



Overview

(/study/app)

4. The global economy / 4.6 Balance of payments

186-

cid-

754025/



(https://intercom.help/kognity)



Balance of payments

Section

Feedback

Table of
contents

The balance of payments is a record of all monetary inflows and outflows of a country. Think of it like your bank account, with money coming in and money going out. It is extremely important information for policy makers, investors and economists. The balance of payments has only to do with monetary inflows and outflows of a country; that is, whenever money changes hands for a good, service, investment, property or remittance, among other things. The IMF has a [comprehensive guide](http://www.imf.org/external/pubs/ft/bopman/bopman.pdf) (http://www.imf.org/external/pubs/ft/bopman/bopman.pdf) on how countries should construct the balance of payments, the essential detail of which is outlined below.



Glossary

Reading
assistance

Surplus and deficits on an account

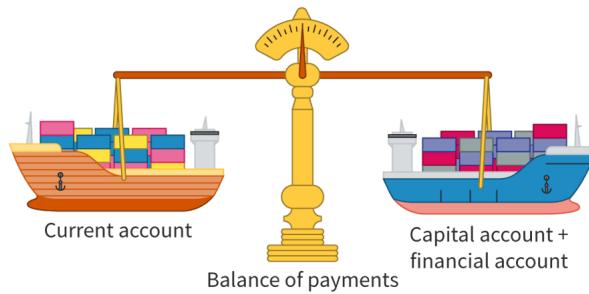


Figure 1. The balance of payments is a record of international transactions between the residents of one country and the rest of the world.

[More information for figure 1](#)


The image depicts a balance scale in the center, with two ships on either side, symbolizing the concept of the balance of payments. The left ship is labeled 'Current account' and is filled with colorful containers. The right ship is labeled 'Capital account + financial account' and carries similar containers. The balance scale suggests the weighing and balancing of these accounts in international transactions.

[Generated by AI]

The balance of payments is a record of the value of all transactions between the residents of one country and the residents of all other countries in the world over a given period of time. The three main components of the balance of payments are the current account, the capital account and the financial account.

As you can see from **Figure 1**, the balance of payments (BoP) is made up of two halves:

$$\text{BoP} = \text{Current account} + \text{Capital account} + \text{Financial account} = 0$$

Home
Overview
(/study/app/
186-
cid-
754025/

The current account records transactions in goods and services. It records money flowing overseas to pay for imports, and money flowing into the country in exchange for selling exports. The current account also includes income flows and transfers, such as foreign aid.

Where does United States export to? (2018)

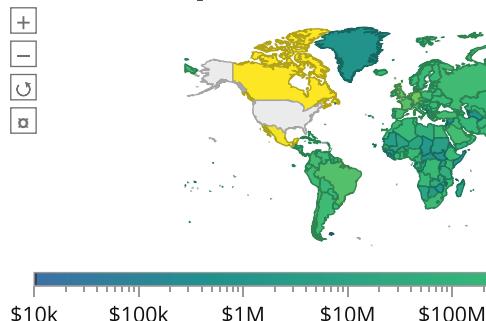


Figure 2. Where does the United States export to?

Source: <https://oec.world/en/visualize/embed/geomap/hs92/export/usa/show/all/2018/?controls=false>

(<https://oec.world/en/visualize/embed/geomap/hs92/export/usa/show/all/2018/?controls=false>)

More information for figure 2

This interactive world map is displaying the export data of the United States for the year 2018. The interface allows users to explore the geographical distribution of U.S. exports using a color-coded representation, where different countries are shaded based on the volume of trade. Users can move their cursor over any country to reveal a tooltip displaying trade values and key exported goods. A color gradient indicates the scale of exports, helping users visually compare trade volumes across different countries. The total value of U.S. exports in 2018 reached approximately \$1.44 trillion. The top trading partner based on export value includes: Canada: \$318 billion — including vehicles, machinery, and mineral fuels. Mexico: \$265 billion — including machinery, electrical equipment, and vehicles. China: \$120 billion — with major exports in aircraft, soybeans, and integrated circuits. South America and Africa have lower export volumes but still feature important trade relationships, such as Brazil and South Africa. Users gain insight into the global distribution of U.S. exports in 2018. They can identify key trading partners of the United States and compare the relative export volumes across regions.

Student view

The capital account and financial account record transactions in income-producing assets. The income earned from the assets is recorded in the current account.

In section 4.6.2 (</study/app/pp/sid-186-cid-754025/book/components-of-the-balance-of-payments-id-30960/>), we will explore each component in more detail.

The balance of payments should always 'balance' and so be equal to 0. The balance of payments (in theory) should balance because any transaction in one account is offset by an equal transaction in the other account.

⚠ Be aware

Although we say that the balance of payments should equal 0, in reality, it might not as there is often an omission or statistical error. However, in economics we assume that it is equal to 0 to create simplicity for economic models.

Home
 Overview
 (/study/app/
 186-
 cid-
 754025/)

If a country imports more than it exports, it will have a current account deficit of, for example, \$1000. How will the country pay for the deficit? One possibility is to borrow \$1000 from abroad. This transaction will be recorded on the financial account.

Therefore, any deficit on the current account will be offset by a surplus on the capital and financial account surplus.

Therefore, we can summarise the behaviour of the balance of payments as follows:

$$\text{Current account} = - (\text{Capital account} + \text{Financial account})$$

For example, imagine a country has a current account surplus of \$500 billion, and the capital account is also in surplus by \$100 billion. Calculate the **financial** account.

$$\text{Current account} = - (\text{Capital account} + \text{Financial account})$$

$$500 \text{ billion} = - (100 \text{ billion} + \text{Financial account})$$

$$\text{Financial account} = - 600 \text{ billion}$$

Worked example 1:

1. Imagine a country has a current account surplus of \$200 billion, and the capital account is also in surplus by \$100 billion. Calculate the **financial** account.

$$\text{Current account} = - (\text{Capital account} + \text{Financial account})$$

$$200 \text{ billion} = - (100 \text{ billion} + \text{Financial account})$$

$$\text{Financial account} = - 300 \text{ billion}$$

Student view

2. Imagine a country has a capital account surplus of \$100 billion, and a financial account deficit of \$300 billion. Calculate the **current** account.

$$\text{Current account} = - (\text{Capital account} + \text{Financial account})$$

$$\text{Current account} = - (100 \text{ billion} + (-300 \text{ billion}))$$

$$\text{Current account} = - (-200 \text{ billion})$$

$$\text{Current account} = 200 \text{ billion}$$

Important

The balance of payments relates to money exchanges to and from a country. It does not relate to physical goods or services entering or leaving a country. When a good is imported, for example, that is recorded as a debit because money leaves the country, even though the physical item comes into the country.

Credit and debit items

When money leaves a country it is called a debit. This includes money leaving a country for investment, imports, aid to other countries, purchase of foreign businesses, and so on. Money coming into a country is referred to as a credit. Credits include the purchase of assets, businesses, property and domestically produced goods by people in other countries.



Figure 3. Credits and debits refer to money flowing into (credit) and out of (debits) the economy.

Credit: Getty Images mariusz_prusaczyk

Countries are often concerned about imbalances on the balance of payments. If a country has a current account deficit, it must by definition manage a capital account surplus or financial account surplus. Throughout this subtopic, we will find out more about the strain on an economy from an imbalance within the balance of payments.

Case study

Dominica's current account deficit

Dominica is a small island located in the Caribbean. Its location makes it vulnerable to tropical hurricanes, which have caused severe damage. The island is very mountainous and only 25% of the land is arable. Dominica specialises in the cultivation of bananas. On the whole, the economy is very dependent on banana exports to the EU. In 2018, the IMF declared that Dominica's current account deficit was equal to 40.9% of its GDP.

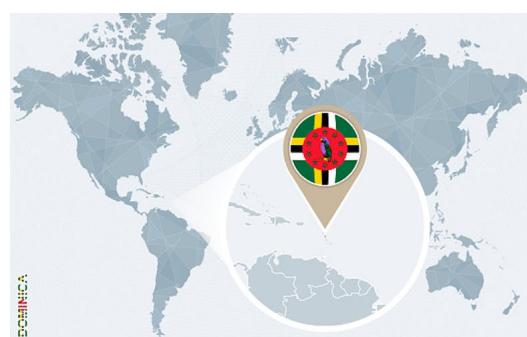


Figure 4. Dominica is a small island located in the Caribbean.

Credit: Getty Images ekavector

 More information for figure 4

If Dominica's current account deficit is equal to 40.9%, what are the implications for the other accounts on the balance of payments?

In order for the balance of payments to balance, what must be true about the capital and financial accounts?

Find out more about Dominica from the most recent [report ↗](#) (<https://www.imf.org/external/pubs/ft/scr/2016/cr16244.pdf>) from the IMF.

Complete section with 3 questions

[Start questions](#)[◀ Previous section \(/study/app/pp/sid-186-cid-754025/book/the-big-picture-id-30345/\)](#)[Next section ➤ \(/study/app/pp/sid-186-cid-754025/book/com...](#)



(https://intercom.help/kognity)



Overview
(/study/app)

4. The global economy / 4.6 Balance of payments

186-
cid-
754025/

Table of
contents

Notebook
Glossary
Reading
assistance

Student
view

Components of the balance of payments

The current account

The current account is the most frequently discussed balance-of-payments account, because of the large trade volumes around the world. Most countries that get into balance-of-payments difficulties will have problems in their current account.

The current account is a record of all the money coming into and going out of a country for trade in goods and services, income flows and transfers.

There are four components of the current account:

1. Balance of trade in goods: This is the visible balance, where tangible goods are traded between countries. When a country imports goods, the import expenditure leaves the country and is recorded as a debit on the current account. When a country exports goods, money enters the country and this is recorded as a credit on the current account.



Figure 1. Trade in goods refers to the export and import of physical goods.

Credit: Getty Images wildpixel

2. Balance of trade in services: This is the invisible balance, consisting of the balance of trade of legal services, hospitality, consultancy, and so on. This sector is a major earner for developed nations for a number of reasons. As countries grow and develop, they move away from primary and secondary industries towards tertiary industries that have the ability to generate large amounts of surplus value. In turn, these countries provide these same services to those countries that have yet to develop a sophisticated service sector.

3. Income: Income refers to the factor payments for the factors of production. You might own property in another country and receive rent that is credited to the current account of the country you live in. This component also includes investment income in the form of, for example, dividend payments when you own shares of a company. It is not the same

- as when the purchase of an asset is made, which is covered by the financial account, but refers to only the income derived from owning that asset, such as earning interest on bonds.
- 4. Current transfers:** A transfer on the current account refers to a payment between one government and another that is **not** in exchange for any good or service. An example is foreign aid.

ⓘ Exam tip

When you define the current account in an exam, it is important that you *include all four components*, not just the balance of trade, or you will lose marks.

When the sum of the four components of the current account is negative, we say it is a **current account deficit**. When the sum is positive, it is called a **current account surplus**. It is true that most of the time countries import more than they export, causing a current account deficit, but it can also be because the current and income transfers outweigh the balance of trade.

The capital account

The **capital account** is usually the smallest of the three accounts, because of the nature of its constituents.

The capital account is a record of all the transfers of ownership of capital and other assets between countries.

There are two components of the capital account:

- 1. Capital transfers:** Capital transfers consist of transactions involving transfers of ownership of fixed assets, transfers of funds linked to the buying and selling of fixed assets, or debt forgiveness.
- 2. Transaction in non-produced, non-financial assets:** Non-produced assets largely cover intangibles, such as patented entities, leases or other transferable contracts, and payments of goodwill. For example, a lease is a contractual arrangement between a landlord and a tenant. A company in country A can sell a lease that it owns to another company in country B. This will be recorded as a credit on country A's capital account and a debit on country B's capital account.

The financial account

The financial account is extremely important in the balance of payments. It is the account that most helps to balance the balance of payments.

The financial account is a record of all financial transactions and direct investment between countries, and currency reserves held by central banks.

There are four main components of the financial account:

- 1. Foreign direct investment (FDI):** Foreign direct investment is the purchase of a firm, or part of a firm, by a firm from another country. When companies do this, they become multinational corporations. When only part of a firm is bought, it must be at least 10% of the shares of the company to be considered a foreign direct investment.



Overview
(/study/ap/
186-
cid-
754025/)



Figure 2. Dutch company Shell building an oil refinery in Nigeria is an example of foreign direct investment.

Credit: Getty Images krisanapong detraphiphat

2. Portfolio investment: Portfolio investment refers to the purchase and sale of financial capital. This includes shares, bonds, derivatives, the trading of commodities and currencies. This only considers the transfer of funds when a purchase is made, not the income derived from that investment (such as dividends from owning shares, which is included under the current account).

⚠ Be aware



Figure 3. Shareholders receive income from the shares they own on a routine basis — these are called dividend payments.

Credit: Getty Images Peter Garrard Beck

People who own shares in a company are called shareholders. Buying shares and receiving dividend income from shares are **not** the same thing. They do not appear in the same place in the balance of payments.

When you buy a share, it appears in the **financial account** under portfolio investment.

The money you make from dividends (which are part of the profits of the company) is considered income flows and is part of the **current account**.



3. **Reserve assets:** These are the foreign currency reserves held by central banks. These should include paper money, deposits, government bonds and securities.

Overview
(/study/ap)

186-

cid-

754025/

4. **Official borrowing:** Official borrowing occurs when the government borrows (debit) or lends (a credit item) money from the IMF, World Bank, or the government of another country.

Activity

Research (https://en.wikipedia.org/wiki/List_of_countries_by_current_account_balance) the components of the balance of payments for your country. Is your country facing a current account deficit or surplus?

Test your knowledge of the components of the balance of payments. For this exercise, you will be given a particular scenario and you must decide:

1. Where it will be recorded on the balance of payments for New Zealand
2. Whether it will be a credit or debit item



Student
view

Interactive 1. Exercise on the Components of the Balance of Payments.

More information for interactive 1



Overview

(/study/app/

186-

cid-

754025/

This interactive visually represents concepts related to balance of payments, particularly how international transactions are recorded. The interface is divided into six sections that outline various economic scenarios, each with multiple-choice questions to assess understanding.

This section presents real-world economic scenarios where users must decide:

1. Which account (Current, Capital, or Financial) records the transaction?
2. Is the transaction a credit (money inflow) or a debit (money outflow)?

The interface displays each question in text format at the top, with answer options below. Each answer option is presented in a multiple-choice format with radio buttons. Selecting answers trigger instant feedback with explanation. Correct! if the choice is accurate. Incorrect if the answer is incorrect.

Users can navigate using the Tab key and select options with Enter/Space.

This interactive provides an engaging and structured way to learn about Balance of Payments, making it accessible to both students and professionals. The combination of multiple-choice questions, real-world examples, and interactive feedback helps users grasp the complexities of international financial transactions effectively.

Complete section with 4 questions

Section

Feedback

[Start questions](#)[◀ Previous section\(/study/app/pp/sid-186-cid-754025/book/balance-of-payments-id-30959/\)](#)[Next section ➤\(/study/app/pp/sid-186-cid-754025/boc](#)Student
view



Table of
contents



Notebook

The accounts of the balance of payments are interdependent. When we add the three accounts together, they will equal zero! You may find this a mind-boggling fact to deal with, so let us look at why it is true.



Glossary



Reading assistance

This appears to be quite complex, but it is just a result of double-entry accounting by those who compile the balance of payments statistics. Double-entry means that for every recorded value in an account, there is an equal and opposite amount recorded in another account. Take your own personal accounts, for example. You have money coming in during the month (credit) and you have money going out each month (debit). If you have more money coming in than you have going out then you are running a surplus on your accounts. What did you do with this surplus money? It must have gone somewhere, and the double-entry indicates what you did with it. For example, you may have used the surplus and put it in the bank as savings, or you may have used it to pay back past debts, or you may simply decide to keep it in reserve for the future. If you have more money going out than is coming in, you are running a deficit on your accounts and in this case you must be able to show where this extra money came from. You may have borrowed it or you could have run down your reserves, but either way it must have come from somewhere.

Student view



Figure 1. The balance of payments must always balance!

Credit: Getty Images Dimitri Otis

The balance of payments accounts work in exactly the same way, except that the income flows are in different currencies and this limits where the money can be spent. For example, if your kind relative who lives in the US sends you USD 200 each month, you are limited to spending that money in the US. Maybe you will invest it in an American bank or just keep it in your reserves of dollars, but it will be recorded somewhere as to what you did with it.

Now let's apply the same concept to the balance of payments. Assume we buy a Japanese car in the US for USD 10 000. At some point in time, a currency exchange needed to take place to get that car into the US, and the Japanese car firm needed to be paid around JPY 1.2 million for the car (assuming there were no transaction costs). At the moment, we have a debit on the current account of the US of USD 10 000 and a credit on Japan's current account of JPY 1.2m.

In order to acquire the foreign currency needed for the purchase, someone (for simplicity, let us assume they are Japanese) with Japanese yen needed to sell their yen for dollars. The Japanese person or firm now has dollars. What are they going to do with those dollars? Is there a country where they might spend those dollars to invest in order to earn interest? You guessed right – it is the US!

✓ **Important**

Remember that the balance of payments always has a zero balance.

The current account and the capital and financial accounts are interdependent. A change in one account will cause an opposite, but equal, change in another. Let us remember: buying a Japanese car in the US is a debit on the US current account and a credit on Japan's current account. Now, here is why the balance of payments balances: those in receipt of dollars for the purchase of the car will invest their dollars in US assets, creating a credit in the US financial account and a debit in Japan's financial account. A country's currency can only be spent on things from within that country. Therefore, the double-entry for Japan will be a credit on their current account and an equal debit on their financial account. Even if they use the dollars to build up their reserve of dollars in Japan it will appear as a debit on their financial account.



Figure 2. A surplus on one account is matched by an opposite but equal deficit on the other.

Credit: Getty Images Andrii Yalanskyi

✓ **Important**

On the balance of payments, surpluses are matched by deficits. The current account and the capital and financial accounts are interdependent. A change in one account will cause an opposite, but equal, change in another.

This is true for the opposite scenario too, that a credit on the current account will result in a debit on the financial account.

Students often ask: why doesn't a country's currency just get spent on goods and services from that country? In other words, why doesn't country A, which earns money from selling its exports to country B, not just spend this money on country B's products?

Home
Overview
(/study/app/
186-
cid-
754025/)

Of course it could, but in reality, this is rarely the case because international trade is crucial in today's world. There is a pattern to what is produced by different countries, and the situation for each country's balance of payments is simply the result of where things are produced and where we have to buy them from. We saw this in the section on absolute and comparative advantage.

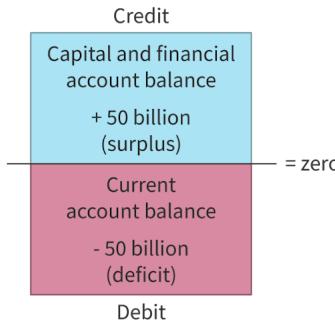


Figure 3. Credits must always be offset by debits, so the balance of payments is always equal to 0.

Source: "Reserve Bank of Australia (<https://www.rba.gov.au/>)"

More information for figure 3

The diagram illustrates the balance of payments, highlighting the credit and debit sections. At the top, labeled "Credit," is a blue rectangle indicating the "Capital and financial account balance" with a note of "+50 billion (surplus)." Below it is a horizontal line representing "= zero." Underneath, labeled "Debit," is a red rectangle showing the "Current account balance" with "-50 billion (deficit)." The visual suggests that the surplus in the capital and financial account offsets the deficit in the current account, resulting in a zero balance.

[Generated by AI]

Section

Complete section with 3 questions

Feedback

Student view

Start questions

Previous section (/study/app/pp/sid-186-cid-754025/book/components-of-the-balance-of-payments-id-30960/)

Next section (/study/app/pp/sid-)



(https://intercom.help/kognity)



Home

Overview

(/study/app/

186-

cid-

754025/

4. The global economy / 4.6 Balance of payments

Section

Feedback

Table of
contents

Notebook In theory, deficits and surpluses in the current account are automatically adjusted under a flexible (floating) exchange rate.



Glossary

Reading
assistance

A current account surplus and the exchange rate

The current account refers to a record of transactions of goods, services, income and transfer flows from one country to the rest of the world. A current account surplus occurs when revenue arising from the sale of exports, inflowing income and transfers is greater than funds flowing overseas to pay for imports, outgoing income and transfers. In 2019, Germany had the largest current account surplus in the world because it is a world leader in the export of cars, machinery and pharmaceuticals.

Current account balance (BoP, current US\$)

Data from [World Bank](#)Student
view

Figure 1. Current Account Balance of Germany from 1971 to 2019.

Source: "[World Bank \(https://data.worldbank.org/indicator/BN.CAB.XOKA.CD?locations=DE\)"](https://data.worldbank.org/indicator/BN.CAB.XOKA.CD?locations=DE)"

More information for figure 1

This line graph presents Germany's Current Account Balance over time, sourced from World Bank. The chart helps users analyze trends, surpluses, or deficits in Germany's external financial transactions. The x-axis represents years from 1971 to 2019, showing how the balance has changed over decades. The y-axis displays the current account balance in USD (Billions), indicating whether Germany had a surplus (positive values) or deficit (negative values). A rising trend means an increasing surplus or decreasing deficit. A falling trend suggests a decreasing surplus or widening deficit. The data points marked on the graph are as follows.

Year	Current Account Balance (BoP, Current US\$)
1971	106,579,705

Year	Current Account Balance (BoP, Current US\$)
1972	339,337,168
1973	4.18 Billion
1974	9.08 Billion
1975	3.1 Billion
1976	3.75 Billion
1977	3.9 Billion
1978	9.28 Billion
1979	Negative 5.39 Billion
1980	Negative 15.66 Billion
1981	Negative 5.3 Billion
1982	4.51 Billion
1983	45.35 Billion
1984	9.21 Billion
1985	17.99 Billion
1986	38.66 Billion
1987	44.22 Billion
1988	53.96 Billion
1989	57.05 Billion
1990	46.46 Billion
1991	Negative 22.38 Billion
1992	Negative 21.06 Billion



	Year	Current Account Balance (BoP, Current US\$)
	1993	Negative 16.18 Billion
	1994	Negative 29.28 Billion
	1995	Negative 27.68 Billion
	1996	Negative 12.34 Billion
	1997	Negative 7.9 Billion
	1998	Negative 10.67 Billion
	1999	Negative 25.85 Billion
	2000	Negative 29.76 Billion
	2001	Negative 3.35 Billion
	2002	41.72 Billion
	2003	38.84 Billion
	2004	129.32 Billion
	2005	134.35 Billion
	2006	177.8 Billion
	2007	233.63 Billion
	2008	212.41 Billion
	2009	204.41 Billion
	2010	200.15 Billion
	2011	239.39 Billion
	2012	258.79 Billion
	2013	256.18 Billion

Year	Current Account Balance (BoP, Current US\$)
2014	285.24 Billion
2015	277.32 Billion
2016	314.86 Billion
2017	304.19 Billion
2018	342.18 Billion
2019	311.83 Billion

As the demand for German exports rises, countries will demand more domestic currency (the euro). This will push out the demand curve from D to D_1 , increase quantity from Q_1 to Q_2 and lead to an appreciation of the euro in terms of USD from P_1 to P_2 .

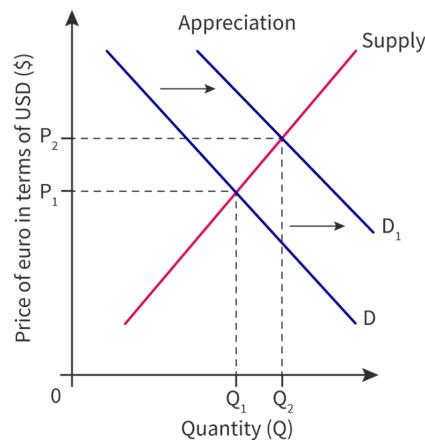


Figure 2. A current account surplus will lead to an appreciation.

[More information for figure 2](#)

The image is a graph illustrating the effects of a current account surplus on currency appreciation. The X-axis represents Quantity (Q), ranging from 0 onward, with marked points at Q_1 and Q_2 . The Y-axis represents the Price of euro in terms of USD (\$), with marked points at P_1 and P_2 .

There are two demand curves labeled D and D_1 . The original demand curve (D) shifts rightwards to D_1 , indicating an increase in demand. The supply curve intersects both demand curves, and the intersection points show the prices and quantities at which the euro appreciates.

The intersection of the supply curve and D indicates initial price P_1 and quantity Q_1 . The intersection of the supply curve with the shifted demand curve D_1 indicates a new equilibrium at price P_2 and quantity Q_2 , illustrating the currency appreciation as the demand increases, moving the demand curve from D to D_1 along with an increase in the euro's valuation from P_1 to P_2 .

[Generated by AI]

Over time, as you can see in **Figure 2**, an appreciation will cause the price of exports to rise and the price of imports to fall in terms of foreign currency. A rise in export prices will decrease the demand for exports and so close the trade surplus. Consumers will start buying cheaper Japanese or Korean cars rather than more expensive German cars. At the same time, imports will become cheaper, and Germans may choose to switch to imports. As imports rise, and exports decrease, the economy will move into a trade balance.

✓ Important

Exchange rates adjust relative to one another. If one country devalues their exchange rate, how will it affect the exports of other countries? Should countries enter into international agreements to avoid competitive devaluations?

A current account deficit and the exchange rate

A current account deficit may occur if a country faces falling exports or rising imports. In 2019, the US had the largest current account deficit in the world. [↗ \(<https://stats.unctad.org/handbook/EconomicTrends/CurrentAccount.html>\)](https://stats.unctad.org/handbook/EconomicTrends/CurrentAccount.html) Some argue that the tax cuts introduced in 2017 helped to finance more domestic spending – on imports. Therefore, US residents will need to sell USD to buy foreign currency to pay for imports. This results in an increase in the supply of USD from S_1 to S_2 and a depreciation of the USD from P_1 to P_2 .

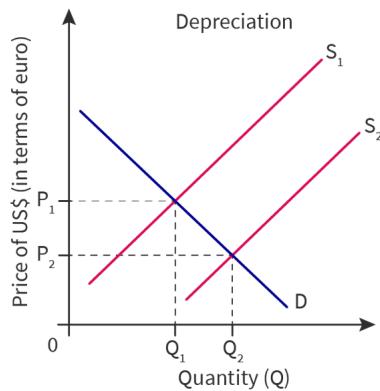


Figure 3. Current account deficits put downward pressure on the exchange rate.

↗ More information for figure 3

The image is a graph depicting the relationship between the price of the US dollar (in terms of euros) and the quantity (Q). The Y-axis represents the price of US dollars in terms of euros, with labels P_1 and P_2 indicating different price levels. The X-axis represents the quantity of US dollars, labeled Q_1 and Q_2 .

There are two supply lines, S_1 and S_2 , and one demand line, D . S_1 and S_2 are upward sloping, with S_2 positioned to the right of S_1 , indicating an increase in supply from S_1 to S_2 . The demand line, D , is downward sloping.

The initial equilibrium is at the intersection of S_1 and D , at price P_1 and quantity Q_1 . After the supply increase to S_2 , the new equilibrium is at a lower price P_2 and a higher quantity Q_2 . This illustrates a depreciation of the USD as the supply increases, moving the equilibrium from P_1 and Q_1 to P_2 and Q_2 .

[Generated by AI]

✓ Important

A current account deficit will lead to a depreciation.

Now that USD are cheaper, US exports become more attractive and the trade balance can return to zero.

⚙️ Activity

Currency traders trade currencies to make profits. They identify currencies that they believe may appreciate and purchase them. When they rise in price, currency traders sell them, and so make a profit.



Figure 4. Will you be a successful currency trader?

Credit: Getty Images honglouwawa

 More information for figure 4

The image is a double exposure photograph showing U.S. dollar bills overlaid with a stock market graph. The face of Benjamin Franklin is prominent from a hundred-dollar bill, with other bills partially visible in the background. Superimposed over the currency is a fluctuating line graph representing financial market trends. The lines show various upward and downward trends, potentially indicating changes in currency values or stock prices. In the lower part of the image, there are out-of-focus city lights creating a bokeh effect, adding a sense of urban activity and hustle related to financial markets.

[Generated by AI]

As IB students, we know that in the long run, we would expect the currencies of countries that have current account surpluses to appreciate.

In your class, carry out a competition over the academic year to predict which currencies will appreciate the most.

Try using this website [↗ \(https://tradinggame.com\)](https://tradinggame.com).

Will you be a successful currency trader?

Complete section with 3 questions

 Start questions



Overview

(/study/app/

186-

cid-

754025/

[◀ Previous section \(/study/app/pp/sid-186-cid-754025/book/interdependence-between-the-accounts-id-30961/\)](#)[Next section ➤ \(/study/app/pp/sid-186-cid-754025/book/the-current-account-and-the-exchange-rate-hl-id-30962/\)](#)Student
view



Overview
(/study/app/
186-
cid-
754025/)

4. The global economy / 4.6 Balance of payments



(https://intercom.help/kognity)



The financial account and the exchange rate (HL)



In 2015, the Swiss franc faced a sudden appreciation of 20%. There had been upward pressure on the Swiss franc for several years, and the Swiss Central Bank could no longer intervene in the market to maintain the peg. On 15 January, the peg was removed, and the forces of demand and supply were free to determine the Swiss exchange rate. But why did the Swiss franc suddenly appreciate?



Glossary



Notebook



Reading assistance

It was due to a rising surplus on the financial account.

The 2008 financial crisis created a lack of confidence in the EU banking system. A series of bank failures in Cyprus and concerns over the Greek, Spanish and Italian banks convinced foreign investors to find a safe haven for their money. Switzerland is considered to be a safe haven, and so over time, more and more foreign investors deposited money in Swiss banks. This caused capital inflows and a surplus on the financial account.

This influx of foreign money in Swiss banks led to an increase in the demand for Swiss francs. This pushed out the demand curve from D to D_1 , increased the quantity from Q to Q_1 and led to an appreciation from P to P_1 .

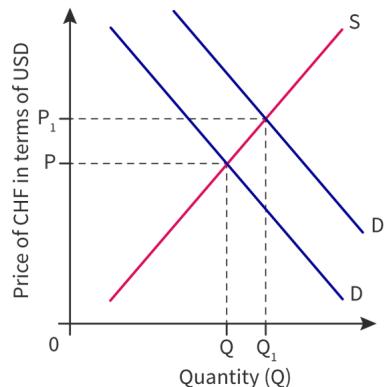


Figure 1. A surplus of the financial account can cause an appreciation.

More information for figure 1

The image is a graph illustrating the relationship between supply, demand, and price changes for Swiss francs in terms of USD. The X-axis represents the Quantity (Q) of Swiss francs and the Y-axis represents the Price of CHF in terms of USD. Both axes are labeled appropriately. The graph shows two downward-sloping demand curves: an initial demand curve (D) and a shifted demand curve (D_1), indicating an increase in demand. There is also an upward-sloping supply curve labeled S. The intersection of the original demand (D) and the supply (S) curve represents the initial equilibrium at point P with a corresponding quantity Q. After the demand curve shifts to D_1 , the new intersection indicates a higher price level at P_1 and a greater quantity at Q_1 , demonstrating the appreciation of Swiss francs when the demand increases.

[Generated by AI]

However, the appreciation will have feedback effects on the current account. This appreciation will cause the price of exports to rise and the price of imports to fall (in terms of foreign currency). A rise in export prices will decrease the demand for exports and so lead to a current account deficit. At the same time, imports will become cheaper, and domestic consumers may choose to switch into imports. As imports rise and exports decrease, the economy will move into a trade deficit and therefore worsen the current account.

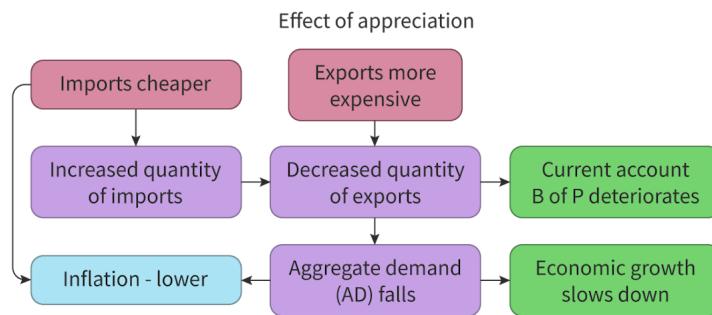


Figure 2. An appreciation can lead to a current account deficit.

More information for figure 2

This flowchart titled 'Effect of appreciation' illustrates the impacts of currency appreciation on various economic factors. The flowchart begins with two primary nodes at the top: 'Imports cheaper' and 'Exports more expensive.' Arrows flow downwards from 'Imports cheaper' to 'Increased quantity of imports,' indicating that cheaper imports increase their quantity. Another arrow leads from 'Increased quantity of imports' to 'Inflation - lower,' showing that increased imports lower inflation.

Simultaneously, an arrow from 'Exports more expensive' points to 'Decreased quantity of exports,' showing that more expensive exports reduce their volume. The next step links 'Decreased quantity of exports' to 'Aggregate demand (AD) falls,' demonstrating a decrease in overall demand due to lower exports.

Two final outcomes result from these changes. The first is that 'Current account B of P deteriorates,' shown by an arrow from 'Decreased quantity of exports.' The second, shown by an arrow from 'Aggregate demand (AD) falls,' is that 'Economic growth slows down.' This path summarizes how both increased imports and decreased exports together negatively affect the broader economy.

[Generated by AI]

Case study

Global currency depreciations

During 2020, many emerging economies faced currency depreciations (https://www.koreatimes.co.kr/www/biz/2020/05/488_289082.html). The currencies of Brazil, South Africa and Mexico depreciated by more than 20%. Why did this happen?

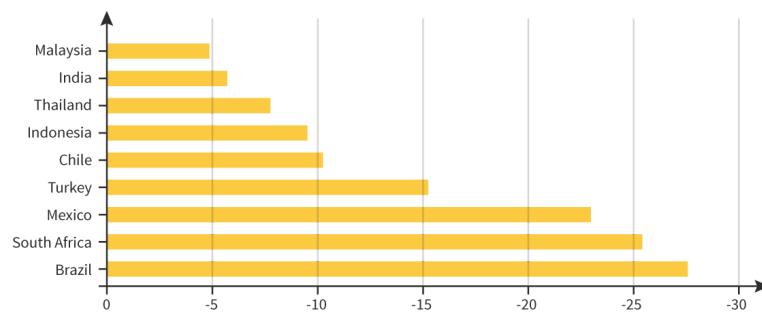


Figure 3. Capital outflows from COVID-19 caused Brazil's real GDP to depreciate by 27% percent.

Source: Xe.com (https://www.xe.com/currencycharts/?from=USD).

 More information for figure 3

The bar chart illustrates the percentage depreciation of the currencies of several countries during 2020. The horizontal axis represents the percentage of depreciation, ranging from 0 to -30% in intervals of 5%. The vertical axis lists the countries: Malaysia, India, Thailand, Indonesia, Chile, Turkey, Mexico, South Africa, and Brazil.

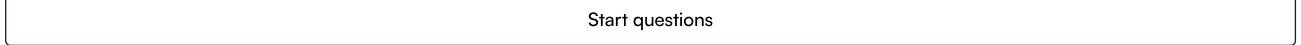
Each bar indicates the degree of depreciation for each country's currency. The countries exhibit varying levels of depreciation: Malaysia shows the least depreciation, while Brazil shows the most significant depreciation, nearly reaching -30%. South Africa and Mexico also experienced notable depreciations, exceeding -20%. The chart provides a comparative visual representation of currency depreciation among these selected countries during the COVID-19 pandemic.

[Generated by AI]

As the COVID-19 pandemic spread globally, the world went into lockdown. Factories closed, production stopped and investment dried up. Economically less developed countries (ELDCs) tend to be very dependent upon investment from abroad. In times of uncertainty, investors are much less likely to take the risk, and investment significantly decreased. This created a deficit on the financial account.

Section Draw an appropriate diagram to show how a decrease in foreign investment will affect the exchange rate 

Complete section with 3 questions

 Start questions

 Previous section (/study/app/pp/sid-186-cid-754025/book/the-current-account-and-the-exchange-rate-hl-id-30962/)

Next section  (/study/app/pp/



Implications of a persistent current account deficit (HL)

Section

[Feedback](#)


Exchange rates

As mentioned in [section 4.6.4 \(/study/app/pp/sid-186-cid-754025/book/the-current-account-and-the-exchange-rate-hl-id-30962/\)](#), current account deficits put downward pressure on the value of the currency. Suppose that the current account deficit arises because exports are falling. If foreign consumers buy fewer exports, then they will also buy less domestic currency. This will decrease the demand for domestic currency from D to D_1 , creating a depreciation from P to P_1 .

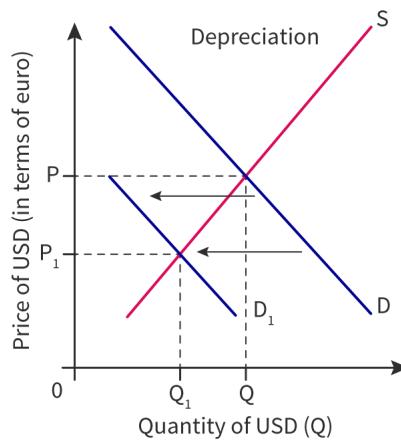


Figure 1. A persistent current account deficit can cause a depreciation in the exchange rate.

[More information for figure 1](#)


The graph illustrates the relationship between the price of USD (in terms of euros) and the quantity of USD (denoted as Q). The X-axis represents the "Quantity of USD (Q)" while the Y-axis represents the "Price of USD (in terms of euro)." The graph contains two curves: the demand curve (D) which shifts to D_1 , indicating a decrease in demand, and the supply curve (S). The initial equilibrium is at point P, where the demand and supply curves intersect. As the demand decreases from D to D_1 , the new equilibrium occurs at point P_1 , indicating a depreciation in the USD value against the euro. Key points labeled are P, P_1 , Q, and Q_1 . The shift from P to P_1 demonstrates how a persistent current account deficit can cause a currency depreciation.

[Generated by AI]

Generally, a depreciation will lead to a readjustment of the current account balance. In time, a depreciation will lead to balance in the current account. A depreciation will cause the price of exports to fall and the price of imports to rise (in terms of foreign currency). We expect that a fall in export prices from P to P_1 will increase the quantity demanded for exports from Q to Q_1 , and import prices increasing from P to P_1 will decrease the quantity demanded for imports.

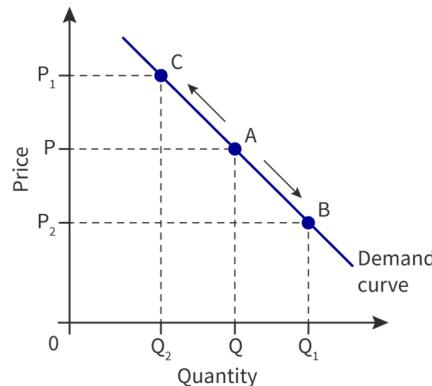


Figure 2. A depreciation will lead to a fall in the quantity demanded for imports, and an increase in the quantity demanded for exports.

[More information for figure 2](#)

The graph displays a demand curve, labeled 'Demand curve,' with a downward slope from left to right. The X-axis represents Quantity and ranges from 0 to Q_2 , Q , and Q_1 . The Y-axis represents Price and ranges from P_2 to P and P_1 .

There are three key points on the demand curve: - Point C at the highest price level P_1 correlates with the lowest quantity level Q_2 . - Point A at the price level P corresponds to the quantity level Q . - Point B at the lowest price level P_2 correlates with the highest quantity level Q_1 .

Arrows between points C and A, and A and B, indicate a leftward shift reflecting how a depreciation in currency value leads to a reduction in price (moving downward on the curve) and an increase in quantity demanded (moving rightward on the curve).

[Generated by AI]

Rising exports and falling imports will close the current account deficit.

Student view

However, under certain circumstances a depreciation can actually worsen a current account deficit. Some countries such as Japan, Singapore and South Korea do not have large stocks of natural resources. They must import any inputs to production. For example, in 2019 South Korea built more steel ships than any other country and yet it does not have any iron ore or oil deposits. If the South Korean currency (won) depreciates, this will increase the cost of importing iron ore and oil, which will increase the cost of ship building. This will make South Korean ships less competitive.

Interest rates

Large current account deficits can push up interest rates. A deficit means that more money (foreign exchange) is leaving the country to purchase imports than is coming in through the sale of exports. The extra money needs to have come from somewhere and if the country is short of reserves it may need to rely on borrowing (financial investments). The country is likely to be judged a higher risk by potential overseas lenders and so the only way that the country can attract these lenders is to offer higher interest rates.

Higher interest rates can cause other domestic problems, as it can lead to a fall in aggregate demand, because consumption and investment both decrease (see [subtopic 3.2 \(/study/app/pp/sid-186-cid-754025/book/the-big-picture-id-30486/\)](#)). This lowers economic activity and might potentially lead to a recession and higher unemployment.



Foreign ownership of domestic assets

Overview

(/study/app

186-

cid-

754025/

- A long-term depreciation will decrease the price of domestic assets in terms of foreign currency. Assume a home in London costs 1 000 000 GBP, and the exchange rate is 1 GBP = 1 EUR. How many euros would it take to buy the house? That's right: 1 000 000 euros. But now, let's assume that the pound has depreciated and so the value of the pound has decreased. It therefore costs fewer euros to buy the house. A persistent current account deficit, and the resulting depreciation, may lead to foreign ownership of strategic assets. The United Kingdom experienced this in 2019, with its relatively large current account deficit. The London property market grew by approximately 40% from 2012 to 2019, much of it caused by foreign purchase of property for investment purposes. As a result, many Londoners have been finding it difficult to join the property ladder.

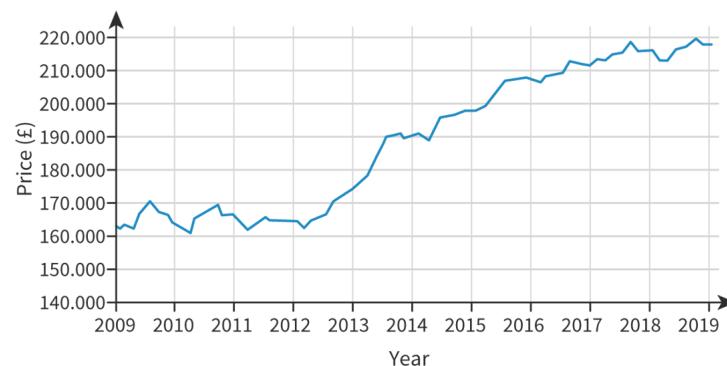


Figure 3. The UK property market has grown significantly from 2012 to 2019.

Source: "ONS (<https://www.ons.gov.uk/economy/inflationandpriceindices/bulletins/housepriceindex/march2020>)"

More information for figure 3

The graph displays the growth of the UK property market from 2009 to 2019. The X-axis represents the years, running from 2009 to 2019. The Y-axis represents the property prices in British Pounds, ranging from £140,000 to £220,000. The line graph shows the property prices starting at approximately £160,000 in 2009. It remains relatively stable with slight fluctuations until 2012, after which it begins to increase significantly. By 2019, the price reaches around £220,000, indicating a substantial growth over the decade. Several small peaks and troughs are visible, showing minor variations within the overall upward trend.

[Generated by AI]

Student view

Debt

We would expect a persistent current deficit – where imports are greater than exports – to put downward pressure on the exchange rate. This may create increased indebtedness in terms of domestic currency.

In 2019, the Argentinian peso depreciated by more than 20%. (<http://www.bbc.co.uk/news/business-49429361>) At the same time, Argentina held USD 285 billion in debt, of which more than 80% was denominated in US dollars. This means that Argentina must exchange more pesos to pay back the same amount of US dollars. Although the debt may be the same in terms of USD, it has skyrocketed in terms of pesos. This makes it harder for Argentina to pay its debt. This has far-reaching effects in the economy. According to the BBC (<https://www.bbc.co.uk/news/business-49429361>), one out of every three Argentines lives below the poverty line in 2019.



Credit ratings

Overview
(/study/app/186-cid-754025/)

An inability to service its financial account surplus (pay back debt with interest) will cause credit rating agencies, like Moody's, Standard & Poor's and Fitch's, to downgrade a country's credit rating. The highest credit rating is AAA (or triple A) and the lowest is D, given when the nation or debtor has defaulted.

A poor credit rating will make it much more difficult for that country to continue to borrow money in order to finance any current account deficit.

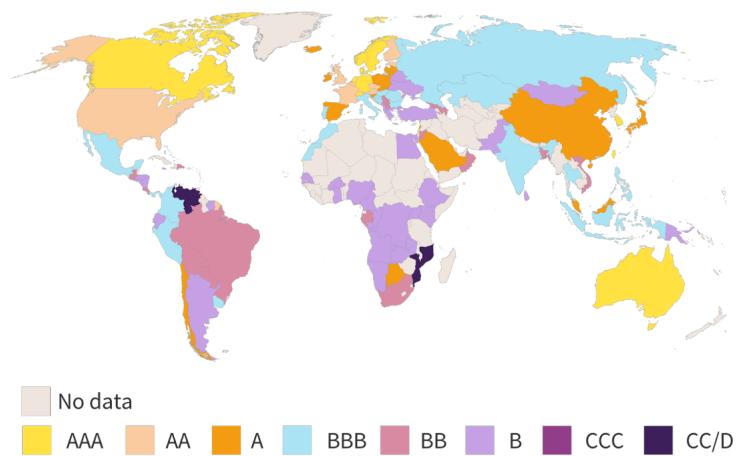


Figure 4. Credit ratings (https://en.wikipedia.org/wiki/List_of_countries_by_credit_rating) for various countries (March 2019).

More information for figure 4

This is a world map displaying the credit ratings for various countries as of March 2019. It uses a color-coded legend to indicate the different credit ratings assigned to each country. The legend includes ratings from AAA, AA, A, BBB, BB, B, CCC, CC/D, and 'No data'. The map visually distinguishes countries based on these ratings, allowing a geographic comparison of credit ratings. Countries in North America, Europe, and Australia generally show higher credit ratings (AAA or AA) while some countries in Africa and South America have lower ratings (B, CCC, or CC/D). The map is a tool for visualizing the global distribution of credit ratings across different regions.

[Generated by AI]

Student view

Demand management

A persistent current account deficit can make it difficult to manage the demand side of the economy. Under some circumstances, a current account deficit can lead to a budget deficit.

Making connections

As you may recall from [section 3.5 \(/study/app/pp/sid-186-cid-754025/book/the-big-picture-id-30340/\)](#), a budget deficit arises when government expenditure is greater than tax revenue. There is a direct link between international trade and the domestic economy.

For example, if the economy is close to full employment, it means that all factors of production are fully utilised in the best way. Any attempt to meet an increase in aggregate demand **cannot** be met by increasing production within the domestic market. It **must** be met by an increase in imports. Therefore, as the economy approaches full employment, it is



much more likely that a budget deficit will do little to stimulate the domestic economy and will simply lead to a trade deficit.

Overview

(/study/app)

186-

cid-

754025/

However, a budget deficit can lead to a trade deficit at output levels below full employment also. The government must carefully consider the type of goods the government is buying. For example, if the Brazilian government increases its expenditure by purchasing some Mercedes cars from Germany (so it buys imports), then the increase in the budget deficit will lead directly to an increased trade deficit.

Economic growth

A persistent current account deficit may have implications for economic growth. As consumers switch to purchasing more imports (for example, American consumers switching out of buying domestically-built Ford cars and into Japanese Hondas), this will force domestic firms to cut back output, lay off workers and leave domestic factories idle.

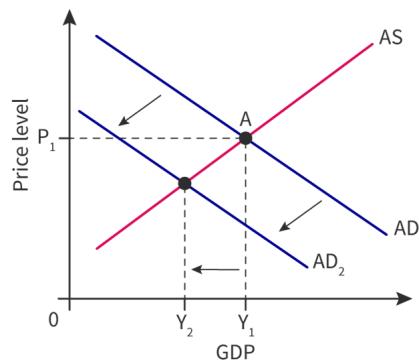


Figure 5. A current account deficit can lead to a fall in economic growth.

More information for figure 5

The image is a graph that represents the relationship between GDP and price levels as influenced by aggregate supply (AS) and aggregate demand (AD). The X-axis denotes GDP, starting from 0, and progressing to Y_1 and Y_2 , marked by dashed lines. The Y-axis signifies the price level, starting at 0 and progressing to P_1 , marked by a horizontal dashed line.

Student view

There are three key lines depicted: 1. The red line labeled "AS," ascending from left to right. 2. The blue line labeled "AD₁," descending from left to right. 3. Another blue line labeled "AD₂," also descending from left to right.

Point "A" is where the AS and AD₁ lines intersect. As the demand shifts from AD₁ to AD₂, it indicates a decrease in GDP from Y_1 to Y_2 and a decrease in the price level from P_1 , reflecting a fall in aggregate demand.

[Generated by AI]

As consumers switch into imports, aggregate demand will fall from AD₁ to AD₂, decreasing the price level and decreasing output from Y_1 to Y_2 .

This will lead to a recession and an increase in unemployment. Economic growth will fall. Under these circumstances, a current account deficit will simply stimulate a foreign economy.

Case study

Falling oil prices

In the first half of 2020, the price of oil dropped so sharply that it entered negative territory. That's right: oil prices were negative! Negative prices mean someone stuck holding oil would be prepared to pay someone to take oil off of their hands. Why? Because the demand for oil was so low that the oil had to be stored. As the available oil storage facilities filled up, it would be cheaper for people holding oil to pay someone else to take it rather than pay to store it.

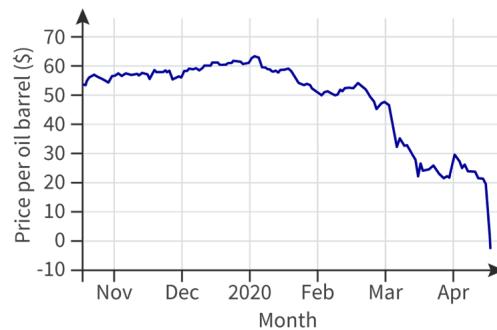


Figure 6. In April 2020, oil prices dropped so sharply that they were negative.

Source: Macrotrends [🔗](https://www.macrotrends.net/2516/wti-crude-oil-prices-10-year-daily-chart)

More information for figure 6

The graph depicts the price per oil barrel in dollars from November 2019 to April 2020. The X-axis represents the months from November to April, while the Y-axis indicates the price per oil barrel, ranging from -10 to 70 dollars. The graph shows that oil prices remained relatively stable between 50 and 60 dollars from November 2019 to March 2020. However, in April 2020, there is a dramatic drop, with prices falling below zero, indicating negative prices. This significant dip represents the unusual economic scenario where oil holders paid others to take their oil due to storage shortages and plummeting demand.

[Generated by AI]

Crashing oil prices have had devastating effects on the current accounts of oil-producing nations. For some nations, oil accounts for the majority of their GDP [🔗](http://www.cnbc.com/2020/04/23/how-the-oil-price-capitulation-will-hit-nigeria-saudi-arabia-and-other-major-exporters.html), such as Iran (65%), Kuwait (up to 60%), and Saudi Arabia (50%). Both Nigeria and Russia rely on oil for approximately 60% of their export revenue. Imagine the effect on the current account from negative oil prices. Even if the oil price crash is very short term, it can have a long-term effect on the economy.

Work together in groups of three and investigate the effects of the resulting downward pressure on the current account deficits of Iran, Kuwait, Saudi Arabia, Nigeria and Russia on:

1. Exchange rates
2. Interest rates
3. Indebtedness
4. Economic growth

Find out more about falling oil prices here [🔗](https://www.ft.com/content/8e1fd8dc-e45d-4cee-b671-bae76f93e3b) and here [🔗](https://www.aljazeera.com/indepth/opinion/worse-oil-market-wti-collapse-200424162623936.html).

Complete section with 3 questions

Start questions



Overview

(/study/app/

186-

cid-

754025/

[◀ Previous section \(/study/app/pp/sid-186-cid-754025/book/the-financial-account-and-the-exchange-rate-hl-id-30963/\)](#)Next section [▶\(/study/app/](#)Student
view



Overview
(/study/app)

186-
cid-
754025/



(https://intercom.help/kognity)



4. The global economy / 4.6 Balance of payments

Correcting a persistent current account deficit (HL)

Section

Feedback



Table of
contents



Notebook



Glossary



Reading
assistance

Be aware

Be aware of the difference between the current account balance and a trade balance. The current account includes transactions in goods, services, income and transfers between a country and the rest of the world. A trade balance is a subset of the current account, and only includes transactions in visible exports and visible imports.

Expenditure-switching policies

The goal of expenditure-switching policies is to switch consumption out of imports and into domestic goods.

Expenditure-switching policies refer to protectionist measures to encourage reduced consumption of imports. Any of the three main methods of protectionism (tariffs, quotas and subsidies) from subtopic 4.2 ([/study/app/pp/sid-186-cid-754025/book/the-big-picture-id-30700/](#)) will result in less imported from abroad and more being produced domestically.

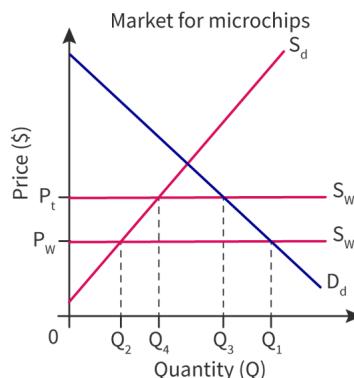


Figure 1. A tariff on microchips will switch consumption from imports to domestic goods.

More information for figure 1

The image is a graph illustrating the market for microchips. The X-axis represents Quantity (Q), marked from 0 to Q1, with specific points at Q2, Q3, and Q4. The Y-axis measures Price (\$), from 0 to Pt, with key points at Pw and Pt.

There are two supply curves, Sw and S_{WT}, and one demand curve, D_d.

1. S_w is the original supply curve, intersecting with the demand curve D_d at the equilibrium point where Price is P_w and Quantity is Q₁.
2. S_{WT} is the shifted supply curve, representing the market condition with tariff, and is parallel to S_w but at a higher price level P_t.
3. D_d is the demand curve, sloping downwards from left to right, intersecting the original supply curve S_w at the point (P_w, Q₁) and shifted supply curve S_{WT} at the point (P_t, Q₂).

With the imposition of a tariff, the supply curve shifts from S_w to S_{WT}, increasing price from P_w to P_t. The quantity of imports reduces from Q₁ - Q₂ to Q₃ - Q₄, indicating less import and more reliance on domestic production.

Taiwan is the world's leading microchip producer, making over half the world's microchips for a large range of electronic products, such as iPhones and bitcoin-mining rigs. However, India is becoming more competitive in microchip production. It might choose to levy a tariff on Taiwanese semiconductors. Looking at **Figure 1**, if a tariff is levied, it will shift the supply curve from S_w to S_{wt} . This will increase prices from P_w to P_t . This reduces the number of imports flowing into India from $(Q_1 - Q_2)$ to $(Q_3 - Q_4)$. Indian electronics manufacturers will have no choice but to use more Indian microchips.

Although this strategy provides the government with an opportunity to raise government revenue, there are other consequences. India might be unlikely to use tariffs to make itself more competitive because it will face retaliation in the form of trade wars or face disciplinary proceedings with the WTO.

Expenditure-reducing policies

Expenditure-reducing policies involve trying to slow down domestic spending in the economy. This is done through the use of contractionary demand-side policies. Because aggregate demand is made up of consumer spending, investment, government spending and *net exports*, contractionary demand-side policies should reduce any negative trade balance.

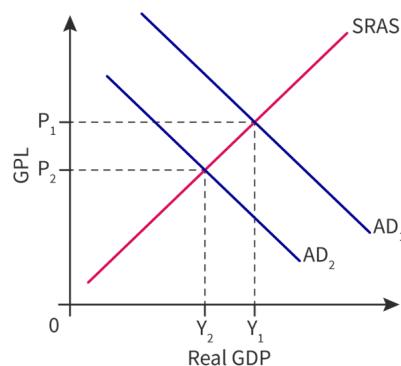


Figure 2. Contractionary policies reducing aggregate demand.

[More information for figure 2](#)

The graph illustrates the impact of contractionary policies on aggregate demand, featuring three lines: AD₁, AD₂, and SRAS. The X-axis represents Real GDP with points marked at Y₁ and Y₂. The Y-axis represents the General Price Level (GPL) with points labeled P₁ and P₂. The initial aggregate demand curve AD₁ shifts to AD₂ due to contractionary policies, reflecting a decrease in aggregate demand. This shift results in a lower price level from P₁ to P₂, and a reduction in Real GDP from Y₁ to Y₂. The Short Run Aggregate Supply (SRAS) line intersects both demand curves highlighting the economic adjustments.

[Generated by AI]

Governments have two choices: they can use contractionary monetary policy or contractionary fiscal policy.

Contractionary monetary policy is where the government intervenes in the market to **increase the interest rate**. This slows down investment (I) and consumption (C), which reduces aggregate demand. Alternatively, the government can use **contractionary fiscal policy** and cut government expenditure (G) or increase taxes. This will lead to less aggregate demand in the economy because households are left with less disposable income and firms with less money to invest. In **Figure 2**, we see AD₁ falling to AD₂, creating less output at Y₂ and a lower general price level P₂.

A fall in aggregate demand will mean that consumers are buying fewer domestic and imported goods. Therefore, there is a decrease in the current account deficit.

Supply-side policies

Clearly, both the above policy options have their disadvantages and advantages. If domestic production is uncompetitive, perhaps there is an inherent reason for this that needs to be dealt with. **Supply-side policies** can address this problem directly, with their focus on increasing the productive capacity and productivity of the economy.

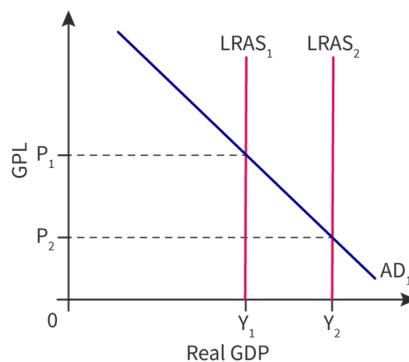


Figure 3. An outward shift in LRAS increases the productive capacity of the economy.

More information for figure 3

The image is a graph illustrating the relationship between Real GDP and General Price Level (GPL). The x-axis represents Real GDP with points Y1 and Y2 marked. The y-axis shows the General Price Level with marks at P1 and P2. The graph displays three lines: a downward sloping line labeled AD (Aggregate Demand), a vertical line labeled LRAS1, and another vertical line labeled LRAS2. The shift from LRAS1 to LRAS2 to the right indicates an outward shift in Long-Run Aggregate Supply (LRAS), signifying an increased productive capacity of the economy. This shift results in higher Real GDP at a lower GPL.

Student view

[Generated by AI]

Market-oriented policies work to improve the competitive environment by allowing market forces to operate more freely. In developed countries, this will involve relaxing business regulations, reducing trade union power and lowering minimum wages. In developing countries, these policy measures will be less appropriate as employment law will not be as well structured and trade unions are unlikely to have much power. Instead, developing countries will want to improve the business environment by making it easy to start new businesses, improving access to credit markets and ensuring an uncorrupt regulatory system. However, it is important to balance any reduction in regulatory constraints with maintaining appropriate protection for workers and the environment.

Improved access to *education* has the potential to solve many problems within a country, including low incomes, poor social mobility, high crime rates and low productivity, among many others. A government's intervention in this area, as well as in *health care* and *infrastructure*, will improve productivity and competitiveness in the economy because the

Home
Overview
(/study/app/
186-
cid-
754025/)

quantity and quality of the factors of production improve. The problem with the use of supply-side policies to correct a current account deficit is that they take a very long time to have a significantly visible impact on output and competitiveness. Governments have to weigh up the advantages and disadvantages of increased investment in essential public services, which carries an opportunity cost, with the immediate need for reducing the current account deficit.

Complete section with 3 questions

Start questions

◀ Previous section (/study/app/pp/sid-186-cid-754025/book/implications-of-a-persistent-current-id-30964/)

Next section ➤ (/study/app/pp/sid-186-cid-754025/book/correcting-a-persistent-current-account-deficit-hl-id-30965/)

✓
Student
view



Overview

(/study/app/

186-

cid-

754025/

4. The global economy / 4.6 Balance of payments



(https://intercom.help/kognity)



Effectiveness of measures to correct a current account deficit (HL)



Section

Feedback



Notebook



Glossary



Reading assistance

Expenditure-switching policies

As you learned in [section 4.6.7](#), expenditure-switching policies refer to the protectionist measures designed to reduce the consumption of imports by switching consumption to domestically produced goods. Using an example, we will examine the effectiveness of this measure to correct a current account deficit.

In 2019, the Czech government [faced a small current account deficit](#). Let's explore the effects of the Czech Republic imposing tariffs on car imports to protect the domestic market from competition.

The Czech car manufacturer Skoda is widely considered to be a close substitute for other similar cars, such as Volkswagen, Ford or General Motors (GM). A tariff will increase the price of imports and encourage consumers to switch into local goods, therefore decreasing the current account deficit. Czech citizens who had previously purchased cars from Germany or the US will switch into Czech cars. In order to measure the effectiveness of a tariff, we need to consider under what circumstances it will be most effective.



Student view

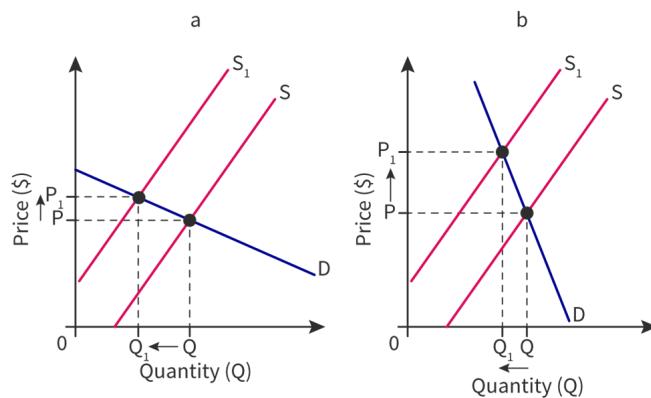


Figure 1a. A tariff placed on cars. **Figure 1b.** A tariff placed on oil.

More information for figure 1

The image consists of two graphs showing the economic effects of tariffs on cars and oil. Both graphs have Price (\$) on the vertical axis and Quantity (Q) on the horizontal axis.

Graph a (left side): - The supply and demand curves are labeled S , S_1 , and D . - Initial equilibrium is at price P and quantity Q where the supply curve S intersects with the demand curve D . - A tariff causes the supply curve to shift leftward to S_1 , increasing the price from P to P_1 and decreasing the quantity from Q to Q_1 . - The demand is shown to be elastic, as a small change in price results in a larger change in quantity demanded.

Graph b (right side): - Similar axes and labels as Graph a. - The supply and demand curves are labeled similarly with S , S_1 , and D . - The equilibrium shift is similar; the supply curve shifts from S to S_1 , increasing the price from P to P_1 and the quantity decreases from Q to Q_1 . - This graph also illustrates tariff effects, although for a different commodity, likely oil as indicated by the figcaption.



Each graph visually represents how tariffs increase prices and reduce the import quantity of goods with elastic and inelastic demand.

Overview
(/study/app-
186-
cid-
754025/)

[Generated by AI]

Figure 1a shows the effects of the Czech Republic placing a tariff on cars. There are many close substitutes for Skoda cars in the Czech Republic, making the demand for cars very elastic. Therefore, even a small increase in the price of imported cars will encourage Czech citizens to switch out of Fords and Volkswagens and into Skodas. As you can see in **Figure 1a**, even a small increase in price from P to P_1 will bring about a larger than proportionate fall in quantity of imported cars from Q to Q_1 . The tariff is very effective and imports are reduced significantly. Clearly, tariffs are effective if they are placed on elastic goods; but what if the good is inelastic?

For example, Japan produces no oil domestically. If it chooses to place a tariff on oil, it will simply act as a tax to collect revenue on the consumption of an essential good. It will do very little to solve the current account deficit. For a tariff to be effective, nations must think very carefully about the elasticity of the good in question.

Expenditure-reducing policies

Governments can use contractionary fiscal or monetary policies to reduce aggregate demand, and therefore spending on imports. This can be an effective way to reduce a current account deficit. It is important to point out that the success of contractionary policies depends on the amount of spare capacity in a country. If the economy is overheating, this implies that the economy is at full employment, so some reduction in aggregate demand may be justified. A good diagram to use would be the Keynesian aggregate supply curve, as shown in **Figure 2**.

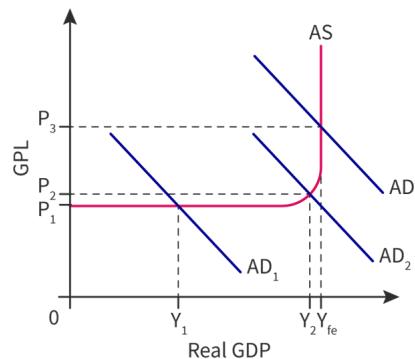


Figure 2. Expenditure-reducing policies may lead to a fall in output and a recession.

More information for figure 2

The image is a diagram representing a Keynesian aggregate supply curve along with three aggregate demand curves labeled AD_1 , AD_2 , and AD_3 . The X-axis represents Real GDP with values starting from 0, and the Y-axis represents the General Price Level (GPL) with values labeled as P_1 , P_2 , and P_3 . The aggregate supply curve (AS) is a backward L-shape, indicating the economy's capacity at full employment, labeled as Y_{fe} . AD_1 is positioned on the lower part of the price level axis, AD_3 is higher indicating more demand, and AD_2 is in between. The diagram shows how different demand levels intersect with the supply curve, illustrating potential outcomes like excess capacity or overheating.

[Generated by AI]

If the economy is overheating and aggregate demand is at AD_3 , then some contractionary measures bringing aggregate demand down to AD_2 will not damage real GDP much at all. However, too much contraction will push aggregate demand too far and will start a recession. In summary, using expenditure-reducing policies can potentially directly lead to a recession.

Supply-side policies

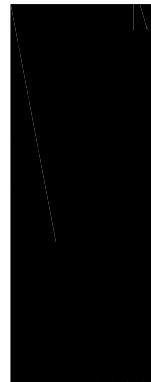
What would be more effective – expenditure-switching or expenditure-reducing policies? The problem with both solutions is that they do little to solve the underlying inefficiencies within the economy. They do not sufficiently address why domestic consumers prefer imports over local goods. They also do not increase productivity. The only way to improve a current account deficit in the long run is to increase the competitiveness of both exports and domestic goods.

Case study

Germany's current account surplus

How has Germany managed to sustain a long-term current account surplus? The answer lies in its focus on increasing productivity and efficiency and growing the supply side of the economy.

Current
account
balance
(BoP, current
US\$)



Student
view

Figure 3. Germany's Current Account Surplus.

Source: "World Bank (<https://data.worldbank.org/indicator/BN.CAB.XOKA.CD?locations=DE>)"

More information for figure 3

The graph shows Germany's current account balance (BoP, current US\$). The x-axis represents the years from 1972 to 2019, and the y-axis displays the balance in billions of US dollars. It indicates fluctuations until 2002, followed by a sharp rise, peaking in later years, reflecting changes in trade and economic performance. The table below displays Germany's current account balance (BoP, current US\$) over time, with columns for Year, representing the timeline from 1972 to 2019, and Current Account Balance, showing the balance in billions of US dollars for each year.

Year	Current account balance of Germany (BoP, current US\$ - in billion)
1971	106,579,705
1972	339,737,168
1973	4.18
1974	9.08

Year	Current account balance of Germany (BoP, current US\$ - in billion)
1975	3.1
1976	3.75
1977	3.9
1978	9.28
1979	Negative 5.39
1980	Negative 15.66
1981	Negative 5.3
1982	5.51
1983	4.35
1984	9.21
1985	17.99
1986	38.66
1987	44.22
1988	53.96
1989	57.05
1990	46.46
1991	Negative 22.38
1992	Negative 21.06
1993	Negative 16.18
1994	Negative 29.28
1995	Negative 27.68
1996	Negative 12.34
1997	Negative 7.9
1998	Negative 10.67
1999	Negative 25.85
2000	Negative 29.76
2001	Negative 3.35
2002	41.72



Year	Current account balance of Germany (BoP, current US\$ - in billion)
2003	38.84
2004	129.32
2005	134.35
2006	177.8
2007	233.63
2008	212.41
2009	204.41
2010	200.15
2011	239.39
2012	258.79
2013	256.18
2014	285.24
2015	277.32
2016	314.86
2017	304.19
2018	342.18
2019	311.83



Learners will understand Germany's economic trends over five decades, analyzing how its current account balance shifted due to trade dynamics, policies, and global market changes.

The key to Germany's current account surpluses is the focus on the supply side of the economy. The German government maintains a productive relationship between trade unions and firms. This reduces the likelihood of industrial action.

In addition, Germany legislates domestic wage restraint. This keeps labour costs reasonable and ensures German firms stay internationally competitive.

Lastly, Germany has a high savings rate. Banks have a large pool of savings available to lend out for investment purposes.

South Korea also enjoys large current account surpluses. In a group of three, research the economy in South Korea and identify the factors that enable the country to increase productivity, efficiency, and therefore the supply side of the economy.

Read these to get you started:

Home
Overview
(/study/app/
186-
cid-
754025/)

- [How Did South Korea's Economy Develop So Quickly? ↗ \(https://www.stlouisfed.org/on-the-economy/2018/march/how-south-korea-economy-develop-quickly\)](https://www.stlouisfed.org/on-the-economy/2018/march/how-south-korea-economy-develop-quickly)
- [South Koreas Economic Prospects in 10 years ↗ \(https://pearsonkorea.com/insights/Koreas-Economic-Prospects-in-10-years/\)](https://pearsonkorea.com/insights/Koreas-Economic-Prospects-in-10-years/)

Complete section with 3 questions

Start questions

◀ Previous section (/study/app/pp/sid-186-cid-754025/book/correcting-a-persistent-current-account-deficit-hl-id-30965/)

Next section ➔ (/study/app/

✓
Student
view



Overview

(/study/app)

186-cid-754025/



(https://intercom.help/kognity)



4. The global economy / 4.6 Balance of payments

The Marshall–Lerner condition and the J-curve effect (HL)



Table of contents



Notebook



Glossary



Reading assistance

The Marshall–Lerner condition

The Marshall–Lerner condition (MLC) describes the circumstances under which a depreciation of the domestic currency will lead to an improvement in the current account.

The Marshall–Lerner condition states that a depreciation will only lead to an improvement in the current account if the sum of the elasticities of a country's exports and imports is greater than 1.

As you know, the current account refers to a record of transactions in exports, imports, income and transfer flows from one country to the rest of the world – and is subject to fluctuations in the exchange rate. A depreciation occurs when the exchange rate moves back into equilibrium by losing value. A depreciation will cause the price that foreign consumers pay for exports to fall and the domestic price of imports to rise.

These price changes may affect the current account in one of two ways:

Firstly, let us take Australia as an example. Australia produces mainly agricultural products and minerals. Minerals such as iron ore are homogeneous, so iron ore from Australia is a perfect substitute for iron ore from Brazil. Therefore, Australian exports are very elastic.

Suppose that the Australian dollar depreciates and so decreases the price of Australian iron ore in terms of foreign currency. Countries which had previously purchased iron ore from Brazil and South Africa will switch into Australian iron ore. This means that although the price of Australian iron ore has decreased from P to P_1 , it has led to a greater than proportionate increase in the quantity demanded, from Q to Q_1 . The overall total revenue ($P_1 \times Q_1$) earned from exports will then rise and the depreciation will lead towards a current account surplus.

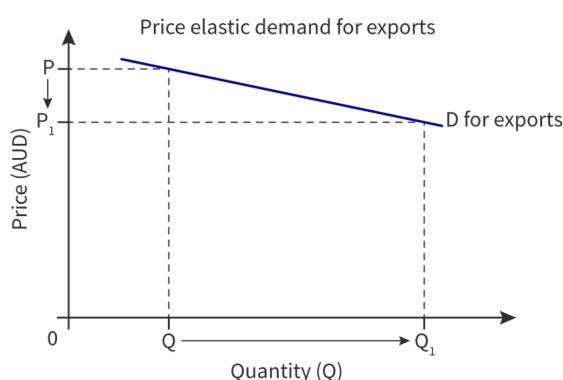


Figure 1. A depreciation will lead to an increase in export revenues.

More information for figure 1

The image is a graph illustrating price elastic demand for exports. The X-axis represents 'Quantity (Q)' starting at 0 and extending to Q_1 . The Y-axis represents 'Price (AUD)' starting from P, decreasing to P_1 . The demand line, labeled 'D for exports', slopes downward from left to right, indicating elasticity in demand. The graph shows points marking changes: as price decreases from P to P_1 , the quantity demanded increases from Q to Q_1 , suggesting that a

[Home](#)
 Overview
 (/study/app-186-cid-754025/)
 [Generated by AI]

At the same time, Australia also imports luxury goods such as champagne, caviar and Louis Vuitton handbags. These goods are also extremely elastic. A depreciation will increase the price of imports. As the price of luxuries increases from P to P_1 , consumers will simply switch into cheaper substitutes such as Australian wine and handbags from Walmart. A rise in the price of imported luxuries from P to P_1 will lead to a greater than proportionate fall in the quantity demanded for these imports, from Q to Q_1 . Therefore, the revenue flowing overseas to pay for imports will fall. Clearly, when both exports and imports are elastic, a depreciation will lead to a current account surplus.

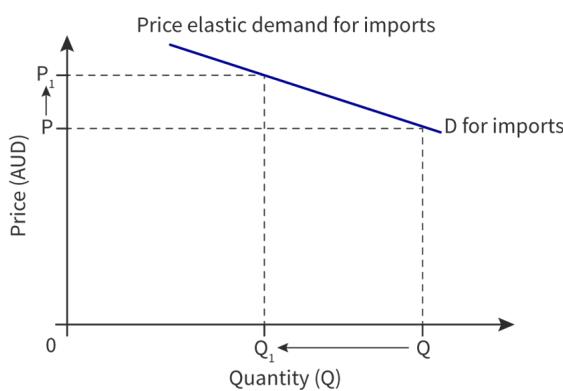


Figure 2. A depreciation will lead to a fall in money flowing overseas to pay for imports.

[More information for figure 2](#)

The graph illustrates the concept of price elastic demand for imports. The X-axis represents Quantity (Q) and ranges from 0 to Q, with a marked point at Q_1 . The Y-axis represents Price (AUD) and ranges from 0 to P, with a marked level at P_1 . The graph features a downward sloping line labeled 'Price elastic demand for imports', intersecting the price lines at P_1 and P. A dashed line extends horizontally from P_1 and vertically down to Q_1 , while another dashed line starts at P and drops to Q. This setup signifies that as the price increases from P to P_1 , the quantity demanded decreases from Q to Q_1 , illustrating the elastic nature of the demand. The label 'D for imports' highlights the demand line, emphasizing the focus on imports.

Student view

[Generated by AI]

However, this is not always the case. For example, Saudi Arabia's main export is oil. Oil is an essential good for production, and demand for it is therefore extremely inelastic. If Saudi Arabia were to depreciate its currency (provided that all oil exporters did the same), the price of oil in terms of foreign currency would fall. Saudi Arabia would earn less for every barrel of oil that it exports. However, since oil is price inelastic, a fall in price from P_1 to P_3 in **Figure 3** will be met by a much smaller proportionate increase in quantity demanded, from Q_1 to Q_3 . Overall, revenue would fall ($P_3 \times Q_3$). In fact, Saudi Arabia would lose from a depreciation – it would lead to a fall in revenue earned from exports.

At the same time, Saudi Arabia imports food, which is also essential and so is extremely inelastic in demand. A depreciation will lead to an increase in the price of imported food. Since food is essential, consumers will continue to buy it regardless of the price increase. A rise in the price of imports from P_1 to P_2 will lead to a smaller than proportionate fall in quantity demanded, from Q_1 to Q_2 . Therefore, overall revenue flowing overseas to pay for imports will rise. In this case – where both the exports and imports are inelastic – a depreciation will lead to a worsening current account deficit.

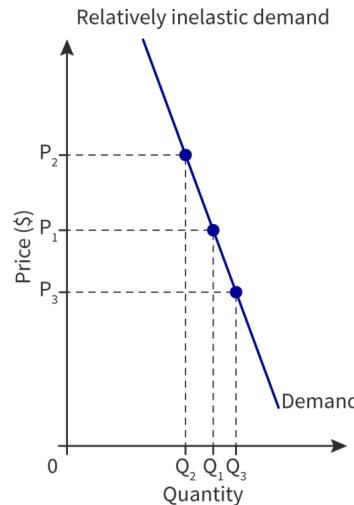


Figure 3. A depreciation will worsen a current account deficit if both exports and imports are inelastic.

More information for figure 3

The image is a graph illustrating relatively inelastic demand. The X-axis represents Quantity, labeled with Q1, Q2, and Q3, showing different quantities. The Y-axis represents Price in dollars, marked with P1, P2, and P3, indicating various price levels. A downward-sloping line indicates the demand curve, labeled 'Demand,' depicting a relatively inelastic nature. The graph visually demonstrates that even with changes in price level between P1 to P2 and P3, the change in quantity demanded from Q1 to Q2 to Q3 is minimal, reinforcing the concept of inelasticity in demand. The visual representation aligns with the economic theory that price changes lead to small changes in quantity demanded when demand is inelastic.

[Generated by AI]

To test whether a depreciation will lead to an improvement in the current account, we can refer to the Marshall–Lerner criterion, which states that a depreciation will only lead to an improvement in the current account if the sum of the elasticities of a country's exports and imports is greater than 1.

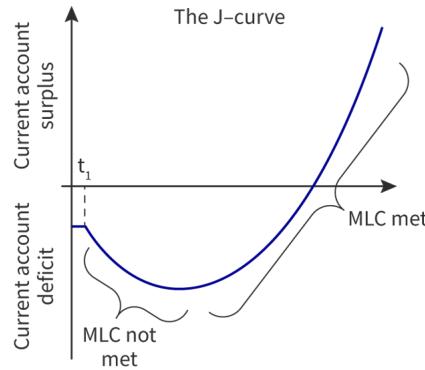
✓
Student view

✓ Important

The **Marshall–Lerner condition** states that a currency depreciation will improve the balance of trade if the sum of PED_X and PED_M is greater than 1.

The link between the Marshall–Lerner condition and the J-curve effect

There is a strong link between the Marshall–Lerner condition and the J-curve effect. With international transactions, and mostly business-to-business trade taking place, contracts are agreed months, if not years, in advance. This means that, immediately after a currency depreciation or devaluation, it may take some time for businesses to respond. We can plot this effect as the J-curve, shown in **Figure 4**. The J-curve describes what happens to the current account when a currency depreciates.

**Figure 4.** The J-curve effect.
[More information for figure 4](#)

The image is a graph depicting the J-curve effect in the context of a nation's current account balance following a currency depreciation. The Y-axis represents the current account balance, ranging from deficit at the bottom to surplus at the top. The X-axis indicates time progression.

Initially, the curve dips into the area labeled "MLC not met," indicating a worsening deficit immediately after depreciation. As time progresses, the curve begins to rise, crossing the horizontal axis at the point labeled " t_1 ," moving into the "MLC met" area, suggesting improvement in the account balance as the depreciation's effects positively influence trade balance.

The curve's shape is similar to a J, with a downward dip followed by an upward trajectory. This illustrates the short-term negative impact of currency depreciation, followed by a longer-term positive adjustment in the current account.

[Generated by AI]

Currently, the US is experiencing a very large trade deficit (<http://www.epi.org/blog/record-u-s-trade-deficit-in-2018-reflects-failure-of-trumps-trade-policies/>). If it allowed its currency to depreciate towards equilibrium, it would affect the current account in both the short run and the long run. Let us examine both of these effects in turn.

Student view

1. In the short run:

This is a period too short for consumers to fully evaluate their consumption decisions. A depreciation may in fact worsen the current account and lead to a **fall in export prices**. However, the short run may be **too** short for foreign consumers to take into account these lower prices (as exports are price inelastic). Therefore, a fall in price will bring about a smaller than proportionate change in quantity demanded. The total revenue earned from exports may actually fall.

At the same time, a depreciation will lead to a **rise in import prices**. But in the short run, consumers may be unable to find substitutes and so may be locked into continuing to purchase imports. This would result in a rise in import prices, and will lead to a smaller than proportionate change in quantity demanded (as imports are price inelastic). The amount of revenue flowing overseas to pay for imports may actually rise. Clearly, in the short run, the current account will **worsen**.

2. In the long run:

In the long run, consumers have enough time to adjust their consumption decisions and so demand for exports and imports becomes more elastic. Over time, foreign consumers will be able to switch into exports, leading to a rise in the total revenue earned for exports. At the same time, domestic consumers may be able to find domestically produced substitutes for imports, and the total revenue flowing overseas to pay for imports will fall. In the long run, the current account will start to **improve**.

The Marshall–Lerner criterion states that a depreciation will only lead to an improvement in the current account if the sum of the elasticities of a country's exports and imports is greater than 1. This is similar to the long-run condition in the J curve, where over time exports and imports become more elastic and therefore lead to an improvement in the current account.

Activity

Research the top five exports and top five imports for your country [here](https://oec.world/en/profile/country/gbr/) (https://oec.world/en/profile/country/gbr/).

Can you categorise them as elastic or inelastic? Do you think a depreciation will lead to an improvement in the current account for your country?

Discuss your results with your peers. Do they agree with you? Why/why not?

Theory of Knowledge

In Rodrik's book [Economic Rules](https://escholarship.org/uc/item/7hr2x4hs) (https://escholarship.org/uc/item/7hr2x4hs), he argues that economics is largely untestable.

The Marshall–Lerner criterion states that depreciation will only improve the current account if the sum of the elasticities of a country's imports and exports are greater than one. Although the Marshall–Lerner criterion sounds convincing in theory, how can we know if it works in the real world? One way is through empirical analysis.

A [research study by Bahmani, Harvey and Hegerty](https://www.researchgate.net/publication/263533670_Empirical_Tests_of_the_Marshall-Lerner_Condition_A_Literature_Review) (https://www.researchgate.net/publication/263533670_Empirical_Tests_of_the_Marshall-Lerner_Condition_A_Literature_Review) examines the export and import elasticities of 29 different countries. The study concluded that the Marshall–Lerner criterion is far less effective than supposed. Furthermore, the study explored earlier studies that used inferior statistical techniques. It found that half of the studies that concluded that the Marshall–Lerner criterion was met did not actually meet the criteria.

Knowledge question: To what extent do you agree with the knowledge claim that 'economics is largely untestable'?

Complete section with 3 questions

[Start questions](#)

[Previous section](#) (/study/app/pp/sid-186-cid-754025/book/effectiveness-of-measures-to-correct-id-30966/)

Next section [X](#) (/study/app/pp/sid-186-cid-754025/book/the-marshall-lerner-condition-id-30967/)



(https://intercom.help/kognity)



Home

Overview
(/study/app)

4. The global economy / 4.6 Balance of payments

186-
cid-
754025/

Section

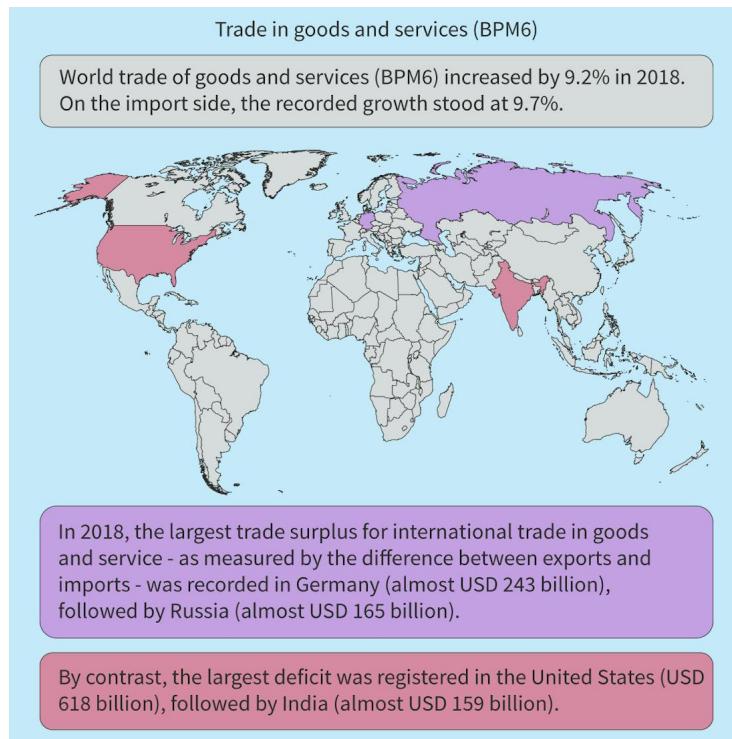
Feedback

Table of
contents

Notebook Since exports and imports make up such a large proportion of the current account, a surplus is most likely to arise when exports are greater than imports. In 2018, Germany and Russia had the largest current account surpluses.



Glossary

Reading
assistance**Figure 1.** The largest surpluses and deficits in the balance of international trade (2018).

Source: "Unctad Stat"

(<https://unctadstat.unctad.org/EN/Infographics.html#&gid=2020&pid=Goods%20and%20services%2C%202018>) is licensed under CC BY 3.0 IGO (<https://creativecommons.org/licenses/by/3.0/igo/>)

More information for figure 1

The image is a world map that highlights the largest trade surpluses and deficits in 2018. Germany and Russia are shown in purple, indicating they had the largest trade surpluses, with Germany reaching almost USD 243 billion, followed by Russia with almost USD 165 billion. In contrast, the United States and India are shown in red, representing the largest trade deficits, with the U.S. at USD 618 billion and India at almost USD 159 billion. There is accompanying text stating, "World trade of goods and services (BPM6) increased by 9.2% in 2018. On the import side, the recorded growth stood at 9.7%."

[Generated by AI]

Although it may seem desirable to have a persistent current account surplus, problems may arise. We will explore the possible implications of a persistent current account surplus below.



Domestic consumption and investment

Overview
(/study/ap/
186-
cid-
754025/)

- A current account surplus may occur for two reasons:
1. Imports are falling
 2. Exports are increasing

An economy that goes into deep recession may find it has a current account surplus. This is because, during a recession, consumption falls and domestic consumers spend less on imports. For example, in 2020, Indonesia [faced falling imports](http://www.thejakartapost.com/news/2020/05/15/indonesias-falling-imports-signals-cooling-economic-activity.html) because consumers were afraid to spend because of COVID-19. At the same time, during a deep recession, we can also expect investment to fall. Firms will cut back on output and hence have no need to invest in new machinery or buying new technology. Although falling imports may lead to a current account surplus, it is not desirable. Under these circumstances, the current account surplus has come about because of a recession – that is, falling consumption and investment.

Alternatively, a current account surplus may arise from increasing exports. This means that a greater proportion of domestic production is sold and consumed overseas. In 2019, Chinese workers produced USD [422 billion more](http://data.worldbank.org/indicator/BN.CAB.XOKA.GD.ZS?locations=CN) worth of goods and services than they consumed. This represents a depression in local living standards, as domestic consumers are not enjoying all the rewards of their labour.

Exchange rates

As you will recall, a current account **deficit** creates a depreciation, while a current account **surplus** will lead to an appreciation. When Nigeria's current account is in surplus, foreign countries will need a supply of naira to pay for Nigeria's exports. The result, then, is that foreign countries will have naira and Nigeria will have foreign currencies. One of two things can now happen:

1. Nigeria uses the foreign currency to buy imports. These are now cheaper because of the stronger naira. The trade balance can return to balance.
2. Nigeria uses the foreign currency in foreign financial markets, which can include increasing its reserves of foreign currency. The current account surplus persists and there is a financial account deficit for Nigeria.

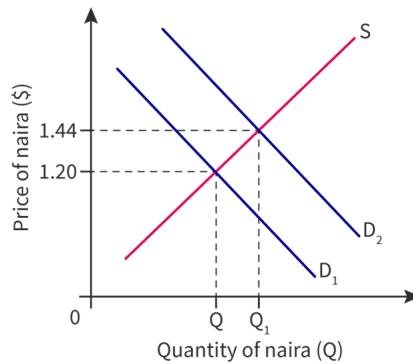


Figure 2. A current account surplus causes the Nigerian currency to appreciate.

More information for figure 2

The image is a graph illustrating the supply and demand curves for the Nigerian Naira. The X-axis represents the "Quantity of Naira (Q)" with marked points at 0, Q, and Q₁. The Y-axis represents the "Price of Naira (\$)" with marked points at 1.20 and 1.44.

The supply curve (S) is depicted as a red line sloping upwards from left to right. There are two demand curves: D₁ and D₂. D₁ is the original demand curve shown as a blue line intersecting with the supply curve at a price of 1.20 and quantity Q. D₂ is the new demand curve, which shifts rightwards to intersect with the supply curve at a higher price of 1.44 and a larger quantity Q₁.

The graph illustrates that an increase in demand from D₁ to D₂ leads to an appreciation of the currency, represented by the movement along the supply curve from intersection with D₁ to intersection with D₂.

[Generated by AI]

Many countries aspire to have a stronger currency, but there are consequences of a persistent current account surplus that must be weighed up against the benefits.

A stronger currency may or may not be a good thing for a country, and this will depend on a number of factors. A currency appreciation will make exports relatively more expensive and imports relatively cheaper. Export revenue may fall if demand is price elastic and import expenditure may rise. Greater volumes of imports give greater choice for consumers, especially if the country does not produce many consumer goods itself. If the country has to import raw materials from abroad, the currency appreciation may also help to reduce inflationary pressures.

① Exam tip

Sometimes, the demand for a country's exports causes the currency to appreciate, but this will make those exports relatively more expensive and may cause demand to return to its original level. There are many factors that determine how fast the response is, and this is a good evaluative point to make.

Inflation

A persistent current account surplus can be inflationary. Let's assume the economy is operating close to full employment, at Y₁. At this level of output, all factors of production are fully employed in the best way. Any additional increase in exports (increasing the current account surplus) will shift out the aggregate demand from AD₁ to AD₂. This will increase output from Y₁ to Y_{fe} and lead to inflation as the price level rises from P₁ to P₃.

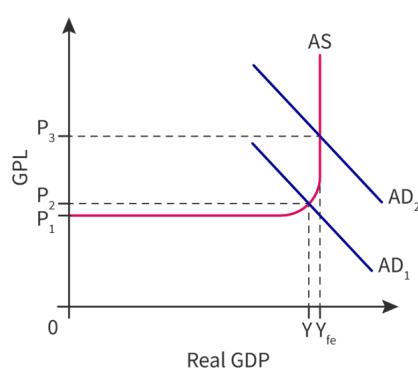


Figure 3. An increase in exports will increase aggregate demand and lead to inflation.

More information for figure 3

The graph illustrates the relationship between Real GDP and the General Price Level (GPL) as influenced by changes in aggregate demand. The X-axis represents Real GDP, extending from 0 to Y_{fe}, indicating full employment. The Y-axis represents the General Price Level (GPL) and is labeled with P₁, P₂, and P₃, indicating different price levels. Initially, the economy operates at aggregate demand AD₁ and general price level P₁. An increase in exports causes



Overview
(/study/app/
186-
cid-
754025/)

a shift in aggregate demand from AD1 to AD2, leading to an increase in Real GDP from Y1 to Yfe. Consequently, the General Price Level rises from P1 to P3, indicating inflation. The aggregate supply curve, labeled AS, intersects both AD curves. This graph visually explains the inflationary effect of increased demand in the context of an economy operating near full employment.

[Generated by AI]

Employment

The effect on the employment rate will depend on the cause of the persistent current account surplus. Improved competitiveness in the economy, particularly in industries that export abroad, should help to improve employment levels in the economy. The more competitive advantage a country gains, the more it will benefit the current account, economic growth and employment levels in the country.

Export competitiveness

A persistent current account surplus will lead to a currency appreciation. This will make exports relatively more expensive. In the international arena, demand may fall as exports lose their competitiveness. This has been affecting South Korea in recent years, with the strong won dampening the country's positive current account balance.



Student view

Figure 4. Hyundai is a major South Korean exporter.

Credit: Getty Images Kevork Djansezian / Stringer

Complete section with 3 questions

Start questions

◀ Previous section (/study/app/pp/sid-186-cid-754025/book/the-marshall-lerner-condition-id-30967/)

Next section ➤ (/study/app/pp/sid-186-cid-754025/book/implications-of-a-persistent-current-2-id-30968/)