MACROECONOMICS AT WORK EXERCISE

THE BALANCE ON CURRENT ACCOUNT AND THE EXCHANGE RATE

REFERENCE: **'Deficit may hit surging Aussie'** (by Liam Walsh)**,**
Courier-Mail, 29 November 2004, p. 17.

CHAPTER RELEVANT TO THIS EXERCISE: 17

CONTEXT

A country's *current account balance* (i.e. the balance of financial transactions with the rest of the world) is made up (roughly equally) by its *trade balance* (the value of exports minus the value of imports) and *net transfers* to/from abroad (made up by payments to factors of production, including profits, plus international transfers, in the form for example of aid) – see pp. 382-5. The magnitude of a country's current account balance will determine the demand for its currency to make payments – and hence the value of its currency in terms of other currencies i.e. the *exchange rate*.

It should be noted that this is only *one* factor determining the demand for the currency (and hence the exchange rate), another being the level of *interest rates* in the country. Thus, for example, a higher rate of interest prevailing in a country compared to that elsewhere will result in a demand for that country's currency by people or institutions who have surplus funds seeking the highest level of return. But this and other things being equal a change in the current account balance will influence the exchange rate.

QUESTIONS

1. What economic circumstances have triggered this article?

2. What have been the main determinants of these circumstances?

3. Analyse the use of the term 'speed bump' to describe the effect of the just-released data on the current account deficit on the exchange rate.

4. Analyse the relevance – and accuracy – of the comment about Australian retailers potentially standing to gain?