

Effect of appreciation of domestic currency on the balance of payment

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Consistent appreciation of the domestic currency of a country's currency has a major impact on the balance of payment in the short term but in the long run the automatic market mechanism leads to the readjustment of the BOP position. For instance, if the AUD significantly appreciate against the US \$ then this means that less AUD will be required to obtain one unit of the US \$, therefore demand for the dollar will increase leading to increase of dollars in the countries, the balance of payment official reserves eventually leading to a surplus BOP in the short run.

(Davidson, 2002, Suranovic 2005 & Piana 2006). However, in the long run, due to the increase in supply of US \$ then there will be a greater supply of US \$ than demand, due to the appreciation of the AUD. Imports will increase since it would be cheaper to buy goods from America due to AUD appreciating against US \$ hence increasing demand of the US \$.

Consequently, the amount of US \$ in Australian official reserve accounts will reduce and the Australian central bank will react by revaluating the price of a dollar to reduce its demand therefore forcing the price of US dollar to appreciate against the local Australian dollar and restoring the balance of payment at equilibrium level in the long run (Piana, 2006).

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