

Exercise walk-through

Policies to correct disequilibrium in the balance of payments ■ 11.1

eXercise

You must be able to

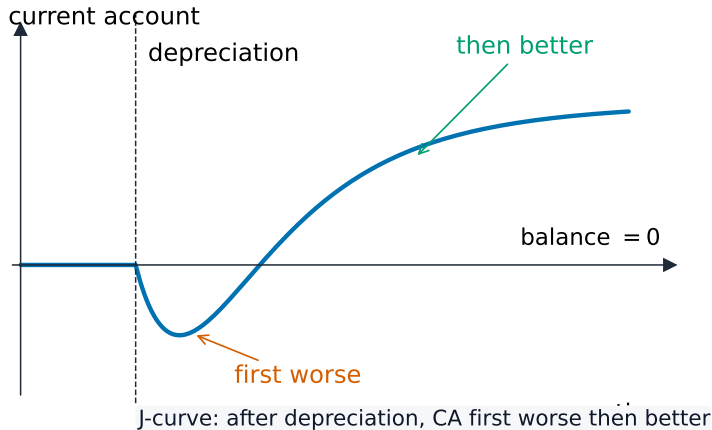
- describe expenditure-reducing and expenditure-switching policies
- state the Marshall–Lerner condition
- explain the J-curve effect

Method — Why a depreciation takes time to work

- **Expenditure-reducing** 支出减少: higher taxes/interest rates cut imports — but slow growth.
- **Expenditure-switching** 支出转换: a lower exchange rate (**depreciation** 贬值 / **devaluation** 法定贬值) makes exports cheaper, imports dearer.
- **Marshall–Lerner**: a lower rate helps only if $PED_{\text{exports}} + PED_{\text{imports}} > 1$.
- **J-curve**: the current account first **worsens**, then improves as volumes adjust.

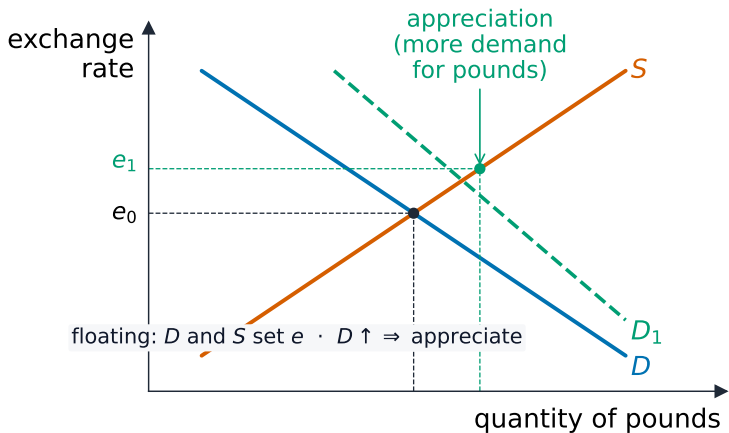
Answer shapes: AO1 + AO2 + AO3 (analysis) + AO4 (a supported judgement *in context*).

Method — Why a depreciation takes time to work



After a depreciation the current account first worsens, then improves — a J shape

Method — Why a depreciation takes time to work



A floating exchange rate is set where demand for the currency meets supply

Practice 2.1 ■ 2 marks

Define the term *expenditure-switching policy*.

Solution 2.1

Method: Why a depreciation takes time to work

Worked steps

a policy that switches spending from imports to domestically produced goods, mainly by lowering the exchange rate (2 for a clear definition; 1 for a partial idea).

Practice 2.2 ■ 2 marks

State the Marshall–Lerner condition.

Solution 2.2

Method: Why a depreciation takes time to work

Worked steps

that the sum of the price elasticities of demand for exports and imports must be greater than one ($PED_X + PED_M > 1$) (2 for the condition; 1 for a partial idea).

Practice 2.3 ■ 1 mark

State what the J-curve shows happens just after a depreciation.

Solution 2.3

Method: Why a depreciation takes time to work

Worked steps

the current account first gets worse (1).

Exam-style 3.1 ■ 1 mark

A depreciation will improve the current account only if:

- A** the sum of the price elasticities of demand for exports and imports is less than 1
- B** the sum of the price elasticities of demand for exports and imports is greater than 1
- C** demand for both is perfectly inelastic
- D** the exchange rate is fixed

Solution 3.1

Method: Why a depreciation takes time to work

- A the sum of the price elasticities of demand for exports and imports is less than 1
- B the sum of the price elasticities of demand for exports and imports is greater than 1** 
- C demand for both is perfectly inelastic
- D the exchange rate is fixed

Worked steps

- B.** The Marshall–Lerner condition requires the elasticities to sum to more than 1.

Exam-style 3.2 ■ 6 marks

Explain the J-curve effect of a depreciation on the current account.

Solution 3.2

Method: Why a depreciation takes time to work

Worked steps

[6] AO1 1 + AO3 up to 5 — straight after a depreciation, import prices rise at once but trade volumes are slow to change (contracts, habits) → so the import bill rises and the current account first **worsens**; over time buyers switch to cheaper exports and away from dearer imports → volumes adjust → the current account improves, tracing a J.

Exam-style 3.3 ■ 12 marks

Discuss whether a depreciation of the currency is the best way to correct a current account deficit.

Solution 3.3

Method: Why a depreciation takes time to work

Worked steps

[12] AO1/AO2/AO3 up to 8 + AO4 up to 4. **For:** a depreciation makes exports cheaper and imports dearer, improving the current account if Marshall–Lerner holds. **Against:** the J-curve means a short-run worsening, it can cause cost-push inflation (dearer imports), and it may invite retaliation. **Alternatives:** expenditure-reducing or supply-side policies. Judgement: a depreciation can work where demand is elastic, but only after a lag and at the cost of inflation — the best choice depends on elasticities and the cause of the deficit.