face strong foreign rivals from the start – the infant-industry argument

A deficit is not automatically bad. It matters how it is financed and whether the imports build future capacity – which is what an evaluation question wants.

Correcting a deficit

A country with a large deficit must borrow money or sell assets to pay for it.

- cut total demand, so people buy fewer imports.
- let the currency depreciate, to make exports cheaper and imports dearer.
- use trade protection (tariffs and quotas) to cut imports.
- use supply-side policy to improve the **competitiveness** of its firms, so exports rise.

Exam tips

- To convert currency: pounds $\rightarrow$ dollars, *multiply* by the rate; dollars $\rightarrow$ pounds, *divide* by the rate.
- When a currency **appreciates**, its exports become dearer and its imports cheaper (so exports fall, imports rise); a **depreciation** does the opposite.
- **Trade protection** (tariffs, quotas, subsidies, embargoes) can protect jobs and infant industries, but it raises prices, cuts choice, and can start a trade war.
- A **current account deficit** means more money flows out than in. It can be reduced by cutting demand, letting the currency depreciate, or improving competitiveness.

Exercises 2.1-2.3

2.1 State the four sections of the current account.

[2]

2.2 Define the term *current account deficit*.

[2]

2.3 State one way a government could reduce a current account deficit.

[1]

Exercises 2.1-2.3

2.1 State the four sections of the current account. [2]

2.1

- the four sections of the current account
- **trade in goods, trade in services, primary income, secondary income** (K)

2.2 Define the term *current account deficit*. [2]

2.2

- a **current account deficit** is when more money flows **out** of a country than into it on the current account (it buys more from abroad than it sells) (K)

2.3 State one way a government could reduce a current account deficit. [1]

2.3

- any **one** of: **cut total demand** / let the currency **depreciate** / use **trade protection** / raise **competitiveness** (K)

Exercises 3.1-3.2

3.1 Which is part of the **current account**?

[1]

☐

A the sale of government bonds to foreigners

B trade in services

C the country's gold reserves

D a loan from a foreign bank

3.2 Explain two reasons why a country might have a current account deficit.

[4]

Exercises 3.1-3.2

3.1 Which is part of the **current account**?

[1]

- ☐ A the sale of government bonds to foreigners
B trade in services
C the country's gold reserves
D a loan from a foreign bank

3.1 B

- **trade in services** is part of the current account (K)
- A, C and D are capital / financial-account items

3.2 Explain two reasons why a country might have a current account deficit.

[4]

3.2

- for **each** of two reasons: $K + A_n$
- e.g. **high demand for imports**: rising incomes mean people buy more foreign goods
→ imports exceed exports
- e.g. **low competitiveness**: home goods are dear or low-quality → exports are low
while imports are high → a deficit

Exercise 3.3

3.3 Discuss whether a current account deficit is always a problem for a country. [8]

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3.3

- **a problem if:** it is large and persistent, the country must borrow or sell assets, and it signals weak competitiveness ($K + A_n$)
- **not always:** a deficit caused by importing **machines** can raise future output; strong investment inflows can sustain one (A_n)
- **judgement (Ev):** a small, temporary deficit to buy capital goods is not a worry, but a **large, lasting** one financed by borrowing is