

Edexcel (A) Economics A-level

A-level Paper 2: National and Global Economy

Example answers

Evaluate possible government action to reduce a current
account deficit.



A current account deficit is where the value of exports is lower than the value of imports and is caused by two main factors: supply side issues and excess AD. Therefore, the government can attempt to solve it through fixing these two issues, as well as through expenditure switching policies.

Firstly, the government can attempt to reduce demand. As income rises, imports rise but exports stay constant and so the balance of payments falls. The government can decrease AD to decrease the demand for imports. There are two main ways they can do this. Firstly, they can use fiscal policy. They could decrease government spending and therefore AD would fall from AD₁ to AD₂, causing national income to fall. The problem with this is that it may reduce investment from the government and so have negative impacts on the supply-side as there is less improvements in productivity. On top of this, they could raise taxes, which would decrease disposable income and therefore decrease consumption, so decrease AD. Moreover, they could use monetary policy through a rise of interest rates which would lower AD through a series of transmission mechanisms. It would increase the cost of borrowing for both businesses and consumers, and so therefore would reduce borrowing from consumers as it may be less affordable and from businesses as it means the rate of return on investment must be higher to make it worthwhile. The reduction in investment and consumption will reduce AD. Another mechanism is the fact that it causes a rise in pound as people will want to save their money in British banks as they can earn higher interest and so will demand pounds. This causes a fall in AD since it makes imports cheaper and exports dearer. However, this will worsen the balance of payments if imports and exports are assumed to be elastic (Marshall Lerner condition) and so may cancel out other affects. The reduction in demand is good to solve the problem since the UK has a high income elasticity of demand for imports. However, it causes problems since it also leads to unemployment and lower growth, causing a trade off in policies.

On top of this, they could use supply side measures. One important way would be to improve productivity. This could be done through increased investment in machinery which would ensure the country has the most up to date technology available. Similarly, increased training will make workers more skilled and better at their jobs so improve productivity. Increased productivity will lower costs and therefore make UK goods more competitive in the international market. One issue with this is that increased investment is likely to increase AD and therefore increase imports, worsening the deficit in the short run. Moreover, the government could improve the supply side by ensuring the UK focuses on areas where it has genuine comparative advantage. This will mean letting some industries die out and helping others to flourish. As a result, the UK will only be producing what it does best and so will ensure resources are used most efficiently, helping them to be more competitive. This is likely to be very politically unpopular and may cause unemployment in the short term. Supply side policies are most important in the UK as the main cause is a lack of productivity and competitiveness. Although the issue will take a long time to solve, it will be more beneficial in the long term since it will help the UK to achieve export led growth.

Additionally the government could use tariffs and quotas to reduce the attractiveness of imports. This will reduce the number of imports and therefore reduce the value and improve the deficit. However, it is also likely to cause other countries to implement trade barriers and protectionist measures, creating a trade war. This will lead to a fall in exports and so therefore may have no or a negative effect on the deficit.



Overall, the best way for the government to solve the deficit is through using supply side measures. The use of demand management is good in the short run but it is unsustainable for a government to continue restricting demand in their own economy in order to fix a current account deficit. Although it will take some time, fixing the supply issues will help to allow the economy to grow whilst solving the deficit. Demand management will only fix the problem for a while, whilst fixing productivity etc. will help the balance of payments in the long term. Protectionist measures are unlikely to be beneficial and reduce welfare.

Teacher's comments: 22/25

Very good effort. You succeed in covering a lot in the time you had. Possibly if the time allowed you could do with increased evaluation.

