

## 150. The relationships between the accounts

Item 150 – Grade 3

### **Ib question**

- Explain that the current account balance is equal to the sum of the capital account and financial account balances (see the appendix, “The balance of payments” at end of this document page 62).
- Examine how the current account and the financial account are interdependent.

➤ **The current account=**

**Capital accounts + Financial accounts (+errors and omissions)**

\***Errors and omissions** → Not only is estimation of credits and debits into and out of a country imprecise but there are always unrecorded illegal cross-border activities, for example involving drugs or weapons.

➤ **Current account and the financial account are interdependent because...**

- If there is a current account deficit, there must be a financial account surplus (the capital account being very small), which provides it with the foreign exchange it needs to pay for the excess of imports over exports. The surplus on the financial account may arise from investments in physical or financial capital by foreigners, including loans from foreigners.
- If there is a current account surplus, the country is accumulating foreign exchange (as it earns more foreign exchange from exports than it pays out to buy imports), which it can use to buy assets abroad (direct or portfolio investments, including loans to other countries).
- In fact, most economists believe that the surplus or deficit of a financial account of a country is the result of what is happening in the current account.

## 151. The relationships between the current account and the exchange rate

Item 151 – Grade 3

### Ib question

- Explain why a deficit in the current account of the balance of payments may result in downward pressure on the exchange rate of the currency.

- A deficit in the current account of the balance of payments may result in **downward pressure on the exchange rate of the currency**.  
(This is more of a problem in a fixed exchange rate system than in a floating exchange rate system.)
- **Fixed exchange rate system**: The deficit implies that a high exchange rate has been set. In the short-run, the deficit may be covered by increases in the capital and financial accounts or by the government using reserve assets to balance the accounts, However, this cannot go on indefinitely, since the reserve assets will run out and so, in the end, the exchange rate will need to be depreciated.
- **Floating system**: The deficit implies that there is an excess supply of the currency on the foreign exchange markets due to falling demand for exports and the currency, or the demand for imports has increased, leading to more demand for foreign currencies and so a greater supply of the domestic currency on the foreign exchange markets. In either case, in a freely floating exchange rate system, the exchange rate should fall, increasing the domestic price of imports.
- A rising current account deficit will exert pressure on the exchange rate to **depreciate (in a floating exchange rate system) or devalue (in a fixed system)**.  
This is because rising foreign import demand means that residents are offering in the foreign exchange market more of their currency while decreasing export revenues means that foreigners are demanding less of the currency in the market.

## **152. Implications of a persistent current account deficit (HL)**

Item 152 – Grade 3

### **Ib question**

- Discuss the implications of a persistent current account deficit, referring to factors including foreign ownership of domestic assets, exchange rates, interest rates, indebtedness, international credit ratings and demand management.

### ➤ **The consequences of current account deficit**

This is mainly due to an excess of imports over exports over long periods of time.

- 1) Foreign ownership of domestic assets
- 2) Exchange rates
- 3) Indebtedness
- 4) International credit ratings
- 5) Demand management

### **1) Foreign ownership of domestic assets**

It may be that a high level of buying assets for ownership is financing the current account deficit. Foreign investors may be purchasing such things as property, businesses, or stocks or shares in businesses. In this case this inflow into the capital account is funding the current account deficit, but as it must be based upon foreign confidence in the domestic economy it is not considered to be harmful. However, there are sometimes fears that if foreign ownership of domestic assets were to become too great than this may be a threat to economic sovereignty. Moreover, if there is a drop in confidence then foreign investors might prefer to shift their assets to other countries. Selling the assets would result in an increase in the supply of the currency and a fall in its value.

### **2) [Depreciating] exchange rates**

A current account deficit puts a downward pressure on the exchange rate. Large depreciations can lead to imported inflation. If there is a risk of default, the downward pressure on the currency is much stronger because people do not want to hold currencies whose value is expected to fall further, and the currency becomes vulnerable to speculative attacks.

### **3) [High] indebtedness**

If a country borrows over long period of time, it runs the risk of accumulating so much debt that it may be unable to pay it back; this is called a risk of default. Risks of default, along with actual default, come with many problems, such as significant currency depreciation, difficulties of getting more loans and painful demand-side policies.

### **4) [Poor] international credit ratings**

International agencies rank countries according to how 'credit-worthy' they are, meaning how likely they are to repay their loans in full and on time. Countries with large and persistent current account deficits have low credit ratings, making it more difficult to get more loans in the future (no one wants to lend to a country that may be unable to pay back its loans). Under such circumstances, a country may have to raise its interest rates very high to attract foreign financial

capital, and this can create a serious recession or make an existing recession deeper.

#### **5) [Painful] demand management**

Countries with serious current account deficits must often pursue contractionary and other policies.

## **153. Methods to correct a persistent current account deficit (HL)**

Item 153 – Grade 5

### **Ib question**

- Explain the methods that a government can use to correct a persistent current account deficit, including expenditure switching policies, expenditure reducing policies and supply-side policies, to increase competitiveness.
- Evaluate the effectiveness of the policies to correct a persistent current account deficit.

### ➤ **Methods to correct a persistence current account deficit**

- **Expenditure switching policies**
- **Expenditure reducing policies**
- **Supply-side policies**

→ Increasing competitiveness

### 1) **Expenditure switching policies**

- It attempts to switch the expenditure of domestic consumers away from imports towards domestically produced goods and services.
- If successful, then expenditure on imports will fall and so the current account deficit should improve

### Examples

- **A devaluation of the exchange rate:** This will make exports to become less expensive and imports to become more expensive. This should see an improvement in the current account as export revenue rises and import expenditure falls. (Effective!!)  
→ **HOWEVER, there is a potential risk of inflation to accelerate.**
- **Protectionist measures:** The government may attempt to restrict the imports of products either by reducing their availability using embargoes, quotas, voluntary export restraints, and administrative their prices using tariffs. If this happens then domestic consumers will switch their expenditure from imports to domestic products.

→ HOWEVER, governments are often reluctant or unable to use such measures because they tend to lead to retaliation and are often against WTO agreements. Also, protecting domestic industries reduces competition, which may encourage them to be inefficient. Therefore it is not a long-run solution (Not that effective!!)

## 2) Expenditure reducing policies

- Policies that decrease the level of AD (Shifting AD to the left)
- If this occurs then expenditure on all goods and services should fall and, since this would include expenditure on imports, the current account deficit should improve. (The size of fall in imports will depend upon the level of the marginal propensity to import)
- However, there is a conflict here between external and internal objectives. Deflating the economy may reduce the current account deficit but the policy is likely to lead to a slow down of growth or even turn negative, Incomes and output will decrease. Firms will contract or shut down and unemployment will emerge.

### Examples

- **Deflationary (Contractionary) fiscal policies:** Increasing direct tax rates and/or reducing government expenditure. Clearly, these would be politically unpopular and a government might be reluctant to use such a policy
- **Deflationary (Contractionary) monetary policies:** Increasing the rate of interest and/or reducing the money supply. Interestingly, the higher interest rates should also increase capital flows from abroad, as foreigners put money into financial institutions attracted by the higher rates. This would lead to a surplus on the capital account, which helps to offset the current account deficit. This type of policy would also be politically unpopular as higher interest rates will increase people's mortgage, loan, and credit card payments. Moreover, the higher costs of borrowing as a result of higher rates of interest may act as a disincentive to domestic investment and limit potential growth.

### 3) Supply-side policies

- It is a solution of a more long-run nature, aiming at increasing the competitiveness of the economy and especially of the export sector
- A persistent current account deficit may be a result of uncompetitive product markets characterized by a high degree of monopoly power and of rigid labour markets with high labour costs and low labour productivity. Supply-side policies can prove useful to restore the competitiveness of an ailing economy and cure a fundamental disequilibrium in the current account
- Drawbacks:  
(\*It is the same as the drawbacks for supply-side policies)



## **154. The Marshall-Lerner condition and the J-curve effect (HL)**

Item 154 – Grade 3

### **Ib question**

- State the Marshall-Lerner condition and apply it to explain the effects of depreciation/devaluation.
- Explain the J-curve effect, with reference to the Marshall- Lerner condition.

### ➤ **The Marshall-Lerner condition**

- It tells us how successful a depreciation or devaluation of a currency's exchange rate will be as a means to improve a current account deficit in the balance of payments
- It states that reducing the value of the exchange rate will only be successful if the total value of the price elasticity of demand for exports and the price elasticity of demand for imports is greater than 1.
- **Equation:  $PE_{\text{exports}} + PE_{\text{imports}} > 1$**

## Diagrams



$P1$  = Price after depreciation

$P$  = Price before depreciation

- The current account improves as less is spent in revenue terms after depreciation than before i.e.  $OP1 < OQ1 < OP < OQ$

- The current account worsens as more is spent in revenue terms after depreciation than before i.e.  $OP1 \times OQ1 > OP \times OQ$

⊙ The more price elastic the demand for imports and exports, the greater will be the fall in demand for imports and the increase in demand for exports and the greater will be the improvement on the current account



$P_1$  = Price after depreciation

$P$  = Price before depreciation

- The current account **improves** as less is spent in revenue terms on exports after depreciation than before i.e.  $OP_1 \times OQ_1 > OP \times OQ$

- The current account **worsens** as more is spent in revenue terms on exports after depreciation than before i.e.  $OP_1 \times OQ_1 < OP \times OQ$

- ✚ We know that one of the determinants of elasticity of demand is the time period under consideration. Remember that demand becomes more elastic over a longer period of time. This applies to the elasticity of demand for exports and imports.

Short-run and long-run PED values in the G-7 countries

Country	Short-run PED <sub>exports</sub>	Short-run PED <sub>imports</sub>	Total short-run PED	Long-run PED <sub>exports</sub>	Long-run PED <sub>imports</sub>	Total long-run PED
<b>Canada</b>	0.5	0.1	0.6	0.9	0.9	1.8
<b>France</b>	0.1	0.1	0.2	0.2	0.4	0.6
<b>Germany</b>	0.1	0.2	0.3	0.3	0.6	0.9
<b>Italy</b>	0.1	0.2	0.3	0.3	0.6	0.9
<b>Japan</b>	0.5	0.1	0.6	1.0	0.3	1.3
<b>UK</b>	0.2	0.0	0.2	1.6	0.6	2.2
<b>US</b>	0.6	0.5	1.1	1.5	0.3	1.8

The table shows:

1. In almost all cases the short-run elasticity values are lower than the long-run values. This is exactly what we would expect to find from the theory stated previously, that price elasticity values increase over time
2. Only the US would meet the Marshall-Lerner condition in the short-run, but all countries, other than France and Germany, meet the condition in the long-run

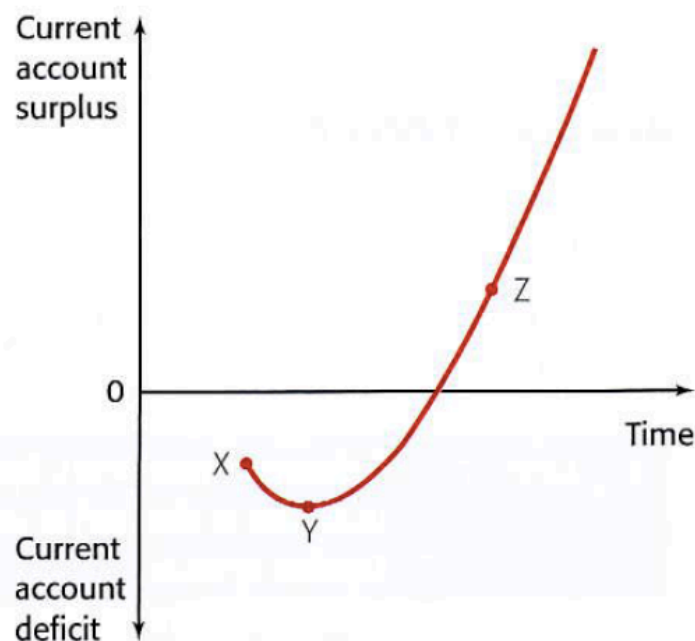
### Ib question

- Explain the J-curve effect, with reference to the Marshall- Lerner condition.

#### ➤ The J-curve

- If a government is facing a current account deficit, it may reduce the exchange rate of its currency in order to make exports relatively less expensive and imports relatively more expensive. If this happens and the Marshall-Lerner condition is satisfied, then we would expect an improvement in the current account deficit.
- However, in the short-run, this is not the case and the current account deficit actually gets worse before it gets better → J-Curve effect
- J-Curve shows what happens to a current account deficit over time when the exchange rate is devalued or depreciated.
- This is because in the short-run, there will be few extra exports sold when prices fall- people overseas do not react immediately and so export demand will take time to change. However, extra money will have to be paid for imports immediately and so the current account will tend to deteriorate. In the medium term, however, the lower export prices will lead to an increase in demand for

The J-Curve



### Explanation

- Assume that a country's current account deficit is at X and the government lowers the exchange rate

## **155. The relationship between the current account and the exchange rate**

Item 155 – Grade 3

### **Ib question**

- Explain why a surplus in the current account of the balance of payments may result in upward pressure on the exchange rate of the currency.

### **The current account surplus**

- It may result in upward pressure on the exchange rate of the currency.
- **Fixed exchange rate system:** The surplus implies that the exchange rate has been set at too low a value. In the short run this may be offset by deficits on the capital and financial accounts or by increases in the reserve assets. In the long run, however, it is likely that other countries will be unhappy with the artificially low exchange rate and will demand higher rates or will threaten protectionist measures against the country's exports. This has often been the case with the exchange rate of the Chinese currency, which is pegged to the US dollar, and China's trading partners.
- **Floating system:** The surplus implies that there is an excess demand for the currency on the foreign exchange markets. This may be because the demand for the exports has risen, as has the demand for the currency, or the demand for imports has fallen, leading to less demand for foreign currencies and so a lower supply of the domestic currency on the foreign exchange markets. In either case, in a freely floating exchange rate system, the exchange rate should rise, decreasing the competitiveness of the country's exports and lowering the domestic price of imports.

## Notes

- A current account surplus exists if the sum of net exports of goods and services plus net income and net current transfers is positive
- One may argue that if the surplus is small or transitory it is not considered an issue. Also, if it is part of a growth and development strategy known as export-oriented growth its benefits may exceed its costs
- A persistent current account involves some risks:
  - 1) It implies that the economy is consuming inside its production possibilities



## **156. Implications of a persistent current account surplus**

Item 156 – Grade 4

### **Ib question**

- Discuss the possible consequences of a rising current account surplus, including lower domestic consumption and investment, as well as the appreciation of the domestic currency and reduced export

### ➤ The consequences of a persistent current account surplus

#### 1. Lower domestic consumption and investment

#### 2. Appreciation of the domestic currency

→ The current account surplus implies an increase in demand for the currency

#### 3. Reduced export

→ As a result of an increase in demand for the currency, it will make imports cheaper so reducing inflationary pressures, but will also make exports more expensive, harming exporters

### Notes

- A capital account surplus, based upon the purchasing of assets for ownership, is mainly a positive thing for the country and allows a current account deficit. However, a capital account surplus based upon high levels of borrowing from abroad is the opposite and is normally a response to a current account deficit.