Edexcel (B) Economics A-level

Theme 3: The Global Economy

3.1 Globalisation

3.1.5 Exchange rate changes

Notes

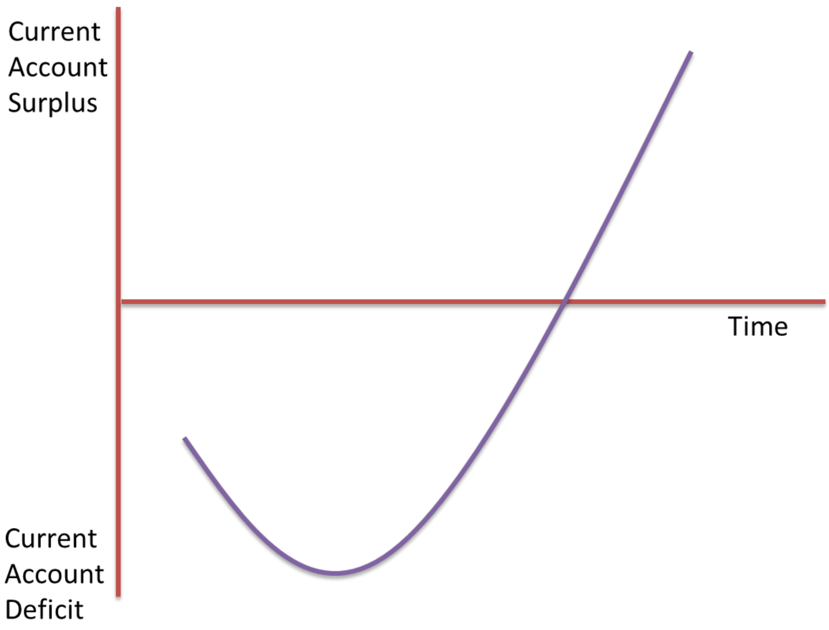
Impact of changes in exchange rates and the possible effects on:

A reduction in the exchange rate causes exports to become cheaper, which increases exports. This assumes that demand for exports is price elastic. It also causes imports to become relatively expensive. This means the UK current account deficit would improve.

However, this is inflationary due to the increase in the price of imported raw materials. Production costs for firms increase, which causes cost-push inflation.

Marshall-Lerner condition and the J-curve effect

The Marshall-Lerner condition states that a devaluation in a currency only improves the balance of trade if the absolute sum of long run export and import demand elasticities is greater than or equal to 1.



The J-curve effect occurs when a currency is devalued. Since devaluing the currency causes imports to become more expensive, at first the total value of imports increases, which worsens the deficit. Eventually, the value of exports decreases, which leads to a reduction in the trade deficit.

When the currency is devalued, there may be a time lag in changing the volume of exports and imports. This could be due to trade contracts and the price inelasticity of demand for imports in the short run, whilst consumers search for alternatives. In the long run, consumers might start purchasing domestic products, for example, which helps improve the deficit.

The effect of exchange rates on AD

The exchange rate affects AD because it affects the price of exports and imports. If the exchange rate appreciates, AD is likely to fall since imports become cheaper and exports become more expensive. Households are likely to switch from buying domestically produced goods to imports. However, this depends on the inflation rate. A lower domestic inflation rate, compared to other countries, might mean that consumers still purchase domestic goods. It also depends on the price elasticity of demand for domestic goods and imports. The UK has a high marginal propensity to import, so households are still likely to import goods, even if the pound appreciates.

A weaker exchange rate is likely to increase exports. This means that domestic firms can increase their sales and increase their profits. Jobs might be created as a result. If it is cheaper to import goods, because the value of the exchange rate increased for example, then jobs in the domestic industry might be lost since demand falls.

The effects of exchange rates on imports and exports can be remembered using the acronym SPICED:

Strong
Pound
Imports
Cheap
Exports
Dear

The effect of exchange rates on firms

A depreciation in the pound means that UK exports become more price competitive. Firms could then reduce the price of the good in the export market to increase sales, or they can keep the price the same to increase their profit margins.

However, if UK goods are relatively price inelastic, a depreciation in the pound will not increase sales in the export market significantly. Moreover, it depends on the rate of economic growth in the export market. The higher the level of consumer and firm confidence, and the more disposable income they have, the more likely they are to purchase UK exports.

If firms are net importers of raw materials, costs of production will increase because imports are relatively more expensive when the pound is weaker. This could make the firm less internationally competitive, and it could mean they make lower profits. However, if firms have fixed contracts for how long they import materials from another country, then changes in the exchange rate will not affect quantity purchased or the price paid. This reduces uncertainty of production costs for firms.

If the pound depreciates, firms might think that they can increase their profit margins by keeping the price the same, without having to increase efficiency or productivity to lower their average costs.

Foreign direct investment (FDI) flows

FDI is the flow of capital from one country to another, in order to gain a lasting interest in an enterprise in the foreign country.

A depreciation in the currency means the country's wages and production costs have fallen relative to other countries. This makes the country more internationally competitive and it is likely to attract more FDI.

Rate of inflation

A depreciation in the exchange rate is likely to be inflationary due to the increase in the price of imported raw materials. Production costs for firms increase, which causes cost-push inflation. Moreover, since AD will be increasing due to the higher level of exports, there could be upward pressure on the average price level.

The Eurozone

The Eurozone is a monetary union. Members of a monetary union share the same currency. This is more economically integrated than a customs union and free trade area.

A common central monetary policy is established when a monetary union is formed. The single European currency, the Euro, was implemented in 1999 to form the Eurozone.

Monetary unions use the same interest rate. The Euro, for example, floats against the US Dollar and the Pound Sterling. Member nations are required to control their government finances, so budget deficits cannot exceed 3% of GDP. This is one of the four convergence criteria countries have to meet in order to join the Euro. The other three are:

- Gross National Debt has to be below 6% of GDP
- Inflation has to be below 1.5% of the three lowest inflation countries
- The average government bond yield has to be below 2% of the yield of the countries with the lowest interest rates. This ensures there can be exchange rate stability.

The optimal currency zone is created when countries achieve real convergence. Member countries have to respond similarly to external shocks or policy changes. There has to be flexibility in product markets and labour markets to deal with shocks. This could be through the geographical and occupational mobility of labour, and wage and price flexibility in labour markets. Fiscal transfers could be used to even out some regional economic imbalances.

In the Eurozone, current account deficits are of greater concern because the countries have a fixed exchange rate. This means they cannot devalue the currency to restore their level of international competitiveness.

In early 2015, the pound reached a 7 year high against the Euro. This means that tourists from the UK going to the Eurozone are able to buy more for the same number of pounds.

It has been suggested that the fear of a Grexit helped the pound appreciate against the Euro. The nervousness surrounding the Euro makes the pound seem safer, so investors have more confidence in it.

It came shortly after the bond buying programme by the European Central Bank (quantitative easing). A weaker Euro means that exports from the Eurozone will be more competitive, which should help boost economic growth.

Economic decline in the Eurozone negatively affected the UK's exports, since Eurozone countries form a large proportion of UK trading partners, within the EU.

Advantages

The participating countries have more currency stability, and the currency is less prone to speculative shocks. This gives future markets more certainty, so there is more investment and growth potential.

There are fewer admin fees and less red tape when travelling abroad or exchanging money.

This also benefits firms which trade with the different member states. It is especially beneficial to small firms, who benefit from the time and money saving of a common currency.

The German monetary credibility might result in all member states having a lower interest rate. This might encourage more investment and spending, which might create more jobs.

Disadvantages

Labour mobility is limited across Europe due to language barriers. Moreover, the differences in economic performance between member countries means a common monetary policy might not be effective.

The exchange rate is not flexible to meet each country's need, such as if they need a boost in exports.

Member nations lose sovereignty when there is a common monetary union. This means that countries with a strong economy have to cooperate with countries that have weaker economies. They cannot adapt their policies to meet each individual requirement.

The one-off cost of joining a currency union of changing labels and prices can be significant.