**Economics 12 – Test – The Balance of Payments and Exchange Rates** Name:

1. Read the extract below and answer the questions that follow:

**Canadian current-account deficit widens**

By John Morrissy, Financial Post November 29, 2010

OTTAWA — The soaring Canadian dollar and weak U.S. demand for Canadian exports pushed the country’s balance of payments with the rest of the world to a deficit of $17.5 billion in the third quarter, its worst level ever, according to data released Monday by Statistics Canada.

The release of **the current account** information — the broadest measure of trade — knocked 31 basis points off the Canadian dollar in early trading and reaffirmed analysts’ belief that growth in Canada’s economy, to be reported Tuesday, will be weak.

“The deterioration in the current account balance reflects the divergence between domestic momentum and subdued foreign demand,” said TD Securities economist David Tulk.

The balance of payments data measures the difference between payments sent abroad and receipts from outside Canada. The federal agency’s report showed that balance running at a deficit — the eighth consecutive shortfall since the fourth quarter of 2008 — that grew by $4.6 billion as imports rose and exports fell.

In fact, Denis Caron, the chief of the current account division at Statistics Canada, said deficits run over the last six quarters were all at record levels. Prior to the recession, which had a big negative impact on the U.S., the country had posted more than nine years of surpluses.

As a result, the current account gap now totals about 4.3 per cent of the country’s total economic output, decidedly above the 3.5 per cent of GDP currently projected for the U.S., according to BMO Capital Markets deputy chief economist Douglas Porter, who remarked in a research note that the figure is also higher than the four-per-cent gap cited by U.S. Treasury Secretary Timothy Geithner as a sign of a dangerous trade imbalance.

“Canada suddenly finds its broadest **trade deficit** in the company of countries that have typically been cited as extravagant over-spenders/under-savers. While this may prove to be a passing phase, it is an early warning that the country may be living beyond its means,” Porter said.

Merchandise trade was the biggest contributor to the current-account deficit, Statistics Canada figures show. The overall deficit on international trade in goods soared by $4.3 billion to $6.5 billion as exports to Canada’s biggest market, the U.S., fell.

Conversely, imports rose as the strong Canadian dollar encouraged businesses to invest in imported machinery, which may help boost the country’s lagging productivity, economists said.

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1. Define the following terms found in bold in the text:
   * 1. The current account (2)
     2. Trade deficit (2)
2. In a clear and step-by-step way, explain how the economic recession which has ravaged the United States has led to Canada moving from a position of current account surpluses to record current account deficits. Keep in mind that the U.S. is Canada’s major trading partner. What would you expect to be the impact of these events on the value of the Canadian dollar? Explain. (4)
3. With the aid of a diagram, explain how the fall in the value of the US dollar compared to the Canadian dollar over the past few years has led to Canada moving from current account surplus to a current account deficit. (4)
4. Using information from the text and your knowledge of economics, evaluate this change in the current account balance, looking at both the short-term and long-term implications. (8)
5. Answer **one** of the following short-answer questions (HL only):
   1. Explain why an improvement in a country’s terms of trade may or may not result in an improvement in that country’s balance of payments.
   2. Explain why some countries in the Euro-zone such as Greece or Ireland may want to have their own currencies (drachma, punt) back again in the wake of their current economic troubles.