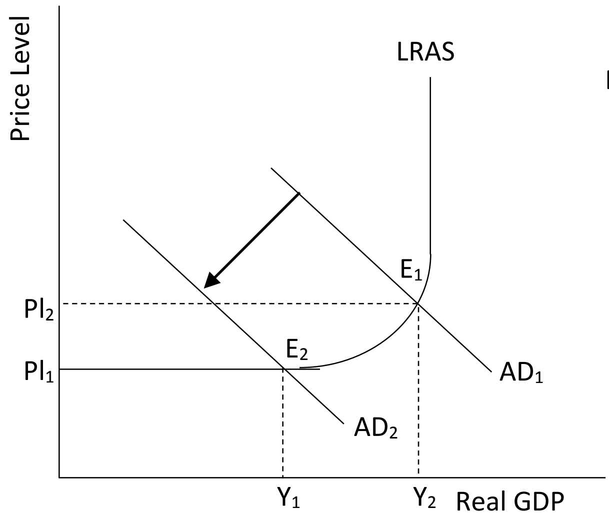
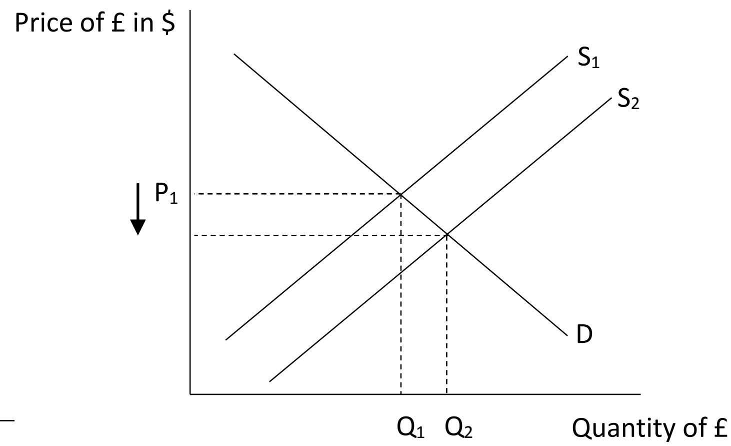
Consequences of a current account deficit

1. Lower AD (X – M) is negative



Depreciation of the pound



- Decrease in growth
- Higher unemployment

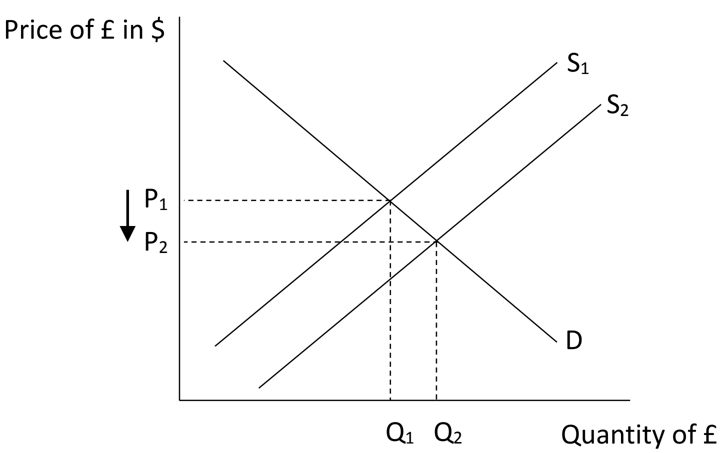
- If a country does not have a very strong export base, a weaker exchange rate will harm the economy and may lead to stagflation

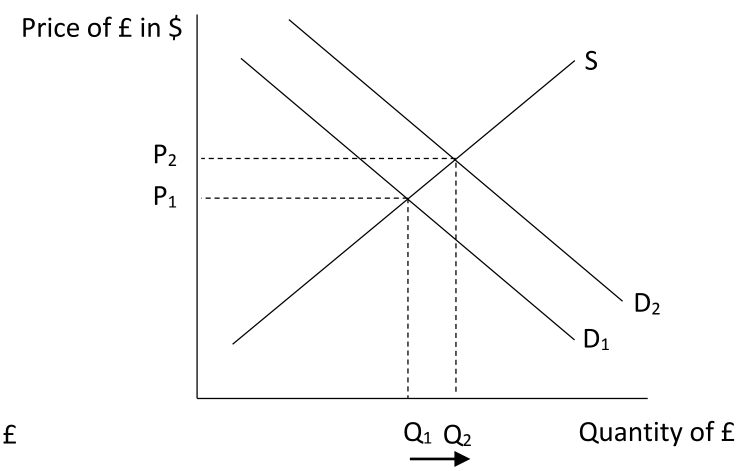
Debt burdens

- If a country with a current account deficit keeps borrowing money by selling bonds for example, to have a financial account surplus, other countries will start doubting whether that country will be able to pay back all the debt and will stop buying bonds. As fear comes in, people in the economy will start moving their money elsewhere, which can cause a currency crisis as the currency depreciates, which can ultimately lead to an economic crisis.

Fixed and floating exchange rates

To support a fixed exchange rate, the government or central bank require to hold large amounts of currency reserves (domestic and foreign).





- If the exchange rate is higher than what it should be (overvalued currency), authorities should sell the currency, increasing its supply and causing it to depreciate

- If the exchange rate is lower than what it should be (undervalued currency), authorities should buy more of the currency, increasing the demand for it and causing it to appreciate this may lead to the exchange rate going back to the fixed level, it can have very bad macroeconomic consequences such as higher unemployment etc…

- Large level of foreign currency reserves needed
- Speculative attacks if exchange rate is set too high or too low

Managed exchange rates – mostly floating exchange rate with government intervention if needed

Government intervention in forex markets

Governments may wish to:

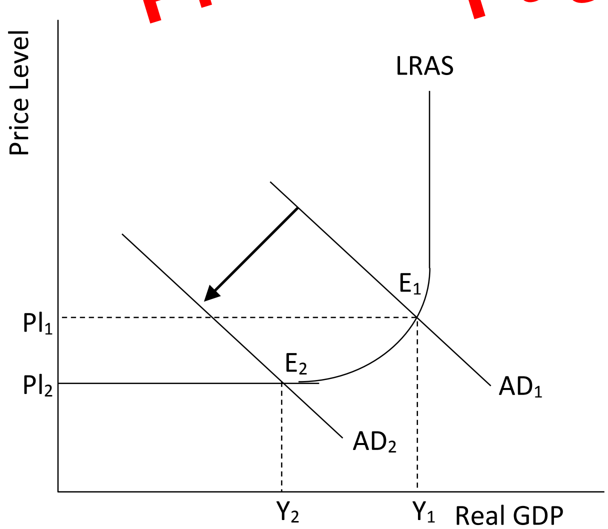
- Decrease exchange rate to increase employment
- Increase exchange rate to fight inflation
- Maintain a fixed exchange rate
- Stabilise a floating exchange rate
- Improve a current account deficit

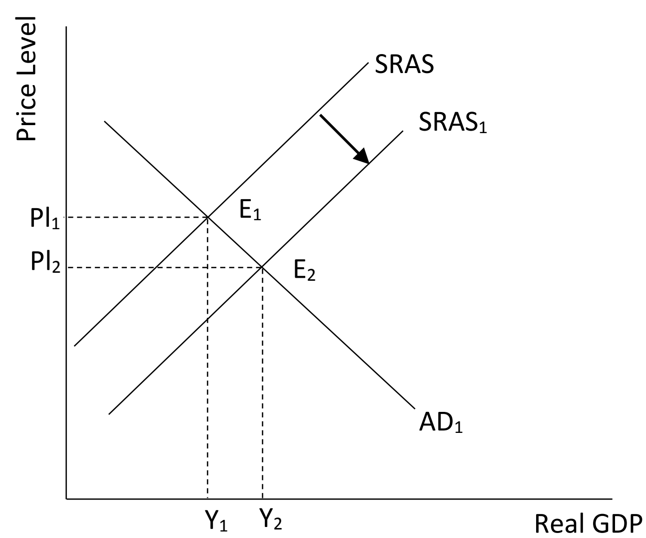
How?

- Buy or sell domestic currency using currency reserves
    - If central bank wants to decrease value of its currency, it can sell its own currency and if it wants to increase its value it can buy its own currency by selling foreign currency
- Change interest rates

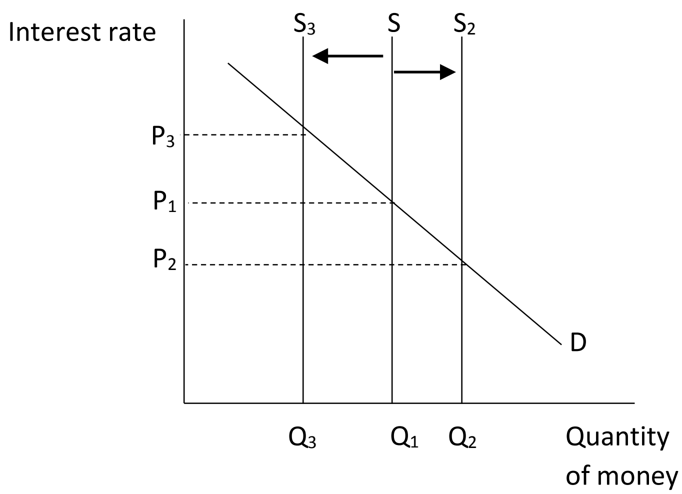
Exchange rate changes impacts

Appreciation → SPICED





How does monetary policy work?



- Reduced money supply = increase in interest rates
- Increased money supply = reduction in interest rates

1. Reserve requirement
    a. To decrease interest rates, reduce reserve requirement
    b. To increase the interest rate, increase the reserve requirement

2. Discount rate
    a. To decrease interest rates, reduce discount rate
    b. To increase interest rates, increase discount rate – make it more expensive for banks to borrow money from central bank thus amount of money in economy decreases

3. Open market operations – buying and selling bonds
    a. To decrease interest rates, buy bonds
    b. To increase interest rates, sell bonds

Monetary policy transmission mechanism