Current account deficits and surpluses

Assessment Objectives

Specific Expectations	
AO3	Evaluate the implications of a persistent current account deficit with regard to exchange rates, interest rates, sale of domestic assets to foreigners, debt, credit ratings, demand management, and economic growth.
AO2	Explain and evaluate methods to correct a persistent current account deficit: expenditure switching, expenditure reducing and supply-side policies.
AO2	Apply the Marshall-Lerner condition and the J-curve effect
AO4	Draw a diagram illustrating the J-ciurve referring to the Marshall-Lerner condition.
AO3	Evaluate the implications of a persistent current account surpluses with regard to exchange rates, domestic consumption and investment, inflation, employment, and export competitiveness.

Consequences of Current Account Deficits

- Most balance of payment problems usually arise in connection with current account deficits, mainly due to an excess of imports over exports over long periods of time.
- This allows countries to enjoy increased levels of consumption over what they produced.
- Current account deficits are paid for by financial account surpluses.
- As the central bank does not have endless amounts of foreign currency to pay for a current account deficit, it must do so either through loans (borrowing from abroad) or by selling some of its physical or financial assets.
  - All of these methods result in inflows of foreign exchange
- Borrowing and sale of assets may pose problems if pursued for a long time.

Consequences of Current Account Deficits

1. **Depreciating exchange rate**
   - A current account deficit puts a downward pressure on the exchange rate.
   - Large depreciations can lead to imported inflation.
2. **Higher interest rates**
   - The possible need for higher interest rates to attract foreign financial investments
   - Higher interest rates discourage domestic investment and consumption spending, possibly leading to a recession in the economy.
3. **Foreign ownership of domestic assets**
   - The need for inflows of funds, in the financial account may lead countries to sell domestic assets to foreigners, such as stocks in the stock market, real estate or factories, all of which eventually may lead to loss of control over its assets.

Consequences of Current Account Deficits

4. **Increasing levels of debt**
   - If a country borrows over long periods of time, it runs the risk of accumulating so much debt that it may be unable to pay it back; this is called default risk.
5. **Cost of paying interest on loands**
   - The interest payment that must be made on loans use up national income of the country that could have been spent elsewhere in the domestic economy.
6. **Fewer imports on needed capital goods**
   - Interest on payments on loans also use up scarce foreign exchange earnings (from exports that could have been used on imports of capital goods or other inputs for production.
7. **Poor international credit ratings**
   - Countries with large and persistent current account deficits have low credit ratings, making it more difficult to get more loans in the future.

Consequences of Current Account Deficits

8. **Painful demand management policies**
   - Countries with serious current account deficits must often pursue contractionary policies.
   - Contractionary monetary and fiscal policies have the effect of lowering incomes, which in turn lead to lower imports that that may help to reduce the current account deficit.
9. **Lower economic growth**
   - If loans accumulate over long periods of time, the cumulative impacts of the above may mean lower economic growth, as resources are used up on interest payments and loan repayments
10. **Lower standard of living in the future**
    - In order to be able to pay back loans or regain possession of domestic assets in the future, the local population will at some point have to consume less than they produce, giving a rise to a decline in the standard of living.

Consequences of Current Account Deficits

- Borrowing can lead to economic growth, and if per capita output and income increase, it becomes possible to have increased consumption of goods and services even as loans are being paid back.
- Important requirements for this to happen are:
  - The current account deficit remains relatively small and does not get out of hand by excessive borrowing
  - Borrowed funds are used to finance imports of capital goods and other inputs needed in production (instead of consumer goods imports)
  - Some production is geared towards export industries so that exports increase, making increased export earnings possible (to help pay back loans and interest, and finance more capital goods imports).

Policies to Correct Current Account Deficits

1. **Expenditure reducing policies** – policies that involve reducing expenditures in the domestic economy so as to bring about a decrease in imports in order to correct a current account deficit; they include contractionary fiscal and monetary policies.
   - May create a recession in the domestic economy
   - Risk that higher interest rates (contractionary monetary policy) lead to currency appreciation, which may discourage exports and encourage imports, partly cancelling out the beneficial effects.
2. **Expenditure switching policies** – policies that involve switching consumption away from imported goods and towards domestically produced goods, in order to correct a current account deficit; include trade protection policies and depreciation.
3. **Trade protection** – reduce current account deficit by restricting imports.
   - They have a number of negative effects, such as higher domestic prices of protected goods, lower domestic consumption, inefficiency, and a global resource misallocation.

Policies to Correct Current Account Deficits

4. **Depreciation** – the central bank may allow the currency to depreciate, in which case it encourages exports (which become cheaper to foreigners) and discourages imports (which become more expensive to domestic buyers).
   - Type of expenditure-switching policy that switches consumption away from imports and towards domestically produced goods.
   - Higher import prices due to the lower value of the currency often result in higher domestic inflation.
5. **Supply-side policies to increase competitiveness** – market-oriented supply-side policies are intended to lower costs of production for firm, and by shifting SRAS and LRAS curves to the right can result in lower rates of inflation
   - Several policies, such as increasing competition, reducing the lower of labour unions, cutting business taxes, deregulation, and others, could have the effect of making firms more competitive in global markets.
   - Lower rates of inflation may increase exports, thereby addressing the current account deficit.

Marshall-Lerner Condition

- When a nations runs a persistent deficit in its current account it should put downward pressure on the country's exchange rate.
  - When a country's currency devalues or depreciates, its imports become more expensive domestically and exports become less expensive to foreigners.
  - The quantity of imports decreases and the quantity of exports increases.
  - Depreciation of a country's currency will likely make things worse before it makes things better.
  - Firms (both domestic and foreign) need time to adjust to the changes in prices brought on by the depreciation.
  - The effect on the current account deficit depends on the price elasticity of demand of exports and imports.
  - In general, depreciation will improve the current account if the elasticity of demand for imports and exports are high (elastic) and worsen it if they are low (inelastic).

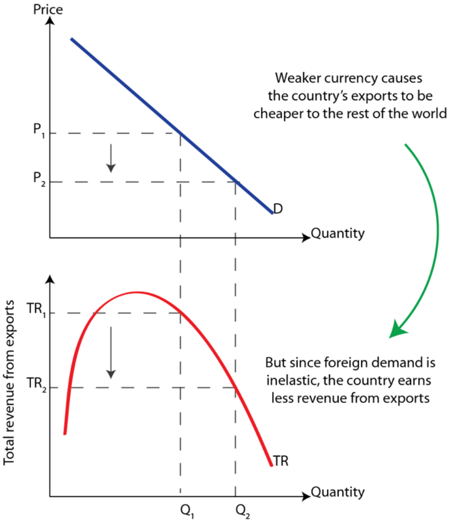
Marshall-Lerner Condition

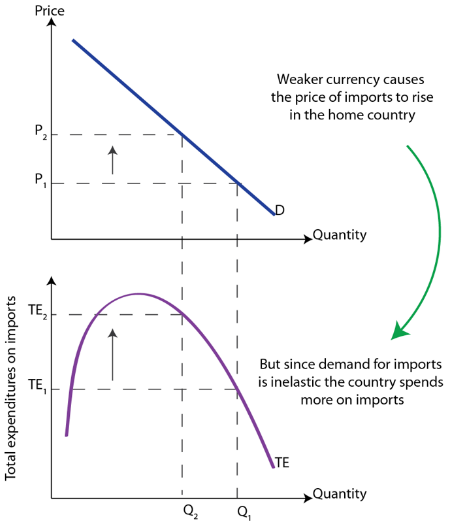
- **Marshall-Lerner Condition (MLC)** is a condition stating when depreciation or devaluation of a country's currency will lead to an improvement in that country's balance of trade.

Condition	**Balance of Trade**
$\text{PED}_{\text{Exports}} + \text{PED}_{\text{Imports}} > 1$	Improves
$\text{PED}_{\text{Exports}} + \text{PED}_{\text{Imports}} = 1$	Unchanged
$\text{PED}_{\text{Exports}} + \text{PED}_{\text{Imports}} < 1$	Deteriorates

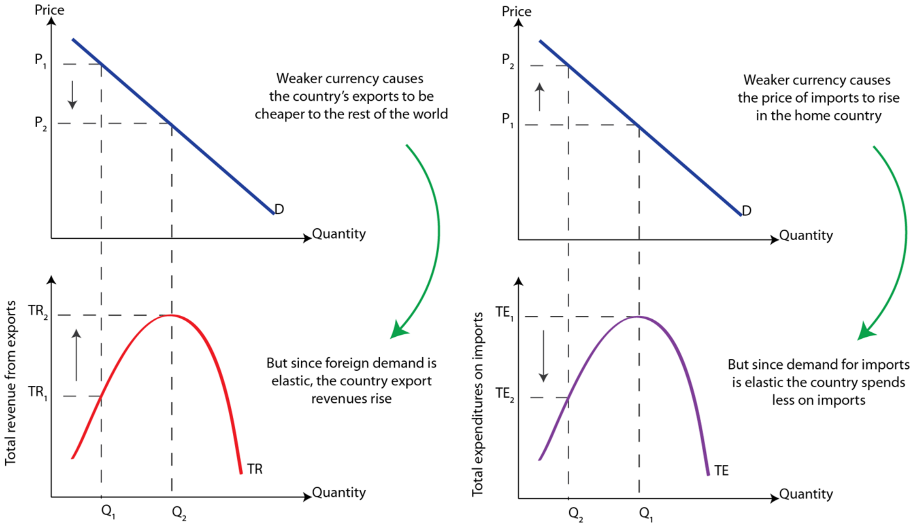
  - For a country a trade deficit, a depreciation of the currency will be more effective the higher (more elastic) the combined elasticities of demand for exports and imports.
  - If a country has combined elasticities of less than one, balance of payments worsens with depreciation and intervention to appreciate the currency would be the best way to improve the trade deficit.

$PED_{Exports} + PED_{Imports} < 1$ (MLC not met)





$PED_{Exports} + PED_{Imports} \geq 1$ (MLC met)



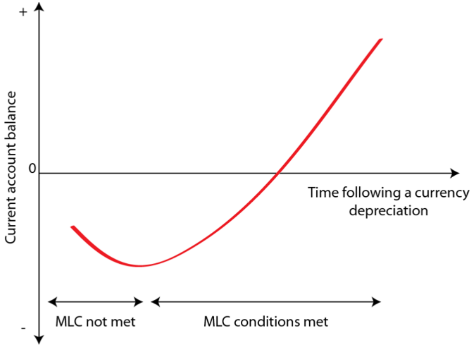
J-Curve Effect

- The Marshall-Lerner Condition (MLC) analysis suggests that a country with an inelastic import and export combination would never want to devalue its currency, as it would worsen the current account.
  - However, price elasticity of demand (PED) or exports and imports becomes more elastic over time.

- **J-Curve Effect** shows how depreciation of the nation's currency is likely to affect the current account balance over time.
  - A country with a devaluing/depreciating currency may see worsening in its trade balance (an increase in a trade deficit) in the period immediately following the devaluation or depreciation.
    - The demand for imports and exports will be relatively inelastic in the short-run.
    - The Marshall-Lerner Condition (MLC) will not be met and the weaker currency moves the country towards a trade deficit.

J-Curve Effect

- As consumers have time to adjust to changes in the price of particular goods, they are able to change their behaviour to consume either more or less of the good depending on how the price changed.
  - In a later period the trade deficit will begin to shrink provided the Marshall-Lerner Condition (MLC) holds.



Consequences of Current Account Surpluses

- Countries with a current account surplus most likely have a trade surplus, with exports greater than imports.
  - They are net purchasers of assets abroad or net lenders to other countries (having financial account deficits).

1. **Low domestic consumption**
   - Lower consumption and levels and lower standards of living for the population since overall production is greater than consumption.
   - Countries with a trade surplus consumer inside their PPF.
2. **Insufficient domestic investment**
   - The financial account deficit (corresponding to the current account surplus) means that funds are leaving the country.
   - Results in a risk of insufficient domestic investment, limiting economic growth prospects.

Consequences of Current Account Surpluses

3. **Appreciation of the domestic currency**
   - A current account surplus puts an upward pressure on the value of a currency, which can lead to lower exports and higher imports (reduced net exports).
   - This could lower the rate of economic growth of the domestic economy as a result of lower aggregate demand.
4. **Inflation**
   - Lower aggregate demand may lead to higher unemployment as workers begin to lose their jobs.
   - However, unemployment may decrease in firms that enjoy lower import costs due to appreciation.
5. **Employment**
   - As the domestic currency appreciates, exports become more expensive to foreigners, and this makes it more difficult for domestic firms to compete with firms abroad.

Consequences of Current Account Surpluses

6. **Retaliation by trading partners**
    - Current account surpluses in some countries correspond to current account deficit in other countries.
    - Current account surpluses persisting over long periods may prompt the deficit countries to impose trade restrictions to reduce their imports from surplus countries.