Consequences of XR fluctuations

Benefits

- Lower import prices are a benefit for consumers and for those producers that import raw materials, components and machinery. Consumers benefit from an increase in living standards as their income buys more G+S. Producers benefit from lower input costs and higher profit margins, or are able to reduce prices to raise demand (An appreciation of XR can also lead to reduced inflationary pressures.)
- Risks from fluctuating exchange rates can be minimised. E.g. paying for contracts up front. But this has risks involved too.
- Another option is the use of futures markets. They are a way for a firm to guarantee an exchange rate by buying the currencies at a fixed rate at some point in the future.
- Despite risks and uncertainties created by fluctuating exchange rates, world trade volumes are remarkably stable. This is because exporters appear to price their goods and services for their export markets, absorbing changes in XR in their profit margins.

Problems

- Appreciation of XR → raises price of exports and reduces the price of imports. Higher X prices → demand for X falls. *The extent to which this is a problem depends on PED for exports.*

  If PED for exports is price elastic, an appreciation of the XR will lower the value of exports → AD falls → economic growth slows → unemployment increases.

  Lower import prices will amplify these effects if price elastic.

  Consequently there would be deterioration in the current account balance of the balance of payments.

- Fluctuating exchange rates create uncertainty and risk through regular movements up and down in the value of the currency.
- Uncertainty and risk may deter international trade. The more a country's exchange rate fluctuates, the more risky trade is with that country and the lower the volume of trade is likely to be.

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Balance of payments problems

- Main focus on the current account position.

A trade deficit in goods or services may come about by:

- High levels of consumption causing excessive spending on foreign-produced G+S.
- High levels of investment spending causing capital goods being imported from abroad.
- A change in comparative advantage → cheaper G+S being imported rather than produced domestically.
- High or over-valued XR causing consumers to switch away from domestically produced G+S to those produced abroad.
- Structural weaknesses in the economy resulting from domestic firms losing competitiveness against imported goods due to a lack of investment, high labour costs or low productivity.

Policies to correct imbalances in the balance of payments (B.of.P)

1. Do nothing

- Current account deficit must be matched by a capital account surplus → i.e. If more money is flowing out of the economy on the current account, then more money must flow in on the capital account (otherwise there will be downward pressure on the XR).
- Some economies such as the UK and USA manage to finance their current account deficit because their economies are fundamentally 'sound'. As a result they have attracted FDI, which counts as a credit in the capital account of the B.of.P.

Where the fundamentals of an economy are not sound & the imbalance represents an underlying weakness in the economy, there needs to be some kind of policy in response to the imbalance.

There are two reasons for this:

- The economy is living beyond its means (spending more than earning from abroad.) → It needs to borrow the difference → Build-up of foreign debt →financial crisis?
- When an economy operates a fixed or semi-fixed XR, it will not be able to afford to support its currency indefinitely by using reserves of foreign currency to intervene in FOREX markets.

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2. Expenditure-switching policies

To encourage a switch in expenditure away from imports towards domestically produced goods and services.

This requires the relative price of imports to rise and the relative price of exports to fall. This can be achieved by:

1. A fall in the exchange rate
2. Tariffs on imports
3. Subsidising exports

Main **problems** with this type of policy are related to their impact on the domestic economy.

The effectiveness is dependent on the PED for imports and exports. Raising the price of imports may have little impact on the volume of imports demanded if the PED for imports is inelastic.

If domestic output is a poor substitute for imported goods (inferior quality & reliability, etc.) then expenditure-switching policies will be ineffective.

They may also make the situation worse. Increase in price combined with a less than proportionate reduction in demand → raise the value of imports. This in itself may be a problem because they may add to domestic inflation by raising both retail prices and costs of production.

Subsidising exports and placing tariffs on imports risks retaliation from the countries affected and would be against the rules of the WTO. There is also a time lag with these policies; there would be a J-curve effect on the current account of the B.of.P.

- Countries where borrowing tends to be at variable rates of interest will show much more response to interest rate changes than countries where borrowing is at fixed rates.
- Different economic structures can also lead economies to experience different kinds of external shocks – oil-importing countries will be affected differently by rising oil prices from countries such as the UK, which is a major oil producer.

Economic convergence: the process by which economic conditions in different countries become similar. Economists distinguish between monetary convergence (for example, similarities in inflation and interest rates) and real convergence (for example, similarities in the structure of economies). Membership of the euro area only requires monetary convergence to have taken place.

- To combat problems created by lack of economic convergence, countries belonging to a monetary union need flexible labour markets, high degrees of labour and capital mobility and a mechanism to redistribute money to countries or areas adversely affected by the problems of a single currency. These requirements help to soothe out differences in economic performance that arise from the loss of monetary policy sovereignty. They are the characteristics of what has become known as OPTIMAL CURRENCY AREAS. Of these characteristics, some economists argue that the most important are those that impact on the supply-side performance of the economy. This is because, economic policy instruments such as the interest rate, exchange rate and fiscal policy are of little consequence in determining long term economic performance.

Optimal currency area: refers to conditions that need to be met to avoid the costs of monetary union. These conditions include: a high degree of labour market flexibility, mechanisms for fiscal transfers, and the absence of external shocks that impact differently on different economies (asymmetric shocks).

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