

Cambridge AS & A Level · Economics 9708 · Notes

Policies to correct imbalances in the current account of the balance of payments

AS

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Last checked 5 October 2026

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What you need to know

By the end of this topic you should be able to:

1. **Explain why a stable current account is a government policy objective:** why governments try to avoid a large or long-lasting deficit, and also a large or long-lasting surplus, on the current account of the balance of payments.
2. **Explain how four kinds of policy affect the current account:** fiscal policy, monetary policy, supply-side policy and protectionist policy. For each, say how it changes spending on imports and revenue from exports, how quickly it works, what it costs, and how it helps or harms the government's other objectives (growth, low unemployment, low inflation, the budget).

Three more ideas in this note are **A Level content**, not AS outcomes: the labels **expenditure-reducing** and **expenditure-switching** (A Level 11.1.3), exchange-rate policy (11.1.2) and the Marshall–Lerner condition (11.2.5). They are covered briefly because AS papers from 2021 to 2024 asked about them. Exchange rates at AS have a topic of their own.

Understand it

Why governments want a stable current account

The current account records trade in goods, trade in services, primary income and secondary income. An **imbalance** is a deficit (more money paid out than received) or a surplus (more received than paid out). "Stability" does not mean a balance of exactly zero every year. It means avoiding an imbalance that is **large** (compared with GDP) and **persistent** (lasting many years).

- **A large, persistent deficit** puts downward pressure on the exchange rate (or drains the reserves that hold a fixed rate), has to be financed by borrowing or by selling assets to foreigners, adds interest and profits paid abroad in future years, and can shake the confidence of lenders and investors. It also means lower aggregate demand, so fewer jobs in industries that export or compete with imports.
- **A large, persistent surplus** can add to inflation near full employment, pushes the exchange rate up, means the country consumes less than it produces, and leaves trading partners with matching deficits, so they may retaliate with protection.

So whether a government acts depends on the **size**, **length**, **cause** and **financing** of the imbalance. A small deficit caused by importing machinery that will raise future output is not a worry; a deficit of 6% of GDP that has lasted ten years because firms have lost competitiveness is.

Three ways to correct a deficit

Every policy works on the current account in one of three ways.

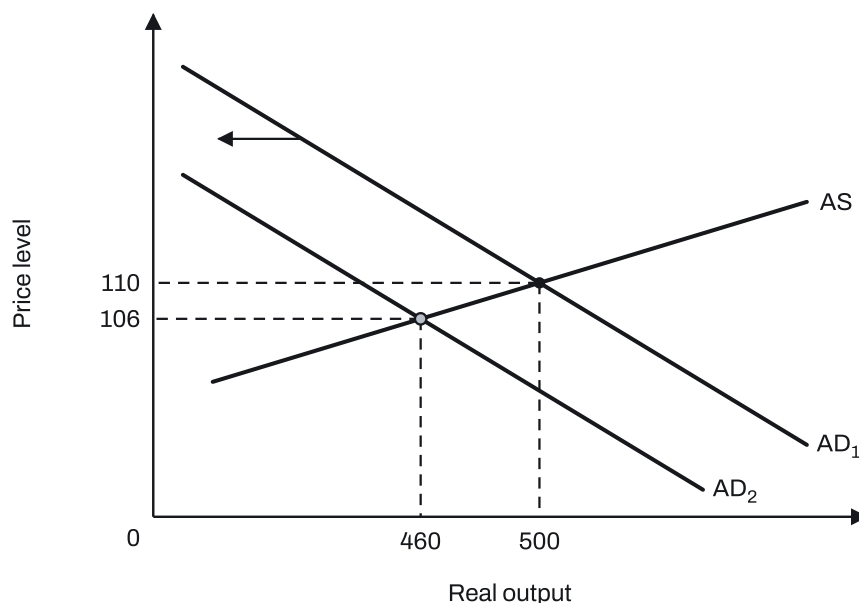
Approach	What it does	Examples
Expenditure-reducing	Cuts total spending (aggregate demand), so people buy fewer of everything , imports included	Higher direct taxes, lower government spending (contractionary fiscal policy); higher interest rates, tighter credit (contractionary monetary policy)
Expenditure-switching	Changes relative prices or availability so buyers switch from foreign goods to home-produced goods	Tariffs, quotas, embargoes, red tape on imports, export subsidies (protectionist policy); a fall in the exchange rate
Supply-side	Raises productivity and quality, so home firms become more competitive over time	Training and education, better transport and communications, grants for investment and research, deregulation

These labels are A Level content (11.1.3), but AS papers from 2021 and 2022 used them, so learn them: examiner reports in 2021 and 2022 say some candidates mixed up "switching" and "reducing", and a question that names one of them gets few marks for writing about the other.

Fiscal policy

Contractionary fiscal policy (higher income tax, lower government spending) is expenditure-reducing.

- **How it helps.** Higher taxes leave households with less disposable income. They spend less on everything, including imported goods and holidays abroad, so **import spending falls**. Lower AD also eases **demand-pull inflation**, so home prices rise more slowly than foreign prices and exports become more price competitive. Firms that can't sell at home may look for buyers abroad.
- **The costs.** Lower AD means lower **output and growth** and higher **unemployment**, usually cyclical unemployment. Only part of each \$1 cut from spending would have gone on imports, so a large fall in AD is needed for a modest fall in imports. The deficit can come back as soon as the policy is reversed.



The diagram shows why expenditure-reducing policy works and why it hurts: the lower real output (500 to 460) means lower incomes and fewer imports, but also fewer jobs.

Expansionary fiscal policy works the other way. A **cut in income tax** raises disposable income, so households buy more imports; exports are not directly affected, so the current account **worsens** (9708/12/O/N/25 Q29). More government spending does the same.

Fiscal policy also pays for other kinds of policy. An **export subsidy** is government spending, so it adds to a **budget deficit**, while tariffs bring in revenue (9708/11/O/N/25 Q30). Grants for training or investment are fiscal tools with supply-side aims.

Monetary policy

Contractionary monetary policy (higher interest rates, less money and credit) is also expenditure-reducing.

- **How it helps.** Borrowing becomes dearer and saving more rewarding, so households spend less on consumer goods, many of which are imported, and firms invest less. Lower AD means **fewer imports** and lower inflation, which makes exports more competitive over time. It is one of the few policies that can cut a deficit **and** lower inflation together (9708/12/O/N/24 Q26).
- **The costs.** Like fiscal policy it slows growth and raises unemployment. It also has a side-effect in the currency market: higher interest rates attract "**hot money**" from abroad, raising demand for the currency. With a **floating exchange rate** the currency **appreciates**, so exports become dearer abroad and imports cheaper at home. If demand for exports is price elastic, export revenue falls and part of the improvement is lost (9708/12/F/M/23 Q30). A higher interest rate puts **upward**, not downward, pressure on the exchange rate.

A **cut in interest rates** has the opposite effects: more spending (more imports), but hot money leaves and the currency tends to depreciate.

The exchange rate and price elasticity

A **depreciation** (or, with a fixed rate, a **devaluation**) is an expenditure-switching change: exports become cheaper for foreign buyers and imports dearer at home. Whether the current account improves depends on **price elasticity of demand**:

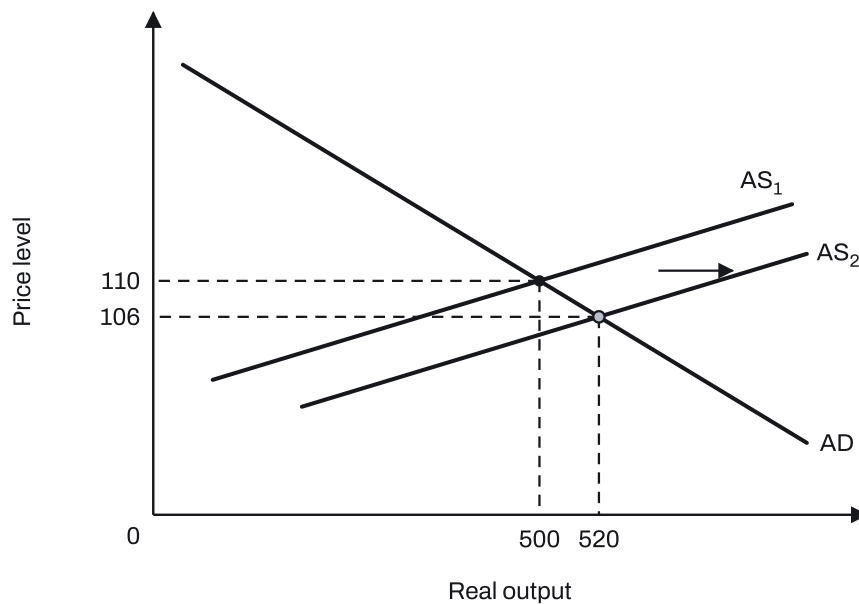
- if foreign demand for exports is **elastic**, the extra quantity sold more than makes up for the lower foreign-currency price, so export revenue rises;
- if home demand for imports is **elastic**, the higher price cuts the quantity bought by a bigger percentage, so import spending falls;
- if both demands are very **inelastic**, a depreciation can make the current account **worse**.

At A Level (11.2.5) this rule has a name, the **Marshall–Lerner condition**: a depreciation improves the current account only if PED for exports plus PED for imports (ignoring the minus signs) is **greater than 1**. Older AS papers ask about it, so learn the one-line version. The improvement also needs foreign markets to be open: if trading partners keep high trade barriers, cheaper exports can't sell more (9708/12/F/M/24 Q25). At AS level, explain the effect with PED; you do not need to name the condition.

Supply-side policy

Supply-side policy works on the **causes** of a deficit that comes from low competitiveness.

- **How it helps.** Training and education raise labour productivity; better roads, ports and broadband cut firms' costs; grants and tax allowances for investment and research bring newer machinery and better products. Lower costs per unit let home firms cut prices, so exports rise and home goods replace imports. Better quality, design and reliability raise **non-price** competitiveness too. A government that subsidises training for factory workers can expect **exports to rise** (9708/11/O/N/24 Q25); grants for new investment are the best long-run answer to a persistent deficit (9708/11/M/J/25 Q28).
- **It fits the other objectives.** Supply-side policy raises productive capacity, so output and jobs can grow **and** inflation stays low while the deficit falls. Trading partners have no reason to retaliate.
- **The costs.** It takes **years** to work (a training course, then the jobs that use the skills; a new port, then the trade it carries), it costs the government money (an **opportunity cost**, and a bigger budget deficit), and the results are uncertain: trained workers may move abroad, and firms may use lower costs to raise profits rather than cut prices.



Compare the two diagrams. Both policies lower the price level from 110 to 106, which helps exports. But the expenditure-reducing policy gets there by **cutting** output (to 460), while the supply-side policy **raises** it (to 520).

Protectionist policy

Protection is expenditure-switching aimed straight at the trade in goods.

- **Tariffs** raise the price of imports at home, so buyers switch to home-made goods. **Quotas** limit the quantity of imports directly; **embargoes** ban them; **red tape** makes importing slow and costly. **Export subsidies** lower the price of exports abroad.
- **Why it appeals.** It works **quickly**, can be aimed at the goods causing the deficit (for example imported consumer goods), raises tariff revenue for the government, and protects jobs in import-competing industries.
- **Why it often fails.**
 - **Price elasticity:** if demand for imports is inelastic (no home substitutes, such as fuel or machinery), a tariff raises the price but hardly cuts the quantity, so import spending falls little.
 - **Retaliation:** trading partners may put tariffs on this country's exports, so export revenue falls too.
 - **Higher costs:** tariffs on imported raw materials and parts raise firms' costs (**cost-push inflation**) and make exports **less** competitive.
 - **Consumers** pay higher prices and have less choice.
 - **Inefficiency:** protected firms face less competition, so they have less reason to cut costs; the deficit returns when protection ends.
 - Members of the World Trade Organization have agreed limits on new protection.

Other components of the current account

Most policies act on trade in goods and services. A deficit on **secondary income** can be cut directly by giving **less overseas aid** (9708/12/M/J/23 Q28). A deficit on **primary income** shrinks only slowly, for example as foreign debt is repaid.

Correcting a surplus

Use the same tools the other way round:

- **expansionary** fiscal policy (lower direct taxes, more government spending) and **expansionary** monetary policy (lower interest rates, more credit): higher AD means more imports (9708/13/M/J/23 Q27);
- **lower tariffs** and fewer quotas, so imports are cheaper and easier to buy;
- letting the currency **appreciate** (or revaluing a fixed rate), so exports cost more abroad and imports less at home.

A surplus policy can conflict with other objectives too: higher AD near full employment means inflation.

Conflicts with other objectives

Most policies that correct the current account harm another objective. Questions often ask which policy fixes the deficit **and** meets (or harms) a second goal.

Policy to cut a deficit	Current account	Growth and jobs	Inflation	Government budget
Higher income tax, less government spending	Improves (fewer imports)	Worse	Lower	Smaller deficit
Higher interest rates	Improves, but appreciation may undo part of it	Worse	Lower	Little direct effect
Tariffs, quotas	Improves quickly, unless there is retaliation	Better in protected industries	Higher (dearer imports)	Tariffs raise revenue
Export subsidies	Improves	Better in export industries	Little direct effect	Bigger deficit
Fall in the exchange rate	Improves if demand is elastic enough	Better (more net exports)	Higher (dearer imports, more AD)	Little direct effect
Supply-side policy	Improves slowly	Better	Lower	Bigger deficit at first

Key facts and formulas

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

Formula	Status
Value of imports = price paid to foreign sellers $\times$ quantity imported (a tariff is paid to the home government, so it is not part of import spending)	Learn it
% change in quantity demanded = PED $\times$ % change in price	Learn it
Tariff revenue = tariff per unit $\times$ quantity imported	Learn it
Current account balance = goods balance + services balance + net primary income + net secondary income	Learn it

The Marshall–Lerner condition (a depreciation improves the current account if PED for exports plus PED for imports, ignoring signs, is greater than 1) is A Level content (11.2.5); older AS papers test it, so it is explained under "Understand it" rather than listed here.

How to do it

We tagged 44 questions for this topic (2021–2025): 32 Paper 1 multiple choice and 12 Paper 2 essay and data-response questions. For Paper 2 we count only the parts about this topic. 1 question has parts of two types, so the counts add up to 45.

Question type	Questions
Assess whether a named policy is the best way to correct a deficit (12-mark essay)	10
How a depreciation affects the current account	8
Choose the policy that would reduce a deficit	6
Choose a policy that fixes the current account and also meets (or harms) another objective	5
Classify a policy: expenditure-switching, expenditure-reducing or protectionist	5
Choose a policy to reduce a surplus	3
Predict a policy's effect on exports, imports or the current account	3
Why a higher interest rate may not improve the balance of payments	3
Explain how one policy corrects an imbalance and judge its success (8 marks or data response)	2

1. Assess whether a named policy is the best way to correct a deficit (10 questions)

Paper 2 Section B (b) parts, 12 marks: 8 for knowledge and analysis (Table A, Levels 1–3), 4 for evaluation (Table B). The named policy so far: protectionism ([9708/23/O/N/24 Q5](#), [9708/22/M/J/23 Q4](#), [9708/21/O/N/22 Q4](#)), protection against contractionary policy ([9708/23/O/N/25 Q5](#)), supply-side policy ([9708/22/O/N/25 Q4](#), [9708/22/F/M/23 Q5](#)), contractionary fiscal policy ([9708/22/F/M/24 Q4](#)), expenditure-switching against expenditure-reducing ([9708/22/M/J/22 Q4](#), [9708/23/M/J/22 Q4](#)) and expenditure-reducing with a floating exchange rate ([9708/21/O/N/21 Q4](#)).

Answer plan

1. **Define (1 short paragraph)**: the current account, what a deficit is, and the policy named, with examples of its tools.
2. **The named policy, for**: two developed chains, each ending at the current account. For example: tariff → dearer imports → buyers switch to home goods → less spent on imports → smaller deficit.
3. **The named policy, against**: two developed limits. For protection: inelastic demand for imports, retaliation, dearer imported inputs. For expenditure-reducing: slower growth and more unemployment, the appreciation from higher interest rates. For supply-side: time lags, cost, uncertain results.
4. **At least one alternative**, analysed the same way (for and against). Without it, "best" is not answered and the answer stays in Level 2.
5. **Evaluate**: compare the policies on **speed** (protection and interest rates act in months, supply-side in years), **cause** of the deficit (a consumer boom calls for expenditure-reducing; lost competitiveness calls for supply-side), **side-effects** on the other objectives, and the **state of the economy** (spare capacity, inflation, exchange rate regime).
6. **Conclude** with a judgement that follows from step 5, often that a mix works best: a quick policy now, supply-side for the long run.

Keep every point tied to the deficit. Mark schemes cap answers that just describe the policies at mid-Level 2, and a one-sided answer gets **no** evaluation marks. If the question names a condition ("with a floating exchange rate", "persistent"), use it: with a floating rate, higher interest rates bring an appreciation that works against the policy.

2. How a depreciation affects the current account (8 questions)

Mostly multiple choice from older papers; one 8-mark (a) part ([9708/22/O/N/25 Q4](#) (a)).

1. A depreciation makes **exports cheaper** abroad and **imports dearer** at home.
2. The current account improves only if demand is **elastic enough**. At AS, explain this with PED. Older AS papers name the A Level rule (11.2.5, the Marshall–Lerner condition): the sum of the PEDs for exports and imports is greater than 1; a sum below 1 means the balance gets worse.
3. It also needs open markets abroad, and the other parts of the current account (primary and secondary income) can still leave it in deficit.

Variations you will meet:

- **State the condition** (9708/11/O/N/22 Q27, 9708/12/O/N/21 Q26): the **sum** of the two PEDs is greater than 1 (not "each is greater than 1", and not elasticities of supply).
- **Which pair of elasticities makes a devaluation worsen the balance** (9708/12/M/J/22 Q24): add each pair; the one with a sum below 1 (the smallest sum) is the answer.
- **Why a depreciation might not work** (9708/12/F/M/24 Q25, 9708/13/M/J/21 Q25): high trade barriers abroad, or a sum of PEDs below 1.
- **A policy mix** (9708/13/M/J/24 Q24): with elastic export demand, let the currency depreciate and **raise** income tax; keep interest rates unchanged. Cutting taxes or interest rates at the same time would raise spending on imports and undo part of the gain.
- **A central bank buying its own currency to improve the balance** (9708/11/M/J/23 Q30): this pushes the exchange rate **up**, which only raises export revenue if export demand is price **inelastic**.
- **8-mark version**: explain the chain for both exports and imports (AO2), then use PED and the **other components** of the current account (the 2025 mark scheme capped analysis at 2 without them), then conclude on "always".

3. Choose the policy that would reduce a deficit (6 questions)

All multiple choice. Cross out options that move the balance the wrong way: lower income tax, lower tariffs, more government spending, an appreciation. What is left usually is a **higher tariff** (9708/12/M/J/25 Q29), **higher interest rates** (9708/12/M/J/24 Q24), a **depreciation** (9708/13/M/J/23 Q19) or an **export subsidy** (9708/12/F/M/21 Q23).

- **"In the long run"** (9708/11/M/J/25 Q28) points to a supply-side measure, such as grants for new investment.
- **One part of the current account** (9708/12/M/J/23 Q28): to cut a secondary income deficit, give less overseas aid. Tariffs and export subsidies act on trade in goods, not secondary income.

4. A policy that also meets (or harms) another objective (5 questions)

All multiple choice. Use the conflicts table in "Understand it".

- **Deficit and inflation together** (9708/11/M/J/22 Q30, 9708/12/O/N/24 Q26): higher interest rates (or other expenditure-reducing policy) cut imports and inflation. A devaluation or tariffs would raise prices.
- **Deficit and unemployment together** (9708/12/F/M/24 Q21): a depreciation raises net exports, which raises AD and jobs. Expenditure-reducing policies would raise unemployment.
- **Keeps unemployment low but causes inflation** (9708/12/M/J/22 Q30): a depreciation (dearer imports and more AD near full employment).
- **Adds to a budget deficit** (9708/11/O/N/25 Q30): export subsidies are government spending. Tariffs raise revenue; quotas and a depreciation cost the budget nothing directly.

5. Classify a policy (5 questions)

All multiple choice.

- **Expenditure-reducing**: higher direct taxes ([9708/13/M/J/22 Q28](#), [9708/12/M/J/21 Q29](#)), lower government spending, higher interest rates. Another name is **deflationary** policy.
- **Expenditure-switching**: a lower exchange rate ([9708/12/F/M/22 Q28](#)), tariffs, quotas, subsidies to home firms that compete with imports ([9708/12/O/N/22 Q28](#)). **Increasing** import quotas lets **more** imports in, so it switches spending the wrong way.
- **Protectionist**: tariffs, quotas, embargoes, export subsidies, red tape ([9708/14/M/J/25 Q30](#)). Interest rates, income tax and the exchange rate are **not** protection.

6. Choose a policy to reduce a surplus (3 questions)

All multiple choice. Reverse the deficit rules: lower direct taxes ([9708/13/M/J/23 Q27](#)), lower tariffs plus expansionary monetary policy ([9708/12/M/J/23 Q23](#)), an appreciation together with lower interest rates ([9708/14/M/J/22 Q28](#)). A devaluation or higher tariffs would make the surplus bigger.

7. Predict a policy's effect on exports, imports or the current account (3 questions)

All multiple choice. Trace each policy to exports and imports separately.

- A **cut in income tax**: imports rise, exports unchanged ([9708/12/O/N/25 Q29](#)).
- **Subsidised training** for workers in industry: productivity and competitiveness rise, so **exports rise** ([9708/11/O/N/24 Q25](#)).
- A **subsidy on machinery** for export firms: more exports, so a smaller **current** account deficit; the capital account is not involved ([9708/12/M/J/21 Q21](#)).

8. Why a higher interest rate may not improve the balance of payments (3 questions)

All multiple choice.

- Higher interest rates attract hot money and put **upward** pressure on the exchange rate. "It will put downward pressure on the exchange rate" is the **invalid** reason ([9708/11/O/N/22 Q29](#)).
- The appreciation makes exports dearer, so **price-elastic demand for exports** weakens the policy ([9708/12/F/M/23 Q30](#)).
- Higher rates fail to attract capital if investors expect the currency to **lose value**, because the loss on the currency can be bigger than the extra interest ([9708/11/M/J/22 Q27](#)).

9. Explain how one policy corrects an imbalance and judge its success (2 questions)

An 8-mark (a) part ([9708/23/O/N/23 Q5](#) (a)) or a 4-mark data-response part ([9708/22/O/N/24 Q1](#) (b)).

1. **Knowledge**: define the policy (for example a tariff: a tax on imported goods), the current account, and an imbalance.
2. **Analysis**: the chain, one link per mark: tariff → higher import prices → less bought from abroad → lower import spending → smaller deficit.

3. **Evaluation:** one or two limits (inelastic import demand, retaliation, other policies may work better), then a justified conclusion.

In the 4-mark data version: name the policy (1), explain how it cuts imports (2), one evaluative point such as inelastic demand for the imported goods (1).

Worked examples

Example 1

A government wants to reduce a deficit on its current account by switching spending from imports to home-produced goods, and at the same time raise extra tax revenue. Which policy does both?

A a rise in the rate of income tax

B a tariff on imported cars

C a subsidy to firms that export

D a cut in the rate of interest

[1]

A cuts all spending (expenditure-reducing), not switching. C switches spending but costs the government money. D raises spending on imports. A tariff makes imported cars dearer, so buyers switch to home-made cars, and the government collects the tariff. The answer is **B** (1).

Example 2

A country makes no electric bikes of its own. It imports 40 000 a year at a world price of \$500 each. The government puts a tariff of \$100 on each imported bike, and the price in the shops rises by the full \$100. The world price does not change.

(a) Price elasticity of demand for electric bikes is -0.4 . Calculate the change in the value of electric bike imports recorded in the current account, and the tariff revenue. [3]

(b) Explain what would happen if price elasticity of demand were -1.5 instead, and what this suggests about the use of tariffs to reduce a deficit. [3]

(a) The price rises by $\frac{100}{500} \times 100 = 20\%$. Quantity falls by $0.4 \times 20 = 8\%$, from 40 000 to 36 800 (1).

Import spending is the price paid to foreign sellers: before, $40\,000 \times \$500 = \20 million; after, $36\,800 \times \$500 = \18.4 million. Imports fall by **\$1.6 million** (1).

Tariff revenue = $36\,800 \times \$100 = \3.68 million (1).

(b) Quantity would fall by $1.5 \times 20 = 30\%$, to 28 000, so import spending falls to $28\,000 \times \$500 = \14 million, a fall of **\$6 million** (1). A tariff cuts import spending by much more when demand for the imported good is price elastic, because buyers switch away (1). So tariffs work best on imports that have close substitutes; on goods with inelastic demand, such as fuel or machinery the country can't make, they raise prices and revenue but do little to the deficit (1).

Example 3

Explain how an export subsidy might reduce a deficit on the current account of the balance of payments and consider whether it is a sensible policy for a government that already has a large budget deficit. [8]

A deficit on the current account means the value of money paid abroad for imports, income and transfers is greater than the value received from exports, income and transfers **(1, AO1)**. An export subsidy is a payment from the government to firms for each unit they sell abroad **(1, AO1)**; it is a form of protection and an expenditure-switching policy **(1, AO1)**.

The subsidy lowers the exporters' costs, so they can cut the prices they charge foreign buyers **(1, AO2)**. If foreign demand is price elastic, the quantity sold rises by a bigger percentage than the price falls, so export revenue rises and the deficit shrinks **(1, AO2)**. On the other hand, the subsidy is government spending, so it makes the budget deficit bigger and the government must borrow more, adding to national debt and future interest payments; and trading partners may treat it as unfair competition and put duties on the subsidised goods, which cancels the gain **(1, AO2)**.

Whether it is sensible depends on how elastic foreign demand is and how big the subsidy must be: a small subsidy that wins a large increase in export sales may pay for itself through extra tax on the higher profits and incomes, while a large subsidy on goods with inelastic demand only adds to the budget deficit **(1, AO3)**. With a budget deficit that is already large, a tariff (which raises revenue) or a supply-side policy aimed at costs is likely to be a better choice, so an export subsidy is sensible only if it is small, short-lived and aimed at goods with elastic demand **(1, AO3, justified conclusion)**.

(Knowledge 3, analysis 3, evaluation 2: **8/8**.)

Example 4

Country V has a current account deficit equal to 6% of its GDP. Over the last five years wages in V's factories have risen faster than productivity. Unemployment is 9% and inflation is 1%. Assess whether raising income tax or spending more on training and transport links would be the better way for V's government to reduce the deficit. [12]

Model answer (outline of each paragraph):

- 1. Terms.** The current account records trade in goods and services, primary and secondary income; V pays out more than it receives, and at 6% of GDP the deficit is large. A higher income tax is contractionary fiscal policy (expenditure-reducing); training and transport spending is supply-side policy. (*Accurate knowledge, part of Table A.*)

2. **Income tax: for.** Higher income tax cuts disposable income, so households spend less, including on imports; in diagram 1, AD shifts left from AD_1 to AD_2 and real output falls from 500 to 460, and lower incomes mean fewer imports. It works within months and also cuts the government's budget deficit. *(Developed chain to the current account.)*
3. **Income tax: against.** The same fall in output means fewer jobs, and V already has 9% unemployment; with inflation at only 1%, there is little inflation to squeeze, so the gain in price competitiveness is small. It does nothing about the real cause, wages rising faster than productivity, so the deficit returns once the tax is cut again. *(The other side of the named policy, explained.)*
4. **Training and transport: for.** Better-trained workers produce more per hour, and better roads and ports cut transport costs, so unit costs fall; in diagram 2, AS shifts right from AS_1 to AS_2 , output rises from 500 to 520 and the price level falls from 110 to 106. V's goods become cheaper relative to foreign goods, so exports rise and home goods replace imports. Output and jobs rise at the same time, which suits an economy with 9% unemployment. *(Developed chain to the current account.)*
5. **Training and transport: against.** Training and building take years to raise productivity, so the deficit stays large in the meantime and must be financed by borrowing from abroad. The spending adds to the budget deficit and has an opportunity cost, and firms may keep the lower costs as profit instead of cutting prices. *(Both policies analysed for and against: Table A Level 3, here 8/8.)*
6. **Evaluation.** The choice depends on the cause, the state of the economy and the time available. V's deficit comes from lost competitiveness, not from a spending boom, which favours supply-side policy; V's high unemployment and low inflation make an expenditure-reducing policy costly, since it would deepen unemployment while barely helping prices. But if lenders stop financing a deficit of 6% of GDP, V needs something that works within months, and only the tax rise does. *(Weighs the conditions: Table B top level.)*
7. **Conclusion.** Spending on training and transport is the better policy for V, because it treats the cause of the deficit and lowers unemployment instead of raising it. A tax rise is worth using only as a short, temporary measure if the deficit cannot be financed while the supply-side policy takes effect. *(Justified conclusion: Table B top level, 4/4.)*

(Table A Level 3: 8; Table B: 4; **12/12.**)

Common mistakes

- **Writing about the policies, not the deficit.** Examiner reports from 2021 to 2023 say many answers describe how tariffs, taxes or training work but never explain how much they reduce a current account deficit. End every chain at "... so import spending falls / export revenue rises, and the deficit shrinks".
- **Mixing up expenditure-switching and expenditure-reducing.** Switching changes relative prices (tariffs, quotas, a lower exchange rate); reducing cuts total spending (higher taxes, higher interest rates). Some candidates wrote about the wrong one and scored almost nothing.
- **Ignoring the policy the question names.** A question on supply-side policy needs most of the answer about supply-side policy; alternatives are for comparison. Writing mostly about alternatives gives an unbalanced answer.
- **Ignoring a condition in the question.** "With a floating exchange rate" wants the appreciation that follows higher interest rates; "persistent" wants structural causes and long-run policies.

- **Asserting elasticity.** "It depends on Marshall–Lerner" earns little on its own. Say what happens to export revenue and import spending when demand is elastic or inelastic.
- **Getting the interest-rate effect on the currency backwards.** Higher interest rates bring hot money in, so the currency **appreciates**, which works against the current account.
- **Forgetting a policy's other effects.** Lower taxes or interest rates raise spending on imports; export subsidies add to a budget deficit; tariffs on imported inputs raise exporters' costs.
- **Summaries instead of evaluation.** Repeating the analysis in a final paragraph is not evaluation. Compare the policies on speed, cause, side-effects and the state of the economy, then decide.
- **One-sided answers.** A 12-mark answer with no "however" gets no evaluation marks and stays in Level 2.

How to get the marks

- **Multiple choice:** for each option, ask "does it raise or lower spending on imports, and raise or lower export revenue?" Then check the extra condition (inflation, unemployment, budget, "long run", "surplus").
- **"Explain":** a chain with at least two links from the policy to the current account: policy → prices or incomes → quantities bought → import spending or export revenue → the balance.
- **"Consider"** in an 8-mark (a) part: point-marked, up to 3 knowledge (define the policy, the current account, the imbalance), 3 analysis (the chain, and a limit), 2 evaluation (one reasoned judgement, one justified conclusion).
- **"Assess" or "discuss" in a 12-mark (b) part:** level-marked, 8 for knowledge and analysis and 4 for evaluation. Level 3 needs the named policy for and against **and** an alternative, all tied to the current account. A one-sided answer gets no evaluation marks.
- **"Best" or "most effective":** compare at least two policies and say which wins, and under what conditions.
- **Data response (4 marks):** one named policy (1), how it changes imports or exports (2), one reason it may not work, such as inelastic demand (1).
- **Use evidence from the question:** unemployment, inflation, the size of the deficit and its cause decide which policy is best, so use any figures given.

Quick check

1. Classify each policy as expenditure-reducing, expenditure-switching or supply-side: (a) a rise in the central bank's interest rate; (b) a quota on imported steel; (c) grants for firms that buy new machinery; (d) a cut in government spending on public sector pay.
2. A country imports 45 000 televisions a year at a world price of \$360. It sets a quota of 30 000 a year, and the world price does not change. Calculate the fall in the value of television imports.
3. A country's price elasticity of demand for exports is -0.7 . Using the Marshall–Lerner condition, what must be true of its price elasticity of demand for imports for a depreciation to improve its current account?
4. Explain why higher interest rates may not reduce a current account deficit in an economy with a floating exchange rate. [3]

5. A country has a large current account surplus and 7% unemployment. Suggest one policy that would reduce the surplus and unemployment together, and explain how. **[2]**

Answers

1. (a) Expenditure-reducing (contractionary monetary policy). (b) Expenditure-switching (protection). (c) Supply-side. (d) Expenditure-reducing (contractionary fiscal policy).
2. Before: $45\,000 \times \$360 = \16.2 million. After: $30\,000 \times \$360 = \10.8 million. Imports fall by \$5.4 million.
3. The two elasticities must add to more than 1 (ignoring signs), so PED for imports must be greater than 0.3 in size.
4. Higher interest rates attract hot money from abroad, raising demand for the currency (1), so with a floating exchange rate the currency appreciates (1). Exports become dearer abroad and imports cheaper at home, so if demand is price elastic export revenue falls and import spending rises, offsetting the fall in imports from lower spending (1).
5. Expansionary fiscal policy, such as a cut in income tax or more government spending (1): higher AD raises output and jobs, and households with more income buy more imports, so the surplus shrinks (1).

Past questions to try

- **9708/12/M/J/22 Q24**: which pair of elasticities makes a devaluation worsen the balance.
- **9708/11/M/J/22 Q30**: one policy to cut both a deficit and inflation.
- **9708/23/O/N/23 Q5**: (a) how tariffs correct an imbalance, and whether they are the best way.
- **9708/23/O/N/24 Q5**: (b) whether protectionism is always the best way to reduce a deficit.