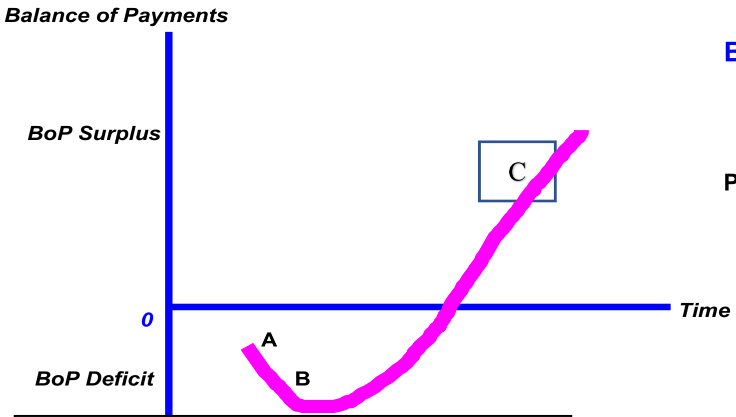
Syllabus Reference 4. 6 : J curve effect

http://economics.isdedu.de

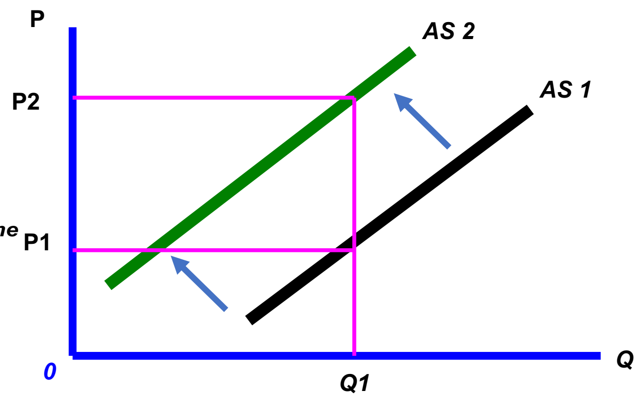
Note: Eg UK / £STG

Consider the following event:
The pound sterling falls in value, this makes exports relatively cheap in foreign currencies and imports relatively expensive in pounds.
Note: revise 2.5 elasticity and TR

A: The J curve effect



B: Cost Push Inflation



- **Short Run Impact of currency depreciation:**
- **J- curve effect can be seen from A to B above**

1. In the short run the demand for imports and demand for exports are likely to be inelastic. This is because consumers and firms have already got their sources of supply and may be reluctant to change. Although the price of exports falls in terms of foreign currency, total amount spent on them will fall because demand is inelastic. Although the price of imports has risen, the total amount spent on them will rise because demand is inelastic. The overall result is that the balance of payments deficit actually worsens in the short run.

- **P exports fall + price imports rises**
- **Exports inelastic : revenue falls**
- **Imports inelastic: revenue rises**
- **Overall result is that BOP worsens in the short run. This is the J curve effect and is seen in Diagram A between points A and B.**

- **Long Run Impact of currency depreciation:**
- Trend is B to C on J- curve

1. In the long run, consumers and firms find alternative cheaper suppliers in other countries and UK buyers switch to the cheaper foreign imports, i.e. the demand for imports and exports is price elastic. With the lower export prices spending on exports rises; with the higher import prices spending on imports rises and the balance of payments improves (see 4.5 Marshall Lerner condition).

2. In the very long run the balance of payments might worsen again. This is because the higher import prices can cause cost push inflation (AS1 TO AS2 price level rises from P1 to P2) and make UK goods and services uncompetitive abroad. Many argue that a depreciation will not improve the balance of payments position over the very long term. This must be considered case by case, country by country.

Why might exports/imports be inelastic in the short run?

1. Firms prefer not to change trading partner so despite higher prices for imports and cheaper prices for exports firms continue to trade as before e.g. importer in domestic economy continues to trade as before and bring in imported raw materials at a higher cost/price due to the depreciation (note: foreign firm has not changed their prices but the depreciation has effectively increased the price.
2. Existing contracts might force firms to continue to trade with existing partners. E.g. this may account for a willingness to pay higher prices for imports worsening the balance of payments deficit.