ECO.MAC4 The Balance of Payments: Causes and Correction of Disequilibrium

AQA 7136 · Calculators not allowed · about 90 minutes

Total Marks

Name: ______________________________ Date: ____ / ____ / ______

Answer all questions. Write full sentences for questions worth 4 marks or more. Time guidance: 90 minutes total.

1 Define 'current account deficit' in the context of a national economy such as the UK, and state one immediate implication for foreign exchange flows.

(Total for Question 1 is 2 marks)

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2 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 2 is 2 marks)

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3 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 3 is 3 marks)

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4 State two ways in which an appreciation of the pound sterling could lead to a larger current account deficit for the UK.

(Total for Question 4 is 2 marks)

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

(Total for Question 5 is 2 marks)

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6 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 6 is 2 marks)

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7 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 7 is 3 marks)

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

(Total for Question 8 is 2 marks)

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9 Explain how expenditure-reducing policies, for example a deflationary fiscal consolidation in the UK, can reduce a current account deficit. Give one likely short-term cost of such a policy.

(Total for Question 9 is 3 marks)

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10 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 10 is 3 marks)

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11 Assess briefly which approach is likely to be more desirable for the UK in correcting a persistent current account deficit: expenditure-switching policies such as depreciation and selective tariffs, or expenditure-reducing policies such as fiscal consolidation. Give two evaluative points.

(Total for Question 11 is 4 marks)

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12 Explain why supply-side policies to improve UK competitiveness often take longer to reduce a persistent current account deficit than expenditure-switching measures, and state one implication of this time lag for policy choice.

(Total for Question 12 is 3 marks)

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13 Context: UK economy facing a persistent current account deficit over several years. Consider the economic mechanisms that link a persistent deficit to growth, exchange rates, foreign liabilities, and policy responses.

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 13 is 25 marks)

Mark scheme · ECO.MAC4 The Balance of Payments: Causes and Correction of Disequilibrium

Question 1

- **B1** a current account deficit is when a country's total receipts from exports of goods and services plus primary and secondary income are less than its payments for imports and income/transfers, i.e. the current account balance is negative
- **B1** implies a net outflow of foreign currency or the need for financing from capital inflows or reserves to pay for the excess of imports over exports
- **Answer: A current account deficit occurs when a country's receipts on goods, services and income are less than its payments, implying net outflows of foreign exchange or a need to finance the gap with capital inflows or reserves.**

Question 2

- **B1** higher relative wage or production costs raise UK export prices and reduce export volumes
- **B1** slower productivity growth increases unit costs for UK firms, encouraging imports and reducing net exports
- **Answer: Higher relative wages or costs that make UK goods more expensive overseas; slower productivity growth raising unit costs and encouraging imports.**

Question 3

- **M1** faster domestic inflation raises UK prices relative to foreign prices, reducing price competitiveness
- **A1** 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
- **Answer: Higher UK inflation makes domestic goods relatively more expensive, reducing exports and increasing imports, thereby worsening the current account balance.**

Question 4

- **B1** appreciation makes UK exports more expensive for foreign buyers, reducing export volumes
- **B1** it makes imports cheaper for UK consumers and firms, increasing import volumes and worsening net exports
- **Answer: An appreciated pound raises export prices overseas, reducing exports, and lowers prices of imports for UK buyers, increasing imports; both worsen the current account.**

Question 5

- **M1** in a boom domestic incomes and spending rise, boosting imports more than exports and worsening the current account
- **A1** in a recession domestic demand and imports fall, which can temporarily improve the current account
- **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 6

- **B1** 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
- **Answer: Expenditure-switching policies change spending towards domestic goods, for example a depreciation of the pound to boost exports and discourage imports.**

Question 7

- **M1** 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
- **A1** 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
- **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.**

Question 8

- **B1** 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
- **Answer: Protectionism uses tariffs or quotas to cut imports; a likely negative effect is higher prices for consumers and lower consumer choice.**

Question 9

- **M1** expenditure-reducing policies aim to lower aggregate demand so that imports, which are demand-sensitive, fall and net exports improve
- **A1** a fiscal consolidation that reduces government spending or raises taxes lowers domestic income and spending, causing import demand to fall and narrowing the current account deficit
- **A1** likely short-term cost: higher unemployment or a deeper recession as aggregate demand and output fall
- **Answer: Cutting government spending or raising taxes reduces domestic demand and imports, improving the current account, but this can cause higher unemployment or a recession in the short term.**

Question 10

- **B1** 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
- **Answer: Examples: better vocational training raises productivity reducing unit costs; R and D tax relief improves technology and quality, boosting export demand.**

Question 11

- **M1** point: expenditure-switching can improve competitiveness quickly and protect jobs in tradable sectors, but may be inflationary and invite retaliation
- **A1** developed: depreciation helps exporters but, if import-dependent inputs are used, costs rise and inflation may offset competitiveness gains
- **M1** point: expenditure-reducing directly lowers import demand and can reduce the deficit without changing relative prices, but at the cost of lower output and higher unemployment
- **A1** developed: fiscal consolidation may restore confidence and reduce deficits sustainably, but political and social costs may make it undesirable
- **Answer: Switching policies act faster and support tradable sectors but risk inflation and retaliation; reducing policies cut import demand but at the cost of lower output and jobs. The preferable mix depends on the state of the economy and policy trade offs.**

Question 12

- **M1** supply-side policies work by changing the productive capacity, skills, technology or regulatory environment, which takes time to deliver higher productivity or improved products
- **A1** therefore their effect on export competitiveness and the trade balance is gradual and long-term rather than immediate
- **A1** implication: policymakers may need to combine short-term switching measures with long-term supply-side reforms, balancing immediate needs against long-run sustainability
- **Answer: Supply-side reforms take time because they alter capacity, skills and technology, so their effects on exports are gradual; thus short-term switching measures are often used alongside them.**

Question 13

- **Level 1** (1-5): 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.
- **Level 2** (6-10): 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.
- **Level 3** (11-15): 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.
- **Level 4** (16-20): 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.
- **Level 5** (21-25): 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.
- **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.