A. Contractionary monetary policy: The increasing of interest rates by the central bank (Bank of Indonesia for our country). When interest rates are increased, firms and individuals are discouraged to borrow as they have to repay a greater amount of money. As consumers have lower disposable income, they will not have as much money to buy goods and services. Hence, spending and investments will decrease. As spending decreases, spending on imports will decrease as well. Spending on imports can also be further reduced by protectionism. This lowers aggregate demand and is especially useful if a country is experiencing demand-pull inflation.

B. Contractionary fiscal policy: Increase in income tax. Again, with more taxes on income, consumers will have lower disposable income. They will have less money to spend on goods and services. A part of this decrease in spending and investment includes a decrease in import spending. Increase in indirect taxes (sales tax) also contributes to decreasing spending. Another contraction includes a decreased government expenditure. This will reduce AD.

- Why does a reduction in AD improves the current account? A reduction in AD means a fall in inflation rates. (Use demand-pull inflation logic) A fall in inflation rates means that prices of exports decrease and exports (domestic goods) become more price competitive than imports. **Assuming PEDx and PEDm is elastic** this will increase the demand of exports and reduce the demand for imports. There will be an improvement of total trade in the current account. Current account surplus will offset the BOP deficit.

2. Expenditure Switching Policies

- Devaluation: a reduction in the value or exchange rate of a national currency with respect to other foreign currencies
- This works if a country is NOT operating under a free-floating exchange rate
- A devaluation in a country's currency will make its exports cheaper (more price competitive)
- Assuming PEDx and PEDm is elastic, demand for exports will increase and demand for imports will fall.
- Total trade in goods and services in the current account will improve and this will offset or decrease the current account deficit.
- Other ways to switch expenditure from imports to exports are on pages 108-109 of the textbook. (Protectionism)