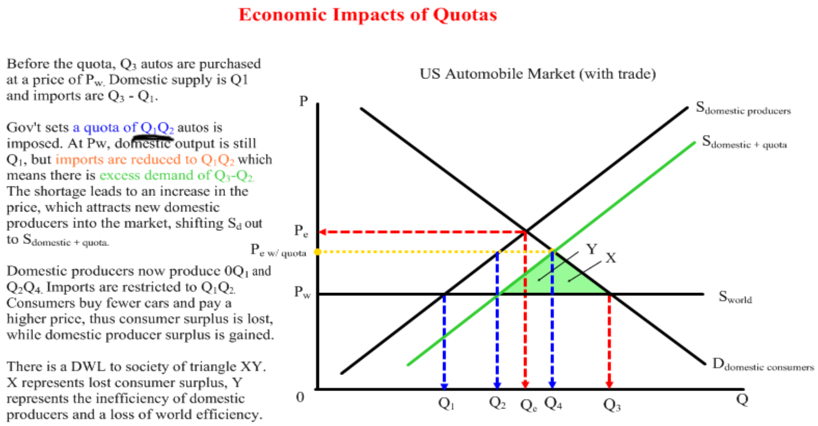
Quota Diagram



- Increase in quantity supplied, decrease in quantity demand, decrease in imports
- Domestic consumers are worse off
- Domestic producers are better off
- Domestic employment increases
- The government neither gains nor loses
- Domestic income distribution worsens
- Increased inefficiency in production

Exchange rates
Determination of freely floating exchange rates

- Exchange rates are determined by forces of demand and supply
- Example of US and the EU
  - If the price of dollars in terms of euros increases, euro zone residents would demand fewer dollars. (indicated by the downward demand curve)
    - If 0.80 euro is needed to buy 1 dollar, euro zone residents buy fewer dollars than if 0.5 euro is needed to buy 1 dollar.
  - As the price of the dollar increases, euro zone goods become cheaper, and so the quantity of dollars supplied increases. (indicated by the upward supply curve)
    - If it now costs 0.8 euros to buy 1 dollar instead of 0.5 euros, that means that 1 dollar can buy a greater quantity of euros. → US residents can purchase goods from the EU more cheaply
  - If the exchange rate were higher (0.8 euro per dollar) → excess supply of dollars
  - If the exchange rate were lower (0.5 euro per dollar) → excess demand for dollars

certainty	arise ➔ Negative effects on trade and investment flows ➔ Large and abrupt changes can cause problems for countries that are heavily export dependant ◆ Can lead to financial crisis due to large current account deficits	**of certainty** (they know what the exchange rate will be in the future) ➔ Easier for firms to plan: ◆ Future investments domestically and abroad ➔ Consumers can plan: ◆ Travel abroad ◆ Purchase imported goods and services and financial investments in other countries ➔ Governments can plan: ◆ Foreign transactions ● Purchases of imports ● Payments of interest and capital on foreign loan
Foreign Currency reserves	● **There is no need for central banks to hold foreign currency reserves** since there is no need for intervention in foreign exchange markets. ● The balance of payments balances **entirely through market forces.**	● Central bank intervention to maintain a fixed exchange rate **requires sufficient supplies of reserves of foreign currencies.** If there is a current account deficit, reserve currencies can be sold to buy domestic currency → creates credits in financial account to offset the excess debit in the current account. ● **Problems can arise if central banks do not have enough reserves to intervene.**
Ease of adjustment	Adjust automatically to excess demand or supply of the domestic currency → automatically bringing a balance. ● A current account deficit is eliminated through currency depreciation ● A surplus is eliminated by currency appreciation. There is easy adjustment to external shocks. A fall in oil prices leading to a current account deficit is met by a fall in the value of the currency.	**No easy methods to correct imbalances.** ➔ External shocks (sudden increase in oil prices leading to current account deficits for oil importers) cannot be handled quickly and easily. ➔ Large or persistent current account deficits require large quantities of foreign currency reserves or access to foreign borrowing. If these aren't available, countries resort to: ➔ Contractionary policies ➔ Trade protection ➔ Exchange controls If current account deficits continues, the country may have to devalue its currency.
Flexibility offered to policy makers	**Great flexibility** Domestic economic policy does not need to respond to balance problems → they can focus on other domestic issues eg. When there is a current account deficit, there is no need to pressure contractionary fiscal/monetary policies (which will cause a recession), the government can pursue	**No flexibility** The need to maintain the exchange rate at the fixed level forces the government/central bank to pursue a range of policies that come with certain disadvantages: ➔ Interest rates increase to attract financial investments but have contractionary effects in the domestic economy. ➔ Borrowing from abroad also increases inflows

demand

- Uses contractionary fiscal and monetary policies to reduce aggregate demand and therefore output and incomes → lower demand for imports and lower rate of inflation, which may make domestic goods more competitive and increase exports

Expenditure-switching policies: Policy intended to shift consumption away from imported goods and towards domestically produced goods

- Trade protection
    - Advantage: Increases barriers to trade to restrict imports, which can mitigate current account deficits
    - Disadvantage:
        - Higher domestic prices of protected goods
        - Lower domestic consumption
        - Inefficiency and domestic and global misallocation of resources
- Depreciation
    - Advantage: The government allows the country's currency value to depreciate as they anticipate that the rise in import prices would encourage domestica consumers to purchase more domestically produced goods.
    - Disadvantage:
        - Higher import prices often result in higher domestic inflation
        - If the imported goods include capital goods and other production inputs, firms experience higher costs of production which may increase prices for consumers
- Depreciation and managed changes in exchange rates
    - Advantage: The government encourages depreciation because exports become cheaper. This is an opportunity for them to expand export industries, expand the economy and increase employment
    - Disadvantage:
        - Creates an unfair competitive advantage to other countries
- Supply side policies to increase competitiveness
    - Advantage:
        - Lower costs of production for firms by increasing competition → lower prices (lower inflation)
        - Over a long period of time, lower rates of inflation may increase exports, thereby addressing the current account deficit
    - Disadvantage:
        - Lag time

The Marshall-Lerner condition and the J curve effect

Marshall-Lerner

- The marshall lerner condition is one that allows devaluation or depreciation to lead to an improvement in a country's balance of trade
- The marshall lerner condition states:
    - If the sum of the PEDs for imports and exports is greater than 1, devaluation or depreciation will improve the trade balance (will make a trade deficit smaller)
    - If the sum of the two PEDs is less than 1, devaluation/depreciation will worsen the trade balance (will make trade deficit larger)
    - If the sum of the two PEDs is equal to 1, devaluation/depreciation will leave the trade balance unchanged

J-curve effect, with reference to the marshall-lerner condition

- Devaluing/Depreciating country may experience a worsening trade balance immediately