2.22 The Effects of Exchange Rate Changes on Trade and the Macroeconomy: 10-minute Pack

Total Marks

AQA 7136 · Calculators not allowed · about 10 minutes

Name: _____ Date: ____ / ____ / _____

Answer all questions. A calculator is not allowed. Show working for calculations where asked.

1 Percentage calculation: The UK imports a commodity worth £10 billion pre-depreciation. After a 25% depreciation, the sterling price of that commodity rises in the short run by 25% if quantity is unchanged. Calculate the sterling value of imports of that commodity immediately after the depreciation, assuming no change in quantity. Show arithmetic.

(Total for Question 1 is 2 marks)

2 Define the price elasticity of demand for imports and explain briefly why a high elasticity of demand for imports makes a depreciation more likely to improve the current account.

(Total for Question 2 is 2 marks)

3 State the Marshall-Lerner condition as it applies to the UK current account after a depreciation of the pound, and explain briefly in words what the condition means in terms of export and import volumes.

(Total for Question 3 is 3 marks)

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Mark scheme · 2.22 The Effects of Exchange Rate Changes on Trade and the Macroeconomy: 10-minute Pack

Question 1

calculate new value = £10 billion * (1 + 0.25)	**M1**
equals £12.5 billion	**A1**

Answer: £10 billion * 1.25 = £12.5 billion.

Question 2

definition: price elasticity of demand for imports measures the percentage change in the quantity of imports demanded in response to a 1% change in the price of imports in domestic currency	**B1**
explanation: if import demand is highly elastic a depreciation raises import prices and leads to a large percentage fall in import volumes, reducing import spending and helping the current account	**B1**

Answer: PED for imports is the percentage change in import quantity for a 1% change in import price. If import demand is highly elastic, a depreciation that raises import prices will cause a large fall in import volumes, reducing imports in value and making an improvement in the current account more likely.

Question 3

states the condition: price elasticity of demand for exports + price elasticity of demand for imports > 1	**M1**
explains that if the sum exceeds 1, the percentage increase in export volumes and the percentage decrease in import volumes together raise the value of net exports in domestic currency terms	**A1**
alternative phrasing allowed that conveys the same idea, for example a depreciation will improve the current account only if the combined elasticities exceed unity	**B1**

Answer: Marshall-Lerner: price elasticity of demand for exports plus price elasticity of demand for imports must be greater than 1; this means a depreciation will improve the current account only if the percentage responses of export and import volumes are large enough to offset the price effects.

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