# Current Account and Exchange Rates

# Assessment Objectives

| Specific Expectations | |
|---|---|
| AO2 | Explain the relationship between the exchange rate and the current account |
| AO4 | Draw a diagram showing the relationship between the current account balance and the exchange rate |
| AO2 | Explain the relationship between the exchange rate and the financial account |

# Current Account and Exchange Rates

- Under a floating exchange rates, when there is a deficit in the current account, market forces create a downward pressure on the currency exchange rate.
- When there is a surplus in the current account, market forces create upward pressure on the currency exchange rate.
- As a result, exchange rate changes automatically eliminate current account deficits and surplus, and create a balance in the balance of payments.
- In a fixed exchange rate system, the balance of payments are made to keep the exchange rate fixed.

# Advantages of Fixed Exchange Rates

- Some of the advantages of fixed exchange rates include:

  1. **Stability**
     - Businesses and investors prefer certainty and stability in prices.
     - They do not have to take into account possible changes in exchange rate when calculating costs and sales
     - This simplifies business plans and reduces the costs for MNCs
  2. **Inflation**
     - Changes in import prices will not occur due to exchange rate fluctuations, therefore they cannot threaten internal inflation.
     - Exports are vulnerable to domestic inflation, which could raise export prices and reduce the demand for those exports.
     - The government is compelled to manage inflation to keep export prices competitive.

# Advantages of Fixed Exchange Rates

3. **Speculation**
   - There is no place for speculation to de-stabilize the exchange rate because the exchange rate is fixed.
   - Free-floating exchange rates are at the mercy of the market, where speculators can heavily influence the buying and selling of currency.
4. **Increased Trade**
   - Businesses are more willing to trade due to increased certainty of a fixed exchange rate.

# Disadvantages of Fixed Exchange Rates

- There are significant disadvantages of fixed exchange rates:
  1. **Domestic policy dictated by world economy**
     - A fixed-rate system is managed largely by manipulation of interest rates. The ability to use those interest rates for domestic policy is significantly restricted.
     - Inflation is dictated by world inflation rates since domestic monetary policy is neutralized.
     - If the exchange rate is kept too low, it is possible that continued buying of high-priced imports would cause imported inflation.
     - When the currency is fixed too high, it can cause a trade deficit because exports are priced uncompetitively.
  2. **Limited options with external shocks**
     - Fixed exchange rate can limit the range of options available to respond to crisis.
     - Supply side shocks become a major issue and balances of payment disequilibrium requires government intervention.

# Disadvantages of Fixed Exchange Rates

3. **Reserves**
   - To operate a fixed exchange rate system large stocks of gold and foreign reserves have to be held to be able to intervene in the market to support the currency.
   - These resources are used to protect against speculators and instill confidence that the government can properly defend the currency.
   - These reserves could be better used to buy and sell needed resources
4. **Difficulty setting the rate**
   - The ultimate fixed rate is a complex decision, and includes a number of unknown factors.
   - A high rate can hurt exporters and domestic industry, while a low rate may help exports but cause imported inflation.
5. **Vulnerability to charges of unfair competition**
   - Sustaining an undervalued currency that increases exports, may encounter resentment from competitor nations. This can result in poor trade relations, trade sanctions or protectionist policies being levied against them.

# Advantages of Floating Exchange Rates

- There are several key advantages of a floating exchange rate system:

  1. **Domestic policy freedom**
     - Government is free to manipulate monetary policy, specifically interest rates, to manage the balance between domestic growth rates and inflation
  2. **Auto-correction**
     - The balance of payments is self-correcting, it requires no government intervention.
  3. **No surplus currency reserves**
     - There is no central bank intervention, and therefore no foreign reserves are required.
     - Financial resources are allocated more efficiently.
     - Foreign exchange can be used for productive ends, such as purchasing capital goods or imported resources.

# Advantages of Floating Exchange Rates

4. **Flexible responses to external shocks**
   - Sudden disruption to the economy can be managed without the need to devote resources to fixing the exchange rate.

# Disadvantages of Floating Exchange Rates

- Although flexible exchange rates automatically work to eliminate payment imbalances, they may cause several significant problems including:

  1. **Increase uncertainty**
     - The risks and uncertainties associated with flexible exchange rates may discourage the flow of trade.
     - Businesses prefer to know the exchange rate when they make trading decisions.
  2. **Influence of random events**
     - Not all external shock can be resolved by exchange rate self-adjustment.
     - Severe international political tension, domestic turmoil, and other random events can depress markets.

# Disadvantages of Floating Exchange Rates

3. **Risk of imported inflation**
   - Countries that have constant need of foreign resources may develop a persistently low exchange rate, which puts inflationary pressure on the entire economy.
   - The resulting cost- push inflation can slow economic growth on the supply-side.
4. **Destabilization**
   - Flexible exchange rates may destabilize the domestic economy and make doing business more difficult.
   - Wide fluctuations stimulate and then depress industries producing exported goods.
   - Developing countries often seek to peg their currency to a large trading partner.
5. **Increased speculation**
   - Speculation can lead to violent currency fluctuations in exchange rates

# Evaluating monetary Union

- **Monetary Union** a high form of economic integration involving the adoption by a group of countries of a single currency.
  - Monetary union in addition involves the adoption of a common monetary policy carried out by a single central bank, which is necessitated by the use of a single currency.
- Advantages of a monetary union include:
  1. **Eliminates exchange rate risk and uncertainty**
     - Exchange rate fluctuates create risks and uncertainties for traders and investors, who do not know what the future exchange rate will be.
  2. **Encourages price transparency**
     - Price transparency refers to the ability of consumers and firms to compare prices in all countries that have adopted a common currency without having to make exchange rate calculations and conversions.

# Evaluating monetary Union

3. **Eliminates transaction costs**
   - A single currency eliminates the transaction costs of the conversion, resulting in significant savings that have the effect of encouraging trade, investment and financial flows of all kinds.
4. **Promotes a higher level of inward investment**
   - Inward investment refers to investments from outsiders towards the member countries with a common currency, and these can be expected to rise because of the absence of currency risk within an expanded market, resulting in greater economic growth.
5. **Low interest rates, more investment and increased output**
   - If a member country has a high rate of inflation, its exports become less competitive, possibly a current account deficit.
   - There is no possibility of currency depreciation to regain competitiveness since there is no domestic currency.
   - Therefore member countries become committed to maintaining a low rate of inflation.

# Evaluating monetary Union

- Disadvantages of a monetary union include:

  1. **Loss of domestic monetary policy**
     - Countries are unable to carry out their own monetary policy to influence the rate of interest and hence the level of economic activity within its boundaries.
  2. **Undifferentiated monetary policy**
     - The single monetary policy pursued by the single central bank is likely to have different impacts on each of the member countries.
  3. **Loss of exchanges as a mechanism for adjustment**
     - If a member country has a trade deficit with another member country, it no longer has its own national currency, that could depreciate or devalue in order to correct the imbalance.
     - Instead it must use contractionary fiscal policy to correct the imbalance which leads to recession

# Evaluating monetary Union

4. **Fiscal policy is constrained by convergence requirements**
   - Whereas each member country retains the ability to carry out its own fiscal policy, there are certain restrictions imposed by convergence requirements.
   - **Example:** In the case of European Monetary Union, total public debt cannot be greater than 60% of GDP and the budget cannot be greater than 3% of GDP.
5. **Loss of domestic sovereignty**
   - It is no longer national government and national central banks that are responsible for economic policy, but rather the central bank that oversees the monetary system of all the member countries of the monetary union.