IB Economics HL

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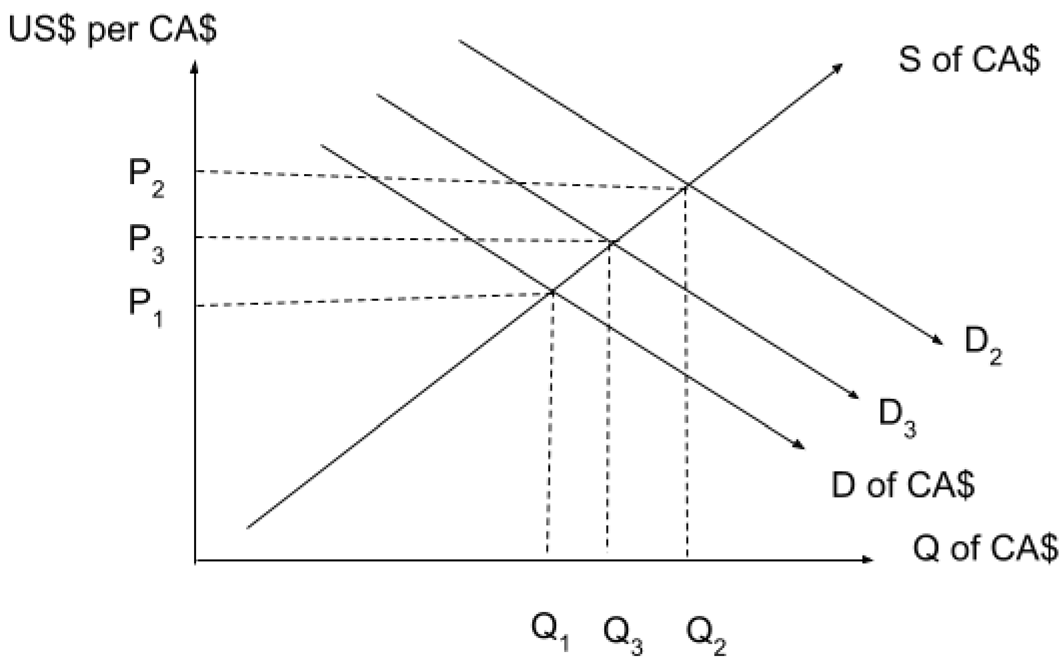
The article highlights how the Canadian dollar has stopped appreciating due to rising oil prices. This has led to more inflation in the country. Appreciation refers to the increase in the value of a currency when compared to other currencies. Inflation is the general rise in the market's price level of goods and services. Exports are goods and services sold to other countries in exchange for money. Interest rates determine the cost of borrowing money by determining the amount required to be paid back. Aggregate demand is the total amount of aggregate output that consumers want to buy at different possible price levels. Monetary policy includes policies carried out by the central bank influencing the supply of money to increase and decrease aggregate demand. The decrease in the appreciation of the Canadian dollar is further shown in Figure 1.

Figure 1: The Market for Canadian Dollars



The market for Canadian dollars is shown in Figure 1. In the article, it states that oil prices have gone up due to the war between Russia and Ukraine. Oil is a primary input in the production of many goods, and so many producers must continue to buy oil even with the increased prices. Canada is an exporter of oil. As the prices of oil have gone up, we can see an increase in the demand for Canadian dollars from D to D_2, resulting in an appreciation of the Canadian dollar from P_1 to P_2. However, this relationship has changed for some reason and the increased oil prices are not increasing the demand for the Canadian dollar as much as they should be. This is shown by an increase from D to D_3, which results in a weaker Canadian dollar at P_3 than what it should be, P_2. When a currency appreciates, the aggregate demand of that country falls. This is because the higher value currency makes products originating in the country more expensive, decreasing exports. Furthermore, products from other countries whose currencies have not appreciated become cheaper, resulting in increased imports. A fall in aggregate demand results in lower inflation. However, a lower appreciation of a currency leads to a smaller fall in inflation. As Canada is experiencing an inflation rate of 5.1%, which is too high, other methods must be used to reduce inflation. An alternative method of reducing inflation stated in the article is shown in Figure 2.

Figure 2: The Market for Money in Canada

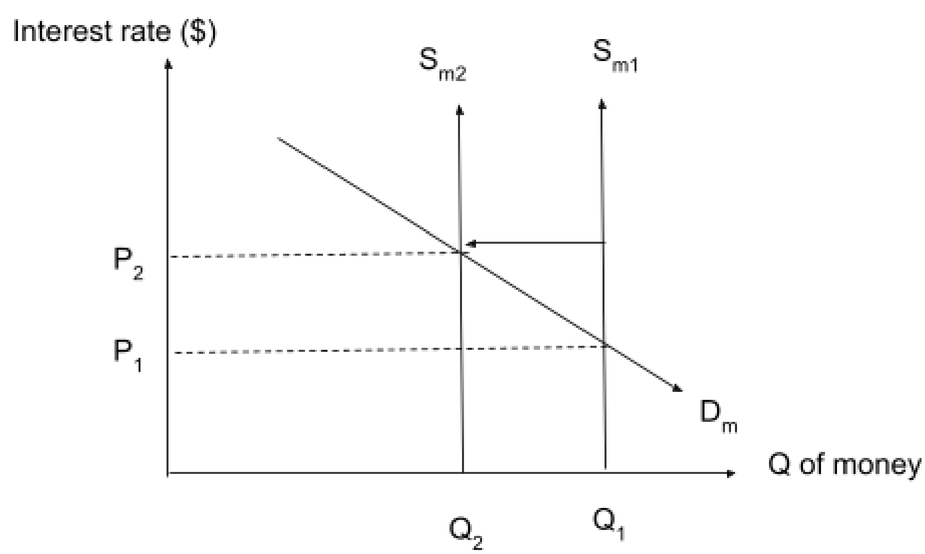


Figure 2 shows the money market in Canada. A solution central banks use to decrease inflation is monetary policy. This policy involves the central bank decreasing the supply of money in a country, as shown in Figure 2 from S_{m1} to S_{m2}. This causes the interest rate of a country to go up(in this case from P_1 to P_2). As the interest rate of a country increases, consumers and firms will be able to borrow less money due to the increased price of money. This results in less consumer spending and investment, leading to lower aggregate demand and thus lower inflation. Increasing the interest rate of a country also appreciates the currency of the country as higher interest rates attract foreign investors, who demand the currency of the country to invest in the country, increasing demand for the currency.

Increasing the interest rate of a country by decreasing the supply of money can have many adverse effects. Monetary policy cannot deal with stagflation or cost-push inflation, which is inflation that occurs as a result of increased aggregate supply. Decreasing inflation through a decrease in aggregate demand can lead to increased unemployment in the market. However, there are many benefits to using monetary policy to decrease inflation. Monetary policy can be used incrementally to fine-tune the economy. Monetary policy also takes effect relatively quickly, when compared to fiscal policy. Monetary policy also does not need the use of the government budget. In this scenario, where the currency was not appreciating enough and inflation was too high, the benefits of monetary policy greatly outweigh the consequences as increasing interest rates appreciate a currency and reduce inflation.

The problem of inflation arose due to change in the economy. The relationship between the Canadian dollar and increasing oil prices changed. This change resulted in more changes in the Canadian economy that stakeholders of the economy did not expect. Inflation reached a 30-year high of 5.1%. The central bank changed key interest rates for the first time in 3 years.

These changes show that economies are unpredictable and stakeholders of the economy (consumers, producers, government etc.) must always be prepared for the changes.

In conclusion, to appreciate the Canadian dollar and decrease inflation, monetary policy is the best solution the central bank could have used as it solves all the problems faced by the economy with very few consequences.