

Examining the implications for an economy of a rising exchange rate



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Assignment Titles 1. Examine the implications for an economy of a rising exchange rate FT 23 8 11 p16 Exchange rate kills Australian steel exports FT 7 9 11 p4 Bold move seen as high risk (Swiss max exchange rate)) FT 9 9 11 p32 Hong Kong faces dilemma over its peg to the dollar Financial Update 11/12 see Brazil, Australia, Switzerland and Japan Introduction Whilst popular opinion centres on the assumption that rising exchange rate has mostly positive effects on the economy, the impacts are both diverse and extensive.

In the short run, a major implication is the improvement in the terms of trade as exports become more expensive and imports become relatively cheaper. This rise in the terms of trade leads a larger amount of imports to be purchased with a given amount of exports; an increase in the purchasing power of domestic production As a result of relative price fluctuations, there is likely to be an increase in domestic spending on imports, and decreased demand for exports in foreign countries.

In order to explore rising exchange rate effects on economy we need to understand essential macroeconomics like Aggregate Supply (AS) and Aggregate Demand (AD). Economics- S. Nordhaus- 16th ed. - 1998 - McGraw-hill- US - p388 The central concepts for understanding the determination of national output and the price level are aggregate supply (AS) and aggregate demand (AD). Aggregate demand consists of the total spending in an economy by household, businesses, governments and foreigners. It represent the total output that would be willingly bought at each price level, given the monetary and fiscal policies and other factors affecting demand.

Aggregate supply describes how much output businesses willingly produce and sell giving prices, costs, and market conditions. AS and AD curves have the same shapes as the familiar supply and demand curves analysed in microeconomics. The downward sloping AD curve shows the amount that consumers, firms, and other purchasers would buy at each level of prices, with other factors held constant. The AS curve depicts the amount that businesses would willingly produce and sell at each price level, other things held constant.

The overall macroeconomic equilibrium, determining both aggregate price and output, comes where the AS and AD curves intersect. At the equilibrium price level, purchasers willingly buy what businesses willingly sell.

Equilibrium output can depart from full employment and potential output.

Rising exchange rate can only be seen in floating exchange rate regime rather than fixed exchange rate regime. We can summarize the effects of rising exchange rates on four topics: 1st effect is on BoP: Economics - A.

Griffiths & S. Wall - 2005 - Pearson - 2005 - London - p407-9

Balance of payments The balance of payment situation for a country will both influence the exchange rate for its currency and in turn be influenced by that exchange rate. As well as a high level of employment (low unemployment) and low inflation, government policy will seek to contain within reasonable limits any deficit on the balance of payments and may even seek a surplus. The overall accounts are constructed so that they must balance (accounting identity), with this balance achieved by either drawing on reserves (if deficit) or adding to reserves (if surplus).

The 'balancing item' represents these values, which are required to maintain the accounting identity. Economics - D. Begg - 9th edition - 2008 - McGraw-Hill Education - Berkshire - p552-5 Internal and external balance

Next we discuss the relation between the state of the economy - boom or recession - and the current account on the balance of payments. Figure 28.3 shows the different combinations of boom and recessions and current account surpluses and deficits. Think about demand and supply for domestic output. Equation (3) reminds us of the basic equation for goods market equilibrium:

$Y = C + I + G + (X - Y)$ Domestic output Y equals aggregate demand that arises from spending on consumption, investment, government purchases and net exports. A country is in internal balance when aggregate demand equals potential output. A country in external balance has a zero current account balance. Simultaneous internal and external balance is the long-run equilibrium of the economy. With sluggish wage and price adjustment, lower aggregate demand for domestic output equals potential output is internal balance restored. For a floating exchange rate, the total balance of payments is always zero.

Saying that the current account is in balance then also implies financial account balance. Similarly, a higher real exchange rate (lower competitiveness) reduces export demand and raises import demand. The fall in net exports induces both a current account deficit and lower aggregate demand, leading to a domestic slump as shown in the bottom left hand quadrant. The figure shows other shocks that move the economy into other

quadrants, causing departures from both internal and external balance. The long-run equilibrium real exchange rate

In long-run equilibrium, both internal and external balance must fall.

Domestic output Y is at potential output Y^* and the current account is in balance. For countries with large foreign debts or foreign assets and thus large flows or interest income, the current account can deviate a lot from trade balance. However, for most countries, trade balance and the current account balance are similar. Initially, we focus on this latter case. External balance then requires that net exports $X-Z$ must be zero. Long-run equilibrium then requires $Y^* = Y = (C+I+G) + (X-Z)$

In external balance, net exports $(X-Z) = 0$. Internal balance then requires that domestic demand $(C+I+G)$, the domestic absorption of resources, equals potential output Y^* . Net exports depend on real income at home, real income abroad and the real exchange rate that determines competitiveness. In long-run equilibrium both domestic and foreign income are fixed at their respective levels of potential output. Given these income levels, net exports depend only on the real exchange rate. Figure 28. 4 shows that there is a unique real exchange rate that makes the net exports equal to zero.

Given domestic and foreign levels of potential output, a lower real exchange rate raises exports demand and reduces import demand the net export schedule NX slopes down. Only at the real exchange rate R_0 are net exports zero. Higher real exchange rate, competitiveness is too low and net exports are negative. At a lower real exchange rate competitiveness too high and net exports are positive. When exchange rate rises export prices rise and

Balance of Payment (BoP) surplus occur. BoP removes pressure on interest rates and balances itself. BoP and ER (Exchange Rate) correct each other, self correcting mechanism. nd effect is on growth: Rising exchange rate has negative effect on growth. Price of exports are increased and this slows the growth. We need to understand Thirlwall Theory and Marshall Learner Condition in order to explore rising exchange rates effects on growth. Thirlwall's law (named after Anthony Thirlwall) states that if long run balance of payments equilibrium on current account is a requirement, and the real exchange rate stays relatively constant, then the long run growth of a country can be approximated by the ratio of the growth of exports to the income elasticity of demand for imports (Thirlwall, 1979).

If the real exchange rate varies considerably, but the price elasticities of demand for imports and exports are low, the long run growth of the economy will then be determined by the growth of world income times the ratio of the income elasticity of demand for exports and imports which are determined by the structural characteristics of countries.

One important example of this is that if developing countries produce mainly primary products and low value manufactured goods with a low income elasticity of demand, while developed countries specialise in high income elasticity manufactured goods the developing countries will grow at a relatively slower rate (Davidson, 1991). The Marshall Lerner Condition shows the conditions under which a change in the exchange rate of a country's currency leads to an improvement or worsening of a country's balance of payments.

Under a floating exchange rate regime a balance of payments disequilibrium should automatically be restored to equilibrium without the need for government policy. In the case of a fixed exchange rate, a devaluation or a revaluation may be used to restore disequilibrium. However, this is based on certain key assumptions which, some economists argue, do not apply to certain LDCs. The assumptions concern the extent to which a change in import and export prices affect the quantity of imports and exports demanded. The inflows and outflows of foreign currency recorded in a country's balance of payments account are dependent on these price changes.

Crucially the price elasticity of demand will determine the impact of the price change on the quantity of exports demanded and the quantity of foreign exchange earned. If the exchange rate of a country rises then the price of its exports will rise and the price of imports falls. Initially one might expect little to happen to the amount of exports and imports demanded as consumers take time to change their preference from domestically produced goods to imported goods. The balance of payments might be expected to surplus as the value of exports would rise and the value of imports would decrease.

In the longer time period once consumers' preferences have adjusted to the changes in imports and export prices then the amount of exports and imports will change. The amount by which they change will determine the effect on the balance of payments on current account. The extent of the change will depend upon the price elasticity of demand for imports and exports. If a balance of payments disequilibrium is to be restored then it is

important that the PED coefficient for exports is greater than 1 and that the PED coefficient for imports is greater than 1.

This is embodied in a condition called the Marshall Lerner Condition and this states that: " Provided that the sum of the price elasticity of demand coefficients for exports and imports is greater than one then a fall in the exchange rate will reduce a deficit and a rise will reduce a surplus. " 3rd effect is on unemployment: if you import finished goods rising exchange rate has downward pressure on growth and unemployment. If you import raw material rising exchange rate is good for the economy, growth is increased unemployment goes down.

The structural change caused by the appreciation of the dollar will create more employment opportunities in expanding sectors. The subsequent increase in employment is likely to exceed the initial rise in unemployment. A reduction in demand and output may cause job losses as businesses seek to control costs. Some job losses are temporary - reflecting short term changes in export demand and import penetration. Others are permanent if domestic industries move out of some export markets or if imports take up a permanently higher share of the UK market Some industries are more exposed than others to currency fluctuations - e. . sectors where a high percentage of total output is exported and where demand is highly price sensitive (price elastic) 4th effect is on inflation. Although inflation rises at first, BoP corrects its self and eventually effects on inflation will disappear. The appreciation of the dollar also has the effect of reducing inflationary pressures within the economy through the lower domestic prices of imports.

Also, the structural change brought about the appreciation will also
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contribute to lowering inflation in the long term by increasing efficiency in economic production.

This will minimise the need to tighten monetary policy in order to address inflationary concerns both in the short term and long term, resulting in lower interest rates. Keynesian model multiplier explain 45 degree and aggregated supply and demand. $E = C + I + G + (X - M)$ E= Expenditure C= Consumption I= Investment G= Government expenditure X= Export M= Import X-M= BoP
Economics - Lipsey & Chrystal-10th ed. - 2004- Oxford - New York -p432-3
Holding domestic and foreign price levels constant, a depreciation of sterling will make imports more expensive for domestic residents and UK exports cheaper for foreigners.

This is because UK residents will get less foreign currency for each pound sterling and foreigners will get more pounds for each unit of their own currency. Both foreigners and domestic consumers will shift spending towards to UK - produced goods, which have become cheaper relative to foreign goods. The net export function will thus shift upward. An appreciation of sterling (holding price levels constant) has the opposite effect. It makes UK goods relatively expensive, thus shifting the net export function downward. Exchange rate changes maybe brought by changes in interest rates implemented by the monetary authorities.

The domestic currency will generally appreciate (other things being equal) when the domestic interest rate is raised, vice versa. This is because more people will wish to buy assets denominated in the home currency to take advantage of the high domestic interest rates and a high demand for

anything including currency tends to push its price upwards. Changes in the exchange rate are important way in which monetary policy can exert leverage over domestic aggregate spending in an open economy with a floating exchange rate.

The results of these important chain of reasoning are summaries below; UK prices rise relative to foreign prices if either the UK inflation rate exceeds the rate in other major trading countries (with exchange rate fixed) or the pound sterling appreciates (with price levels constant). This discourages exports and encourages imports, causing the net export function to shift downwards. Essentials of economics - J. Soloman -3rd edition -2004 - Pearson Education - p296 Economic Growth The income and expenditure approach [pic] In figure below to continue lines are shown.

The 45 degree line out from the origin plots $C_d + W$ against Y . It is a 45 degree line because by definition $Y = C_d + W$. To understand this, consider what can happen to national income: either it must be spent on domestically goods (C_d) or it must be withdrawn from the circular flow. The other contentious line plots aggregate demand. In this diagram it is known as the national (or aggregate) expenditure line (E). It consists of $C_d + J$: in other words, the total spending on the product of domestic firms. If national expenditure exceeded national income, at say Y_1 there would be excess demand in the economy (of e-f).

In other words people would be buying more than was currently being produced. Firms would thus find their stocks dwindling and would therefore increase their level of production. In doing so, they would employ more

factors of production. National income would thus rise. If national income exceeded national expenditure, at say Y2 there would be insufficient demand for the goods and services currently being produced. Firms would find their stocks of unsold goods building up they would thus respond by producing less and employing fewer factors of production. National income would thus fall and go on falling until Y_e was reached.

Economics - N. Gregory Mankiw and Mark P. Taylor - 2006 - Thompson learning- London - p 685-6 The basic model of economic fluctuations Our model of short-run economic fluctuations focuses on the behaviour of two variables. The first variable is the economy's output of goods and services, as measured by real GDP. The second variable is the overall price level, as measured by the CPI or the GDP deflator. Notice that output is a real variable, whereas the price level is a nominal variable. Hence by focusing on the relationship between these two variables, we are highlighting the breakdown of the classical dichotomy.

We analyse fluctuations in the economy as a whole with the model of aggregate demand and aggregate supply, which is illustrated in figure 33. 2. On the vertical axis is the overall price level in the economy. On the horizontal axis is the overall quantity of goods and services. The aggregate demand curve shows the quantity of goods and services that households, firms and the government want to buy at each price level. The aggregate supply curve shows the quantity of goods and services that firms produce and sell at each price level.

According to this model, the price level and the quantity of output adjust to bring aggregate demand and aggregate supply into balance. Conclusion

While the appreciation of the exchange rate has many implications for the economy, ultimately, it will have an expansionary effect on the economy in the long term, largely through the instigation of structural change. The higher income flows that will accrue to industries will eventually flow to households through wages, which will in turn result in higher expenditure in the economy.

This will eventually lead to higher sustained levels of economic growth in the economy. The government needs to consider their response to the risks and environmental impacts associated with this.

- Intervene in the foreign exchange market, (Use reserves of dollars to buy excess ?)
- Impose direct restrictions on international transactions (e. g. tariffs, quotas)
- Adopt tighter aggregate demand policies. Restrictive monetary or fiscal policies, reduce UK imports due to reduced UK incomes, reduced inflation makes UK exports more competitive
- Allow the exchange rate to adjust