Webnote 334

Syllabus Reference 4. 3: Solving a current account deficit

A

What is a Current account deficit ?

The domestic economy is spending more on foreign goods and services than is being spent on domestic goods and services. Money is leaving the country. A leakage form the circular flow (J) See Section 3.1 webnote 301

B Problems of current account deficit

1) In the long run this could indicate problems with the competitiveness of a country's industries.
2) Usually more of a problem in a fixed exchange rate system, compared to a floating rate.
3) In a floating system the external value of currency falls, making exports competitive again. Self-adjusting mechanism. This is the PPP concept.
4) In a fixed system the deficit may be offset by inflows on the capital account (foreigners buy domestic currency in order to bring funds into the economy) or the Government will have to intervene to buy up excess currency (this cannot continue indefinitely as the country will run out of foreign currency reserves or it must borrow abroad in order to pay for the deficit on the current account).

See blink 302-303

Two options to reduce a **balance of payments deficit**[1]

Option 1
Expenditure switching policies

These are attempts to make imports relatively expensive compared to exports, e.g.

a) import controls such as tariffs

b) bringing about a reduction in the exchange rate such as a devaluation such as the Swiss Government did between 2011-2015 fixing the exchange rate with the Euro whereby 1 Euro = 1.2 CHF thereby boosting exports and reducing imports. The market rate of exchange > 1.2 CHF

Option 2
Expenditure reducing policies

The Government attempts to reduce spending throughout the economy, i.e deflate the economy. This is likely to reduce the amount spent on imports (although at the same time the amount spent on UK goods and services will also fall). To reduce spending, the Government could increase taxation rates, cut its own spending or increase interest rates.

Policy packages

It may be necessary to use a combination of policies, e.g. a depreciation will result in consumers switching from imports to exports. However, if domestic industry is at or near full capacity, it cannot produce enough and the result is inflation. Therefore, the Government might deflate the economy (expenditure reducing) to provide capacity for a depreciation (expenditure switching). Expenditure reducing and expenditure switching policies are complementary, not substitutes in terms of policy action.

Note carefully that a depreciation and appreciation are used in describing flexible exchange rates and devaluation and revaluation are used in describing fixed exchange rates.

[1] Consider the opposite for balance of payments surplus