2.6 The Balance of Payments: Causes and Correction of Disequilibrium

Total Marks

AQA 7136 · Calculators not allowed · about 65 minutes · Write-in edition

Name: _____ Date: ____ / ____ / _____

Answer all questions. Write full sentences for questions worth 4 marks or more. Time guidance: 65 minutes total.

1 State two ways in which a loss of international cost or price competitiveness in UK firms can cause a current account deficit.

(Total for Question 1 is 2 marks)

2 Explain briefly how the trade cycle can cause temporary swings in the UK current account balance over a few years.

(Total for Question 2 is 2 marks)

3 Define protectionist measures used to correct a current account deficit and state one potential negative side effect for UK consumers.

(Total for Question 3 is 2 marks)

4 State two supply-side policies the UK government could use to correct a persistent current account deficit by improving competitiveness, and state one way each policy works to help net exports.

(Total for Question 4 is 3 marks)

5 Evaluate the view that a persistent current account deficit is always a problem for the UK economy. In your answer, analyse possible causes and costs of a persistent deficit, consider circumstances in which a deficit might not be problematic, discuss the effectiveness and costs of corrective policies, and reach a supported judgement. Where relevant, indicate what diagrams you would draw.

(Total for Question 5 is 25 marks)

6 Explain how a sustained period of faster domestic inflation in the UK, compared with major trading partners, can contribute to a current account deficit.

(Total for Question 6 is 3 marks)

7 Define 'expenditure-switching' policies in the context of correcting a current account deficit, and give one clear example relevant to the UK.

(Total for Question 7 is 2 marks)

8 Explain how a deliberate devaluation or depreciation of the pound could help reduce a UK current account deficit, stating one condition that must hold for it to succeed.

(Total for Question 8 is 3 marks)

Mark scheme · 2.6 The Balance of Payments: Causes and Correction of Disequilibrium

Question 1

any one valid way, e.g. higher relative wage or production costs raise UK export prices and reduce export volumes — **B1**

a second, different valid way (e.g. an appreciation of the pound, higher relative inflation), or: slower productivity growth increases unit costs for UK firms, encouraging imports and reducing net exports — **B1**

Answer: Higher relative wages or costs that make UK goods more expensive overseas; slower productivity growth raising unit costs and encouraging imports.

Question 2

in a boom domestic incomes and spending rise, boosting imports more than exports and worsening the current account — **M1**

in a recession domestic demand and imports fall, which can temporarily improve the current account — **A1**

Answer: During booms higher incomes raise import demand and can worsen the current account; during recessions lower demand reduces imports and can improve the current account temporarily.

Question 3

protectionist measures are policies such as tariffs, quotas or import restrictions designed to reduce import volumes and protect domestic industries — **B1**

negative side effect: they raise prices for UK consumers, reducing consumer welfare and potentially causing retaliation from trading partners — **B1**

Answer: Protectionism uses tariffs or quotas to cut imports; a likely negative effect is higher prices for consumers and lower consumer choice.

Question 4

investment in vocational training or education, which raises labour productivity and lowers unit labour costs, making UK firms more price competitive abroad — **B1**

subsidies or tax relief for R and D and capital investment, which improve technology and product quality, increasing non-price competitiveness and export demand — **B1**

each linked to how that policy helps net exports: higher productivity lowers costs and prices; better technology raises quality and demand overseas — **B1**

Answer: Examples: better vocational training raises productivity reducing unit costs; R and D tax relief improves technology and quality, boosting export demand.

Question 5

Level 1 Basic statements about current account deficits, limited analysis. May identify one or two causes or costs with little development. Judgement, if present, is unsupported or implied. — **1-5**

Level 2 Clear explanation of causes and some costs of a persistent deficit, and some analysis of policy options. Some evaluation, but argument may be unbalanced or lacking depth. Diagrams mentioned or partially explained. — **6-10**

Level 3 Detailed analysis of the causes and consequences of a persistent deficit, with balanced evaluation of different scenarios. Considers policy effectiveness, time lags, distributional effects and financing issues. Clear judgement supported by evidence or reasoned argument. Diagrams are correctly described and used to support points. — **11-15**

Level 4 Comprehensive analysis and evaluation, including consideration of macroeconomic context, role of capital flows, credibility, and structural factors. Contrasting positions explored and limitations of models assessed. Diagrams are integrated and used effectively. A nuanced, well-supported conclusion is given. — **16-20**

Level 5 Excellent, sustained evaluation showing mastery of the topic. Arguments are balanced, explore alternative interpretations and policy trade offs, and integrate short-run and long-run perspectives. Diagrams and empirical reasoning are used to support a sophisticated, well-justified judgement. — **21-25**

Indicative content:

- Causes: persistent relative inflation and weak productivity growth reducing competitiveness; exchange rate overvaluation; structural issues in tradable sectors; high domestic demand and import dependence; cyclical factors made persistent by policy or structural change.
- Costs: ongoing net outflows requiring financing, rising foreign liabilities and income payments abroad, vulnerability to sudden stops in capital inflows, possible depreciation pressures, loss of tradable sector jobs, crowding out of domestic tradables.
- Circumstances where a deficit may not be problematic: if it finances productive investment that raises future growth and returns (eg financing R and D, infrastructure), if capital inflows are stable and finance productive assets, or if deficit simply reflects a high level of imports of capital goods that will raise future export capacity.
- Financing and sustainability: distinction between temporary deficits and structural deficits; role of capital and financial account inflows and their volatility; rollover risk and interest cost dynamics.
- Policy options and trade offs: expenditure-switching (depreciation, tariffs) can restore competitiveness quickly but risk inflation, retaliation, and higher import input costs; expenditure-reducing (fiscal/monetary tightening) lowers import demand but causes recession and unemployment; supply-side reforms improve competitiveness long term but have long lags and political costs.
- Distributional and macro effects: who gains and who loses, effects on inflation, wages, unemployment, real incomes and growth; impacts on investment and confidence.
- Diagrams to draw: real exchange rate diagram showing depreciation effect on net exports; a goods market AD/AS or Import demand curve showing the effect of expenditure-reducing policy; a loanable funds or capital flow schematic to show financing of the deficit.
- Evaluation points: magnitude and persistence matter; composition of the deficit (goods versus services, capital imports versus consumption imports) matters; the openness of capital markets and credibility of financing sources; empirical UK context: strong services exports may mitigate goods deficit; policy mix often required.
- Supported judgement: weigh short-term stabilisation needs against long-run structural reform, conclude under what conditions a persistent deficit is a serious problem for the UK and when it may be manageable or even beneficial.

Question 6

faster domestic inflation raises UK prices relative to foreign prices, reducing price competitiveness **M1**

this tends to reduce export volumes as foreign buyers switch to cheaper alternatives and increase import demand as foreign goods become relatively cheaper **A1**

the combined effect is a deterioration in net exports, which can widen the current account deficit **A1**

Answer: Higher UK inflation makes domestic goods relatively more expensive, reducing exports and increasing imports, thereby worsening the current account balance.

Question 7

expenditure-switching policies are measures that aim to change the pattern of domestic spending away from imports toward domestically produced goods and services **B1**

example: a deliberate depreciation of the pound sterling to make UK exports cheaper and imports more expensive, or targeted temporary tariffs on certain imports **B1**

Answer: Expenditure-switching policies change spending towards domestic goods, for example a depreciation of the pound to boost exports and discourage imports.

Question 8

depreciation makes UK exports cheaper in foreign currency terms and imports more expensive in domestic currency terms, tending to increase export volumes and reduce import volumes **M1**

this improves net exports (X - M) and shifts aggregate demand toward domestic production, reducing the current account deficit **A1**

condition: the Marshall-Lerner condition must hold over time, i.e. the sum of price elasticities of demand for exports and imports must exceed 1, so volume responses offset price effects **A1**

Answer: Depreciation makes exports cheaper and imports costlier, raising export volumes and lowering import volumes to improve net exports, provided the Marshall-Lerner condition holds so volumes respond sufficiently.