

Cambridge AS & A Level · Economics 9708 · Notes

Policies to correct disequilibrium in the balance of payments

A2

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What you need to know

The AS notes explain the four parts of the current account and how fiscal, monetary, supply-side and protectionist policy can reduce a current account deficit. This A Level topic widens the view to the **whole** balance of payments and asks how each kind of policy affects it. You need to be able to:

1. **Describe the three accounts** of the balance of payments: the **current account** (trade in goods, trade in services, primary income, secondary income), the **capital account** and the **financial account** (direct investment, portfolio investment, other investment such as loans, and reserve assets), plus net errors and omissions. Put any transaction in the right account, and explain why the accounts add up to zero while the balance of payments can still be in **disequilibrium**.
2. **Explain the effect on the balance of payments** of five kinds of policy: **fiscal**, **monetary**, **supply-side**, **protectionist** and **exchange rate** policy. That means the effect on the current account **and** on the financial account, how quickly it works, and what it does to the government's other objectives.
3. **Explain the difference between expenditure-switching and expenditure-reducing policies**, give examples of each, and judge when each is likely to work better.

How exchange rates are set, and the full Marshall–Lerner and J-curve analysis, belong to the next topic (Exchange rates, 11.2). This note uses them only as far as they decide whether an exchange rate policy corrects a deficit.

Understand it

The three accounts

The balance of payments records every transaction between the residents of a country and the rest of the world over a period, usually a year. Money **coming in** is a credit (+); money **going out** is a debit (–).

Account	What it records	Examples
Current account	Payments for goods and services, income earned from abroad, and one-way transfers	Exports and imports of goods; tourism, transport, banking; interest, profits, dividends and short-term workers' wages (primary income); aid, gifts and remittances from settled migrants (secondary income)
Capital account	Small transfers of capital and the sale of assets that are not produced	A foreign government cancelling a debt; a grant to build a hospital; selling a patent, a brand or land for an embassy
Financial account	Buying and selling financial assets across borders	Direct investment (FDI: building a factory abroad or buying a lasting, controlling stake in a foreign firm); portfolio investment (shares and bonds bought without control); other investment (bank loans, deposits, trade credit); reserve assets (the central bank's foreign currency and gold)

Two rules settle most questions.

- **The asset and its income go to different accounts.** Buying shares in a foreign firm, lending abroad or building a foreign factory is a **financial account** entry. The dividends, interest or profits that the asset earns later are **primary income**, in the current account. So when a US firm receives a dividend from shares it owns in a Brazilian firm, it is a **credit in the US current account (9708/32/O/N/24 Q26)**, and investing in a gas pipeline abroad is not in the current account at all (**9708/32/F/M/24 Q27**).
- **On the financial account, follow the money.** Foreigners buying the country's assets, or lending to it, bring money **in** (credit). Residents buying foreign assets, or depositing money in foreign banks, send money **out** (debit). When the central bank sells some of its reserves to pay for a deficit, that is also an inflow.

Why the accounts add up to zero

Every transaction has two sides. If a country buys more abroad than it earns (a current account deficit), it must pay with something: foreigners invest in it, it borrows from abroad, or the central bank uses its reserves. Those all show up as inflows on the financial account. So

$$\text{current account} + \text{capital account} + \text{financial account} + \text{net errors and omissions} = 0.$$

Net errors and omissions is the balancing item: the amount that makes the total zero when records are incomplete. For example, country L has a current account deficit of \$30 billion, a capital account surplus of \$2 billion and a financial account surplus of \$25 billion. The three add to -3 , so net errors and omissions are $+3$ billion.

A two-country example shows how flows across accounts net out. Country E sells extra gas abroad and earns \$300 million (a current account credit). It deposits \$120 million of the earnings in banks in country F. For E, the deposit is money going out on the financial account, so its total currency flow is $300 - 120 = +180$ million. Country F pays \$200 million more for gas and receives the \$120 million deposit, so its total is $-200 + 120 = -80$ million. (**9708/32/F/M/22 Q28** works the same way with other numbers.)

What "disequilibrium" means

Since the accounts always add to zero, "disequilibrium" cannot mean that they fail to balance. It means the **current account** is out of line in a way that cannot last:

- a **deficit** that is large (several per cent of GDP) and **persistent**, paid for by running down reserves, by short-term borrowing or by "hot money" that can leave at any time; or
- a **surplus** that is large and persistent, which builds up reserves, adds to inflation and leaves trading partners with matching deficits.

A deficit puts pressure on the exchange rate. To buy imports, residents sell their own currency; foreigners buy it to pay for exports. If imports are bigger than exports, more of the currency is supplied than demanded, so a **floating** exchange rate **falls**. With a **fixed** exchange rate, the central bank must buy its own currency with its reserves to hold the rate, and the reserves run down. Either way, a persistent deficit cannot go on for ever.

The causes of a deficit (high inflation, an overvalued currency, a boom in spending at home, weak non-price competitiveness, a narrow export base, imports of capital goods) are in the note on the current account. Two points matter for policy. First, the **cause** decides the cure: a deficit from a spending boom calls for a different policy than one from uncompetitive industries. Second, not every deficit needs a cure: importing **new technology** raises imports now ([9708/32/F/M/25 Q22](#)) but can raise exports later.

Expenditure-reducing and expenditure-switching

Every policy that corrects a deficit works in one of two ways (supply-side policy is a third, slower way, below).

Expenditure-reducing policy lowers **total** spending in the economy. When aggregate demand falls, national income falls, and households and firms buy fewer goods of every kind, imported ones included. Examples: higher income tax or sales tax, lower government spending (contractionary fiscal policy), higher interest rates or slower growth of the money supply (contractionary monetary policy).

How much imports fall depends on the **marginal propensity to import (MPM)**, the share of each extra dollar of income that is spent on imports:

$$\Delta M = \text{MPM} \times \Delta Y.$$

If the MPM is 0.2, national income must fall by \$5 for imports to fall by \$1. That is why expenditure-reducing policy is costly: to remove a deficit of \$10 billion with an MPM of 0.2, national income must fall by $10 \div 0.2 = 50$, that is \$50 billion, with the lost output and jobs that go with it. The higher the MPM, the smaller the fall in income needed.

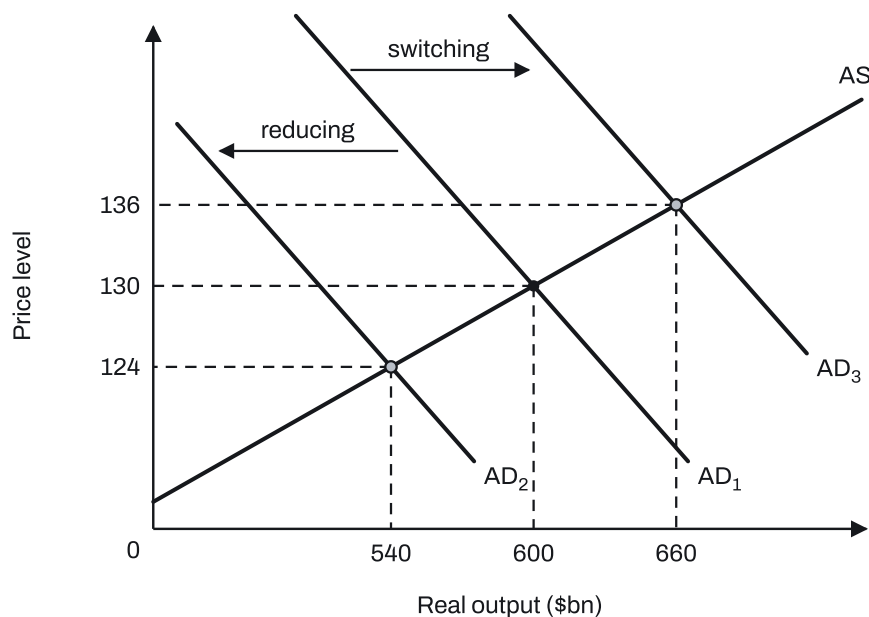
It has a second, slower effect. Lower demand at home slows inflation, so the country's prices rise more slowly than its trading partners', and its exports become more competitive. Firms that cannot sell at home may also look harder for buyers abroad.

Expenditure-switching policy changes **what** people buy, not how much. It makes foreign goods dearer (or harder to get) compared with home-produced goods, so both home residents and foreigners switch their spending towards the country's output. Examples: tariffs, quotas, embargoes and red tape on imports, export

subsidies, subsidies to home firms that compete with imports, and a lower exchange rate (devaluation or depreciation).

Switching works only if:

- **demand responds to price:** if demand for imports and exports is price inelastic, dearer imports and cheaper exports change quantities very little, and spending on imports can even rise. For an exchange rate change, the rule is the **Marshall–Lerner condition**: a fall in the exchange rate improves the current account only if the price elasticities of demand for exports and for imports, added together and ignoring minus signs, are more than 1;
- **there is spare capacity** at home to make the extra goods; otherwise the extra demand raises prices instead of output;
- **other countries do not retaliate** with their own tariffs or devaluations.



The diagram shows why the choice matters for the other objectives. Expenditure-reducing policy moves the economy from 600 to 540: imports fall, but so do output and jobs, while the price level falls from 130 to 124. Expenditure-switching policy moves spending from foreign to home goods, so net exports ($X - M$), part of aggregate demand, **rise**: output rises to 660 and the price level to 136. It helps jobs and growth, but it can add to inflation.

	Expenditure-reducing	Expenditure-switching
What changes	The level of total spending	The pattern of spending, through relative prices
Tools	Higher taxes, lower government spending, higher interest rates	Tariffs, quotas, export subsidies, devaluation or depreciation
Effect on AD	Falls (AD shifts left)	Rises, as net exports rise (AD shifts right)
Growth and jobs	Worse: lower output, more (cyclical) unemployment	Better, if there is spare capacity

	Expenditure-reducing	Expenditure-switching
Inflation	Lower	Higher: dearer imports (cost-push) and more demand (demand-pull)
Works best when	Demand is price inelastic , the MPM is high , the economy is overheating with inflation	Demand is price elastic , the MPM is low , there is spare capacity

The last row answers a common question: when will expenditure-reducing policy beat expenditure-switching? When the elasticities of demand for exports and imports add up to **less than 1**, switching fails; when the MPM is **high**, each dollar of lower income cuts imports a lot. Both together make expenditure-reducing the better choice ([9708/34/M/J/25 Q26](#)).

Fiscal policy

Contractionary fiscal policy (higher direct or indirect taxes, less government spending) is expenditure-reducing. Lower disposable income means less spending on imports, and lower AD slows inflation, which helps exports over time.

- **Limits:** only the MPM share of each dollar cut falls on imports, so a large fall in AD and jobs is needed for a modest improvement. The deficit can return when the policy is reversed.
- **Other uses:** tariffs raise **tax revenue**; export subsidies and grants are government spending and widen a budget deficit.

Monetary policy

Higher interest rates affect both accounts.

- **Current account:** borrowing costs more and saving pays more, so households cut consumption and firms cut investment. Lower AD means fewer imports. This is expenditure-reducing.
- **Financial account:** higher returns attract deposits and short-term capital from abroad ("hot money"), an **inflow** on the financial account.
- **The exchange rate decides the net effect.** With a **floating** exchange rate, the inflows raise demand for the currency, so it **appreciates**. Exports become dearer abroad and imports cheaper at home, which works against the current account; if demand is price elastic, much of the improvement is lost. With a **fixed** exchange rate the currency cannot rise, so the current account improves (fewer imports) **and** the financial account improves (more inflows) ([9708/31/O/N/25 Q29](#)).

Lower interest rates (or more money supply) work the other way: they push a floating currency down, which can be used deliberately to make exports cheaper when demand for them is falling, but they also raise spending at home, including on imports. Monetary policy is therefore a weak tool on its own for a deficit caused by falling exports.

Supply-side policy

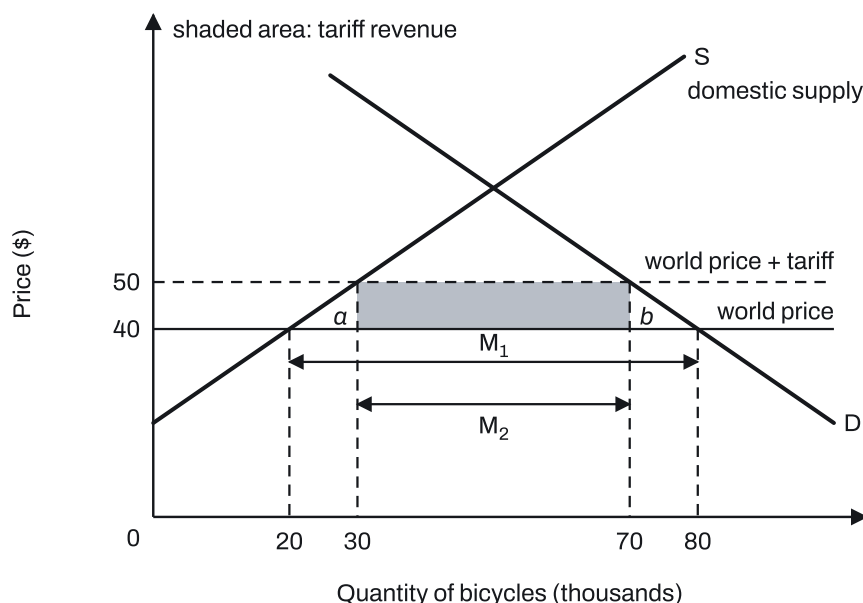
Supply-side policy (training, education, better infrastructure, grants for research and investment, deregulation, privatisation, lower taxes on business) is neither switching nor reducing in the short run. It raises **productivity** and quality, so unit costs fall and home goods become more competitive in **price** and **non-price** terms. Over time exports rise and home goods replace imports, while output and jobs grow and inflation stays low.

- **Deregulation:** fewer rules cut firms' costs, so it can help correct a deficit (9708/32/M/J/25 Q27).
- **Attracting FDI** is the best long-run answer to a persistent deficit among options like borrowing abroad, revaluing the currency or spending the reserves (9708/34/M/J/25 Q25): it brings an inflow on the financial account now, and the new factories add export capacity and productivity later. (The profits they send home later are a primary income debit, which is a cost to weigh.)
- **Limits:** it takes years, costs the government money, and the results are uncertain (trained workers may emigrate; firms may keep lower costs as profit instead of cutting prices).

Protectionist policy

Protection is expenditure-switching aimed at trade in goods and services.

- **Tariffs** raise the home price of imports, so buyers switch to home goods. **Quotas** limit the quantity imported (9708/32/O/N/25 Q27); **embargoes** ban it; red tape slows it; **export subsidies** cut the price of exports abroad.



The diagram shows what a tariff does in one market. At the world price of \$40, home firms supply 20 thousand bicycles, consumers buy 80 thousand and **60 thousand are imported**. A \$10 tariff raises the home price to \$50: home firms supply 30 thousand, consumers buy 70 thousand and imports fall to **40 thousand**.

- **Effect on the current account:** import spending is the price paid to foreign sellers times the quantity, so it falls from $60\,000 \times \$40 = \2.4 million to $40\,000 \times \$40 = \1.6 million, an improvement of **\$0.8 million**.
- **Tariff revenue** for the government: $40\,000 \times \$10 = \0.4 million (the shaded rectangle).

- **Welfare:** consumers lose $\frac{1}{2}(80 + 70) \times 10 = 750$ thousand dollars of consumer surplus; home producers gain $\frac{1}{2}(20 + 30) \times 10 = 250$ thousand of producer surplus; the government gains 400 thousand. That leaves a **net welfare loss** of $750 - 250 - 400 = 100$ thousand dollars, the two triangles **a** (resources wasted making bicycles that cost more at home than abroad) and **b** (consumers who no longer buy).

The improvement depends on how far imports fall, so on the **price elasticity of demand for imports**. If import demand is inelastic (fuel, medicines, machinery with no home substitute), quantity hardly falls; in the extreme, if the price paid for the imports also rises, spending on them **increases** and the deficit gets worse.

Further limits: **retaliation** against the country's exports; **cost-push inflation** if the tariff falls on imported raw materials and parts, which also makes exporters less competitive; less competition for home firms, so less pressure to become efficient; and World Trade Organization rules. Protection mainly affects the **goods and services** part of the current account; it does nothing about deficits on primary income.

Exchange rate policy

A government with a **fixed** exchange rate can **devalue** (set a lower rate); one with a **managed** rate can push the rate down by cutting interest rates or by the central bank selling its own currency. Either is expenditure-switching: exports become cheaper in foreign currency and imports dearer at home ([9708/31/O/N/24 Q25](#)).

- **The upside:** cheaper exports sell more, which creates jobs in export industries ([9708/32/F/M/23 Q24](#)), and buyers at home switch from imports to home goods.
- **Conditions:** the Marshall–Lerner condition (elasticities adding to more than 1). In the short run demand is inelastic because contracts are fixed and buyers take time to switch, so the current account often **worsens first and improves later**: the **J-curve**. Both are studied fully in the next topic.
- **The downside:** dearer imports bring **cost-push inflation**, and extra demand for exports brings **demand-pull inflation**; if wages and prices rise to match, the competitive gain disappears. Other countries may devalue in turn. Foreign-currency debts become dearer to repay.

Correcting a surplus

Reverse each tool: lower tariffs and fewer quotas (imports become cheaper), a **revaluation** or appreciation, and expansionary fiscal and monetary policy (more spending, including on imports). The choice depends on the other objectives. Removing tariffs reduces a surplus **and** lowers inflation, because imports become cheaper ([9708/32/O/N/21 Q30](#)). Cutting interest rates or devaluing would raise inflation; higher direct taxes would cut imports and so make the surplus bigger.

Choosing a policy

There is rarely one right answer. Judge with these questions:

- **What caused the imbalance?** A spending boom calls for expenditure-reducing policy; lost competitiveness for supply-side policy, with switching as a bridge.
- **How big and how persistent is it?** A small, temporary deficit may need no action; a large, persistent one needs a lasting cure.

- **What is the state of the economy?** With inflation and a positive output gap, expenditure-reducing policy costs few jobs. With unemployment and spare capacity, switching is cheaper and reducing is painful.
- **What are the elasticities and the MPM?** They decide whether switching or reducing works.
- **What is the exchange rate system?** It decides what higher interest rates do to the currency.
- **How will other countries react?** Retaliation can cancel protection and devaluation.
- **Short run or long run?** Protection and interest rates act within months; supply-side policy takes years. A mix is usual: a quick policy to stop the deficit growing, and supply-side policy to remove its cause.

Key facts and formulas

There is no formula list in the 9708 exam, so everything here is "Learn it".

Formula	Status
Current account + capital account + financial account + net errors and omissions = 0	Learn it
Change in imports = MPM × change in national income ($\Delta M = \text{MPM} \times \Delta Y$)	Learn it
Fall in national income needed to cut imports by ΔM through expenditure-reducing policy $= \frac{\Delta M}{\text{MPM}}$	Learn it
Import spending (current account debit) = price paid to foreign sellers × quantity imported; a tariff goes to the home government and is not part of it	Learn it
Tariff revenue = tariff per unit × quantity imported after the tariff	Learn it
Marshall–Lerner condition: a fall in the exchange rate improves the current account if PED for exports + PED for imports (ignoring signs) > 1	Learn it
% change in quantity demanded = PED × % change in price	Learn it

How to do it

We tagged 28 questions for this topic (2021–2026; 27 different, because one Paper 3 question appeared on two June 2024 papers): 22 Paper 3 multiple choice and 6 Paper 4 essay and data-response questions. For Paper 4 we count only the part about this topic. No question mixes types, so the counts add up to 28.

Question type	Questions
Classify a policy: expenditure-switching or expenditure-reducing	7
Components of the balance of payments: which account records a transaction	6

Question type	Questions
Evaluate policies to correct a deficit (Paper 4 essay, 20 or 13 marks)	5
Choose the policy that corrects an imbalance	4
Predict a policy's effects, conditions and limits	4
Why a deficit arises	2

1. Classify a policy (7 questions)

All multiple choice.

1. Ask: does the policy change **how much** people spend in total, or **which goods** they buy?
2. **Total spending** (higher income tax or sales tax, lower government spending, higher interest rates, less money supply) → **expenditure-reducing**.
3. **Relative prices or availability** (tariffs, quotas, export subsidies, subsidies to home producers, a lower exchange rate) → **expenditure-switching**.

Variations you will meet:

- **Pick the reducing policy** from a list with a devaluation, a subsidy on home production, a tariff and higher income tax: higher income tax ([9708/33/O/N/24 Q26](#)).
- **Pick the switching policy**: a lower exchange rate ([9708/31/O/N/24 Q25](#)), higher tariff rates ([9708/32/F/M/23 Q29](#)); tariffs on a trading partner's goods are switching, not monetary policy ([9708/32/O/N/24 Q25](#)).
- **"Not an example of an expenditure-reducing policy"**: a depreciation ([9708/33/M/J/24 Q25](#), also set as [9708/31/M/J/24 Q25](#)).
- **A description instead of a name**: "a measure that makes consumers move their spending from imports to home goods" is expenditure-switching ([9708/32/M/J/24 Q26](#)), not the Marshall–Lerner condition, which is a condition for success, not a policy.

2. Components of the balance of payments (6 questions)

All multiple choice.

1. **Is it buying or selling an asset** (factory, firm, shares, bonds, loan, deposit, reserves)? → **financial account**.
2. **Is it income from an asset or from work** (interest, profit, dividends, rent, short-term wages)? → current account, **primary income**.
3. **Goods or services** → current account, trade. **One-way gift or remittance** → current account, **secondary income**. **Debt forgiveness, capital grants, patents** → **capital account**.
4. **Credit or debit**: money in or money out, for the country named.

Variations you will meet:

- **Which statement about the components is correct (9708/31/O/N/25 Q25):** the current account covers goods, services, investment income and remittances; portfolio investment is **not** in it, and investment income and remittances are **not** in the financial account.
- **Match the components to two accounts (9708/32/F/M/25 Q25):** services and secondary income go in the current account; portfolio investment and official reserve assets go in the financial account.
- **FDI against its income (9708/31/O/N/24 Q26):** FDI is in the financial account; interest, profits and dividends are not.
- **A dividend received from a foreign firm (9708/32/O/N/24 Q26):** a credit in the current account. Not the capital account.
- **Not in the current account (9708/32/F/M/24 Q27):** investment in a pipeline abroad. Car exports, tourist earnings and aid transfers are all current account.
- **Total currency flows (9708/32/F/M/22 Q28):** add the current account earnings and subtract money then deposited abroad, as in the gas example in "Understand it".

3. Evaluate policies to correct a deficit (5 questions)

Paper 4 essays, 20 marks since 2023: **Table A** (knowledge and analysis, 14 marks; Level 3 is 11–14) and **Table B** (evaluation, 6 marks; Level 2 is 4–6). So far: "tariffs are the most effective way to correct a deficit" (9708/43/O/N/25 Q5), "the effectiveness of expenditure-switching policies" (9708/42/F/M/25 Q5), "monetary policy alone will solve falling demand for exports" (9708/44/M/J/25 Q4), "expenditure-reducing policies will reduce a deficit but cause significant unemployment" (9708/42/F/M/23 Q4), and the older 13-mark "can a persistent deficit be solved without sacrificing other aims?" (9708/42/F/M/21 Q7 (b)).

Answer plan

1. **Define (AO1):** the balance of payments and its accounts in a sentence or two; what a current account deficit is (the value of money paid abroad for imports, income and transfers is greater than the value received); the policy named (for example, a tariff is a tax on imported goods, a barrier to free trade, and an expenditure-switching policy).
2. **Link the deficit to the exchange rate** where it helps: a deficit means more of the currency is supplied than demanded, so it depreciates (floating) or drains reserves (fixed).
3. **Analyse the named policy (AO2):** at least two developed chains, each ending at the current account. Tariff → dearer imports → buyers switch to home goods → fewer imports → lower import spending → smaller deficit on **trade in goods and services**. Say which part of the current account it affects.
4. **Diagram.** Two essays so far asked "with the help of a diagram", and each credited a different one. **Tariff diagram** (the import market: imports falling from M_1 to M_2 , tariff revenue, the welfare-loss triangles): expected for a question on expenditure-switching (March 2025, where the mark scheme allowed Level 2 at most without a relevant diagram); it also carries the welfare-loss evaluation, which both mark schemes reward. **AD/AS diagram** (switching raises net exports, so AD shifts right; reducing shifts it left): the one credited for a question on correcting the whole balance of payments deficit (November 2025, where the mark scheme said a micro diagram such as the tariff diagram was not acceptable as the diagram). The safe default is to draw both and explain each in the text.

5. **Analyse an alternative:** at least one other policy, analysed the same way. For an essay on expenditure-switching, the March 2025 report expected **at least two** switching policies (for example tariffs **and** a devaluation in a fixed exchange rate system, or export subsidies) for Level 3. For an essay on expenditure-reducing, explain the type of unemployment caused (mostly **cyclical**).
6. **Evaluate (AO3)** with developed points, not one-line assertions:
- **elasticity:** inelastic demand for imports means the tariff hardly cuts the quantity, and spending on imports can even rise; for a devaluation, the Marshall–Lerner condition and the J-curve (worse first, better later);
 - **retaliation:** other countries put tariffs on this country's exports, or devalue in turn;
 - **side-effects** on other objectives: cost-push inflation from dearer imports, demand-pull inflation from extra exports, the **net welfare loss** from a tariff, unemployment from expenditure-reducing policy;
 - **the nature of the deficit:** its size and how long it has lasted; a persistent, structural deficit needs supply-side policy, which works in the long run, while tariffs or interest rates work in the short run;
 - **the state of the economy:** with high inflation and a positive output gap, expenditure-reducing policy costs few jobs and suits the problem;
 - **alternatives** may be better, or a **mix**.
7. **Conclude** on the exact words of the question ("most effective", "alone", "significant"), with a judgement for the short run and the long run.

Variations you will meet:

- **"Monetary policy alone"** for falling exports (**9708/44/M/J/25 Q4**): lower interest rates (or more money supply) push the exchange rate down, or a fixed rate is devalued; exports become cheaper and AD recovers. Evaluate with elasticity, the time it takes, the inflation it causes, and alternatives such as supply-side policy or export subsidies; "alone" needs an alternative.
- **"Reduce a deficit but cause significant unemployment"** (**9708/42/F/M/23 Q4**): analyse how higher interest rates or taxes cut AD, imports and jobs (two developed chains on unemployment for Level 3). Then **question the word "significant"**: the job losses depend on the state of the economy (little unemployment if there is a positive output gap and the aim is to cool inflation), on the type of unemployment already present, on whether supply-side policy is used at the same time, and on whether buyers switch from imports to home goods as incomes fall.
- **"Without sacrificing other aims"** (**9708/42/F/M/21 Q7** (b)): explain what "persistent" means, then go through reducing, switching and direct controls, saying which aim each one costs (reducing: growth and jobs; switching: inflation and trade relations), and decide how far a mix with supply-side policy avoids the sacrifice.

4. Choose the policy that corrects an imbalance (4 questions)

All multiple choice. Cross out options that move the balance the wrong way, then check the extra condition in the question.

- **"A protectionist policy"** to cut a deficit: import quotas, not a revaluation, income tax or interest rates (**9708/32/O/N/25 Q27**).

- **"Most effective long-term solution"** to a persistent deficit: attract more **FDI**, not foreign borrowing, a revaluation or spending the reserves ([9708/34/M/J/25 Q25](#)).
- **Which policy helps a deficit**: fewer government regulations, a supply-side measure; lower direct taxes, a higher exchange rate and more government spending all make it worse ([9708/32/M/J/25 Q27](#)).
- **Reduce a surplus and inflation together**: remove tariffs on imports ([9708/32/O/N/21 Q30](#)). Lower interest rates and a devaluation would raise inflation; higher direct taxes would increase the surplus.

5. Predict a policy's effects, conditions and limits (4 questions)

All multiple choice.

- **Higher interest rates with a fixed exchange rate** ([9708/31/O/N/25 Q29](#)): the current account improves (lower AD, fewer imports) **and** the financial account improves (capital inflows); there is no appreciation to undo it.
- **When reducing beats switching** ([9708/34/M/J/25 Q26](#)): add the two price elasticities. If the sum is **below 1**, switching fails. Then pick the row with the **highest MPM**, because a fall in income then cuts imports most. For example, elasticities of 0.3 and 0.3 (sum 0.6) with an MPM of 0.5 favour expenditure-reducing; elasticities of 0.7 and 0.5 (sum 1.2) favour switching.
- **"Not a possible effect" of expenditure-switching** ([9708/32/F/M/26 Q30](#)): switching **raises** demand for home-produced goods, so a fall in it is not possible. Retaliation, inflation (demand-pull and cost-push) and tariff revenue are all possible.
- **A positive macro effect of devaluation** ([9708/32/F/M/23 Q24](#)): cheaper exports create jobs. Retaliatory depreciation, cost inflation from inelastic imported raw materials and lost import duties are drawbacks.

6. Why a deficit arises (2 questions)

- **Multiple choice** ([9708/32/F/M/25 Q22](#)): the import of new technology raises imports, so it can cause a current account deficit. Repaying debt abroad is in the financial account; export-led growth improves the current account; tax revenue is not a balance of payments item.
- **Data response, 4 marks** ([9708/41/O/N/23 Q1](#) (b)): "a big exporter with a trade deficit". Two reasons, each identified (1) and developed (1): the **value** of imports was greater than the value of exports, which depends on prices and price elasticities, not on how much is exported; export sales fell (a fall in industrial production, lower car sales); a trade war or a pandemic cut demand in its main export markets. Use the figures in the extract.

Worked examples

Example 1

A firm in country P buys 30% of the shares of a mining company in country Q. A year later it receives a dividend from the mining company. How are these two transactions recorded in P's balance of payments?

	Buying the shares	Receiving the dividend
A	debit in the current account	credit in the financial account
B	debit in the financial account	credit in the current account
C	debit in the capital account	credit in the capital account
D	credit in the financial account	debit in the current account

[1]

Buying shares in a foreign firm is buying a financial asset (here a lasting stake, so direct investment), and money leaves P: a **debit in the financial account**. The dividend is income earned on the asset (primary income), and money comes in: a **credit in the current account**. The answer is **B** (1).

Example 2

A country has a deficit on the current account. Its government can either devalue its fixed exchange rate (expenditure-switching) or raise income tax (expenditure-reducing). In which situation is the devaluation most likely to be the more successful policy?

	PED for exports	PED for imports	Marginal propensity to import
A	-0.3	-0.4	0.5
B	-0.8	-0.7	0.1
C	-0.5	-0.3	0.1
D	-0.9	-0.6	0.6

[1]

Add the elasticities, ignoring signs: A 0.7, B 1.5, C 0.8, D 1.5. A and C fail the Marshall–Lerner condition, so a devaluation would not improve the current account. B and D both meet it, but in D the MPM is 0.6, so a fall in income would also cut imports a lot. In B the MPM is only 0.1: income would have to fall by \$10 to cut imports by \$1, so the tax rise is very costly while the devaluation works. The answer is **B** (1).

Example 3

Country T has a current account deficit of \$15 billion and national income of \$300 billion. Its marginal propensity to import is 0.25.

(a) Calculate the fall in national income needed for an expenditure-reducing policy, used alone, to remove the deficit. [2]

(b) Express this fall as a percentage of national income. [1]

(c) Explain why the government might prefer an expenditure-switching policy, and one condition needed for it to succeed. [3]

(a) $\Delta M = \text{MPM} \times \Delta Y$, so $\Delta Y = \frac{15}{0.25} (\text{M1}) = 60$, a fall of \$60 billion (**A1**).

(b) $\frac{60}{300} \times 100 = 20\%$ of national income (**B1**).

(c) A fall of that size would mean a deep recession, with much lower output and many workers losing their jobs (cyclical unemployment) (**1**). An expenditure-switching policy, such as a devaluation or a tariff, moves spending from imports to home-produced goods, so net exports and AD **rise** and output and jobs can grow while the deficit falls (**1**). It succeeds only if demand for exports and imports is price elastic enough (the elasticities add up to more than 1) and there is spare capacity to make the extra goods; otherwise the extra demand raises prices instead (**1**).

(Calculation 3, explanation 3: **6/6**. The calculation ignores the slower effect of lower inflation on exports, which would make the needed fall a little smaller.)

Example 4

With the help of a diagram, evaluate whether a devaluation or a rise in interest rates is the better policy to correct a current account deficit in an economy with a fixed exchange rate. [**20**]

Model answer (paragraph plan):

1. **Terms.** The balance of payments records transactions with the rest of the world in the current, capital and financial accounts; a current account deficit means the value of money paid abroad for imports, income and transfers is greater than the value received. With a fixed exchange rate the central bank holds the rate by buying its own currency with reserves, so a persistent deficit drains the reserves. A devaluation is a cut in the fixed rate (expenditure-switching); a higher interest rate is contractionary monetary policy (expenditure-reducing). (*AO1: accurate knowledge.*)
2. **Devaluation, for.** Exports become cheaper in foreign currency and imports dearer at home, so foreign buyers buy more exports and home buyers switch to home goods. If demand is elastic, export revenue rises and import spending falls, so the deficit shrinks. Net exports rise, so AD shifts right: on the AD/AS diagram, AD_1 to AD_3 , output rises from 600 to 660 and jobs are created. (*AO2: developed chain to the current account, with the diagram explained.*)
3. **Devaluation, against.** The price level rises from 130 to 136: dearer imported materials add cost-push inflation and more demand adds demand-pull inflation. If wages follow, the price advantage is lost. If the elasticities add to less than 1 the current account worsens; in the short run it usually worsens before it improves (the J-curve), because contracts are fixed and buyers take time to switch. (*AO2: the limits analysed.*)
4. **Higher interest rates, for.** Dearer borrowing cuts consumption and investment, so AD shifts left (AD_1 to AD_2): output falls from 600 to 540 and, with an MPM of, say, 0.3, imports fall by 30 cents for each dollar of lost income. The price level falls from 130 to 124, so exports become more competitive over time. With a **fixed** rate there is no appreciation to undo this, and the higher returns attract capital inflows, so the financial account improves too and the reserves are protected. (*AO2: both accounts, linked to the fixed rate.*)

5. **Higher interest rates, against.** Lower output means more cyclical unemployment and slower growth; firms invest less, which harms productivity and future exports. The capital inflows are short-term hot money that can leave quickly. (AO2: *the limits analysed. Two policies, both sides, each linked to the AD/AS diagram: Table A Level 3, here 14/14.*)
6. **Evaluation 1: the cause and the state of the economy.** If the deficit comes from a spending boom with inflation and a positive output gap, higher interest rates treat the cause and cost few jobs. If it comes from lost price competitiveness with unemployment, a devaluation suits it better, because it adds output where there is spare capacity. (AO3: *developed, reasoned comment.*)
7. **Evaluation 2: elasticities, time and reactions.** A devaluation works only if the Marshall–Lerner condition holds, and only after the J-curve dip; trading partners may devalue too. Interest rates act faster on imports but only by squeezing incomes. Neither fixes poor productivity, which needs supply-side policy in the long run. (AO3: *developed, reasoned comment.*)
8. **Conclusion.** For an economy with unemployment and elastic demand for its exports, a devaluation is the better policy, because it cuts the deficit while raising output, provided the government accepts some inflation and waits through the J-curve; higher interest rates are better only when the deficit comes with inflation from excess demand. In both cases supply-side policy is needed for a lasting cure. (AO3: *justified conclusion on "better". Table B Level 2, here 6/6.*)

(Table A: 14; Table B: 6; **20/20.**)

Common mistakes

- **No diagram, or the wrong one.** In March 2025 (Paper 42 Q5, expenditure-switching) a large share of answers had no relevant diagram, even though the tariff diagram is standard, and the mark scheme allowed Level 2 at most without one. In November 2025 (Paper 43 Q5, whether tariffs are the most effective way to correct a deficit) the mark scheme did not accept a micro diagram as the diagram, so the tariff diagram alone earned no diagram credit; an AD/AS diagram was needed. Draw the tariff diagram for switching and welfare loss, the AD/AS diagram for the whole deficit, and explain both.
- **Missing the welfare loss.** The March 2025 report says hardly any candidates earned evaluation marks for the net welfare loss from a tariff. Name the lost consumer surplus and the two deadweight triangles.
- **Asserting instead of developing.** "Other countries may retaliate" or "it depends on Marshall–Lerner" in one line earns little. Say what retaliation does to export revenue, and what elasticities do to import spending and export revenue.
- **Analysing without questioning the statement.** In March 2023 (Paper 42 Q4) many answers explained how expenditure-reducing policies cut imports and raise unemployment, but did not ask **how much** unemployment, which depends on the state of the economy and the type of unemployment. "Evaluate this statement" means testing each part of it.
- **Describing the mechanics of a policy, not its effect on the deficit.** AS reports (June 2022, Papers 22 and 23) found answers that explained how tariffs or tax rises work but never judged how far they would reduce a **persistent** deficit. End each chain at the current account.

- **Mixing up switching and reducing.** In November 2021 (AS Paper 21 Q4(b)) some candidates wrote about expenditure-switching when the question asked about expenditure-reducing. A depreciation is never expenditure-reducing; a tax rise is never switching.
- **Ignoring the exchange rate system.** The same November 2021 report found answers that did not link expenditure-reducing policy to the **floating** exchange rate in the question. Floating: higher interest rates bring an appreciation that works against the current account. Fixed: no appreciation, and both accounts improve.
- **Putting assets in the current account.** FDI, share purchases, loans and deposits are financial account; only the income they earn is in the current account.
- **No short run and long run.** The March 2025 report expected answers to separate policies that work quickly (tariffs, interest rates) from those that only work in the long run (supply-side policy).
- **A conclusion that only summarises.** The March 2025 report asked for conclusions that answer the question, not a repeat of the analysis.

How to get the marks

- **Multiple choice:** for a transaction, ask "asset or income?" and "money in or out?". For a policy, ask "total spending or relative prices?". For a choice of policy, check the extra condition: protectionist, long term, surplus, inflation, fixed or floating rate.
- **Data response "explain" (2 + 2):** identify a reason (1) and develop it (1), twice, using figures from the extract.
- **20-mark essays:** Table A (14) rewards accurate definitions, developed chains that end at the current account, at least two policies, and an accurate diagram that is explained; Table B (6) rewards developed evaluation (Level 2, 4–6) and a justified conclusion. Simple one-line evaluation stays in Level 1 (1–3).
- **"With the help of a diagram":** a relevant, labelled diagram is required for the top level; label the axes (price and quantity of imports, or price level and real output), the curves and the shifts, and refer to the diagram in the text.
- **"Evaluate this statement":** test each part of it ("will reduce the deficit": always? "significant unemployment": how much?).
- **"Most effective" or "better":** compare at least two policies and decide which wins, for which kind of deficit, in the short run and the long run.
- **"Alone":** analyse the named policy, then show what an alternative or a mix adds.
- **Use the four tests in every judgement:** cause of the deficit, size and persistence, state of the economy, and elasticities with the reaction of other countries.

Quick check

1. Classify each policy as expenditure-switching or expenditure-reducing: (a) a quota on imported cement; (b) a rise in the rate of sales tax; (c) a devaluation of a fixed exchange rate; (d) a cut in government spending on new roads.

2. Country R has a current account deficit of \$24 billion, a capital account surplus of \$1 billion and a financial account surplus of \$19 billion. Calculate net errors and omissions.
3. Country S's marginal propensity to import is 0.2. A rise in income tax lowers national income by \$35 billion. Calculate the fall in imports.
4. At a world price of \$200, a country buys 900 solar panels a day and its own firms make 300. A tariff of \$25 a panel raises the home price to \$225; consumers then buy 850 and home firms make 350. The world price does not change. Calculate the fall in daily spending on imported panels and the daily tariff revenue.
5. Explain why higher interest rates may improve a country's financial account but do little for its current account when its exchange rate is floating. **[3]**

Answers

1. (a) Switching. (b) Reducing. (c) Switching. (d) Reducing.
2. $-24 + 1 + 19 = -4$, so net errors and omissions are +\$4 billion.
3. $\Delta M = 0.2 \times 35 = 7$, so imports fall by \$7 billion.
4. Imports fall from $900 - 300 = 600$ to $850 - 350 = 500$ panels. Spending on imports falls from $600 \times \$200 = \$120\,000$ to $500 \times \$200 = \$100\,000$, a fall of **\$20 000** a day. Tariff revenue is $500 \times \$25 = \$12\,500$ a day.
5. Higher interest rates attract deposits and short-term capital from abroad, an inflow on the financial account (1). The extra demand for the currency makes a floating exchange rate appreciate (1). Exports become dearer abroad and imports cheaper at home, so if demand is price elastic export revenue falls and import spending rises, cancelling much of the fall in imports that lower spending at home brings (1).

Past questions to try

- 9708/31/O/N/25 Q29: higher interest rates and both accounts under a fixed exchange rate.
- 9708/32/F/M/22 Q28: total currency flows for two countries.
- 9708/42/F/M/23 Q4: whether expenditure-reducing policies must cause significant unemployment.
- 9708/44/M/J/25 Q4: whether monetary policy alone can fix falling exports.