2.22 The Effects of Exchange Rate Changes on Trade and the Macroeconomy: Test Pack

AQA 7136 · Calculators not allowed · about 20 minutes

Total Marks

Name: _____ Date: ____ / ____ / _____

Answer all questions. A calculator is not allowed. Draw the J-curve diagram requested in Question 4 and label axes, the initial point and subsequent path. Show working for calculations where asked.

1 Select the single best option to describe a depreciation of the pound.

(Total for Question 1 is 1 mark)

2 Define 'currency depreciation' in the context of the UK pound sterling falling against other currencies, naming the market effect and one immediate price consequence for imports or exports.

(Total for Question 2 is 2 marks)

3 Explain, with reference to the Marshall-Lerner condition, why a weaker pound might not improve the UK current account if most UK exports and imports are price-inelastic even in the long run.

(Total for Question 3 is 3 marks)

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4 Diagram task: A 15% depreciation of sterling is announced. Draw a schematic J-curve diagram showing the path of the UK current account balance over time after this depreciation. On your diagram label the vertical axis 'Current account balance (GBP billion)', the horizontal axis 'Time after depreciation', mark the initial balance point, show an initial fall then a later recovery above the initial level if Marshall-Lerner holds, and label the short-run and long-run positions. Indicate clearly which features earn marks.

(Total for Question 4 is 4 marks)

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5 Explain how a depreciation of sterling can lead to higher UK consumer price inflation via import prices, and state one factor that might offset this inflationary effect.

(Total for Question 5 is 3 marks)

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

Question 1

selects option A, a depreciation means the domestic currency falls in value so it buys fewer units of foreign currency **B1**

Answer: The pound buys fewer units of foreign currency than before.

Question 2

a depreciation is a fall in the value of the pound relative to other currencies in the foreign exchange market **B1**

an immediate consequence is that imports become more expensive in sterling terms and exports become cheaper for foreign buyers **B1**

Answer: A depreciation is a fall in the pound's value versus other currencies; imports become more expensive in sterling and UK exports become cheaper for foreigners.

Question 3

states that if export and import demand elasticities are both low, the sum may be ≤ 1 **M1**

explains that with inelastic demand, a depreciation mainly changes prices not quantities, so import spending in sterling may rise and export revenues in sterling may fall, worsening or not improving the current account **A1**

develops that other factors such as contracts, global supply chains and commodity price invoicing in foreign currency can keep quantities inelastic **B1**

Answer: If export and import demand remain price-inelastic so their elasticities sum to less than or equal to 1, a depreciation mainly alters prices and not quantities, so import spending in sterling can rise while export revenues fall, failing to improve the current account; contractual and structural factors can keep demand inelastic.

Question 4

correctly labels vertical axis 'Current account balance (GBP billion)' and horizontal axis 'Time after depreciation' **B1**

marks the initial balance point on the vertical axis and indicates time zero **B1**

draws a curve that first falls (initial worsening) then rises in a J-shaped path, with the later level above the initial point to show improvement if Marshall-Lerner holds **B1**

labels the short-run position (below initial) and the long-run position (above initial) and makes clear which section is short-run and which is long-run **B1**

Answer: Student diagram should show axes labelled, initial point at time zero, a fall then a recovery to a higher level, with short-run and long-run positions labelled.

Question 5

explain inflation channel: depreciation raises the sterling price of imported goods and raw materials, so firms face higher input and product costs and may pass these on as higher consumer prices **M1**

this imported inflation raises the overall CPI if imports form a significant share of the consumer basket **A1**

state one offsetting factor, for example a fall in domestic demand reducing pressure on prices, stronger productivity reducing unit costs, or monetary policy tightening to contain inflation **B1**

Answer: A depreciation raises sterling import prices so firms pay more for imported inputs and goods and may pass costs to consumers, raising CPI; an offset could be weaker domestic demand, productivity gains, or a tighter monetary policy response.

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