CIE Economics AS-level

Topic 5: Government Macro Intervention

b) Policies to correct balance of payments disequilibrium

Notes

- **The effectiveness of fiscal policy, monetary policy and supply-side policies to correct a balance of payments disequilibrium**

- **Fiscal policy:**

- If there is a deficit on the current account, income tax could be increased. This will reduce the amount of disposable income consumers have, which will reduce the quantity of imports. However, it might also impact domestic growth, since consumers will also spend less on domestic goods.
- Governments could also reduce their spending. This would reduce AD and lead to less imports. It forces domestic firms into increasing exports, which helps improve the disequilibrium.
- Fiscal policy is effective in the short term, but not so much in the long term. As soon as the policy measures end, household are likely to revert their expenditure back on imports.
- If taxes are imposed on trading partners, there is the risk of retaliation, which could reduce demand for exports, too.
- Governments might have imperfect information about the economy, so it could lead to government failure.
- If 'green taxes' are implemented, such as carbon taxes, or if there are minimum prices on pollution permits, the competitiveness of domestic firms could be compromised. This could reduce exports from domestic firms.

- **Monetary policy:**

- **Expenditure-reducing and expenditure-switching**

- Expenditure-reducing policies aim to reduce demand in the economy, so spending on imports fall.
- Expenditure-switching policies aim to switch consumer spending towards domestic goods, and away from imports.

- Reducing the growth of the supply of money in an economy can be expenditure-reducing or expenditure-switching.
- If there is a current account deficit, the bank might lower interest rates to cause depreciation in the currency. This causes exports to become cheaper, but it could be inflationary for the domestic economy. Moreover, hot money might flow out of the country, since investors are not receiving a high return on their investment.
- High interest rates could be expenditure-reducing, since the demand for imports falls and inflation might fall.
- Changing the exchange rate could be a government expenditure-switching policy.

- However, it is hard to control the supply of money in reality. Moreover, there is a significant time lag with changing the interest rate and seeing an effect.

- **Supply-side policies:**

- Supply-side policies could help increase productivity with increased spending on education and training, which could result in the country becoming more internationally competitive. This could lead to a rise in exports. However, this incurs a significant time lag, so it is not effective as an immediate measure. In the long term, this can be an effective policy.
- Supply-side policies could also help make the domestic economy attractive to investors.
- The domestic economy could be made more competitive through deregulation and privatisation, which will force firms to lower their average costs. However, privatisation could result in monopolies being formed, which will not increase efficiency.
- If governments provide subsidies to some industries to encourage production, there could be retaliation from foreign countries that see this as an unfair protectionist policy.