Government intervention in currency markets

To some extent, a government / Central Bank can influence the rate of its currency. The government can:

1. **Use foreign currency reserves**. If the UK government wanted to try and increase the value of its currency, it could buy Pound Sterling, using its reserves of foreign currency (the UK tried this in 1992).
2. **Change interest rates**. A Central Bank could try and increase interest rates, to try and attract foreign currency reserves to increase the value of the currency.
3. **Change money supply**. If a country wanted to depreciate its currency, it could print more money, creating inflation and devaluing the currency.
4. **Fiscal / monetary policy**. If the government used tight fiscal policy (higher taxes), it could reduce inflation. Lower inflation would make the currency relatively more attractive.

Evaluation

- A government has only limited foreign exchange reserves. In 1992, the UK government failed to protect the value of the Pound, because foreign currency markets had more buying power than the government.
- The Central Bank could use interest rates to protect the currency but it would be at the cost of lower growth and higher unemployment.
- To manage the exchange rate in the long-term requires efforts to tackle long-term competitiveness.

Effects of an appreciation in the exchange rate

- Makes **exports more expensive**. Therefore, quantity of exports falls.
- Makes **imports cheaper**. Therefore, quantity of imports rises.
- **Lower AD**. Assuming demand is elastic, an appreciation will cause lower aggregate demand and lower economic growth.
- **Lower inflation**. This is due to 3 reasons:
  - Lower import prices e.g. falling oil prices from the appreciation.
  - Lower exports and lower AD, reducing demand pull inflation.
  - To remain competitive, firms have a bigger incentive to cut costs.
- **Worsening of current account** i.e. bigger deficit, because of decline in exports and rise in quantity of imports.
- **Foreign direct investment may fall**. A rise in the exchange rate may discourage FDI (foreign direct investment), because it is now more expensive for foreign firms to invest.

Evaluation of an appreciation

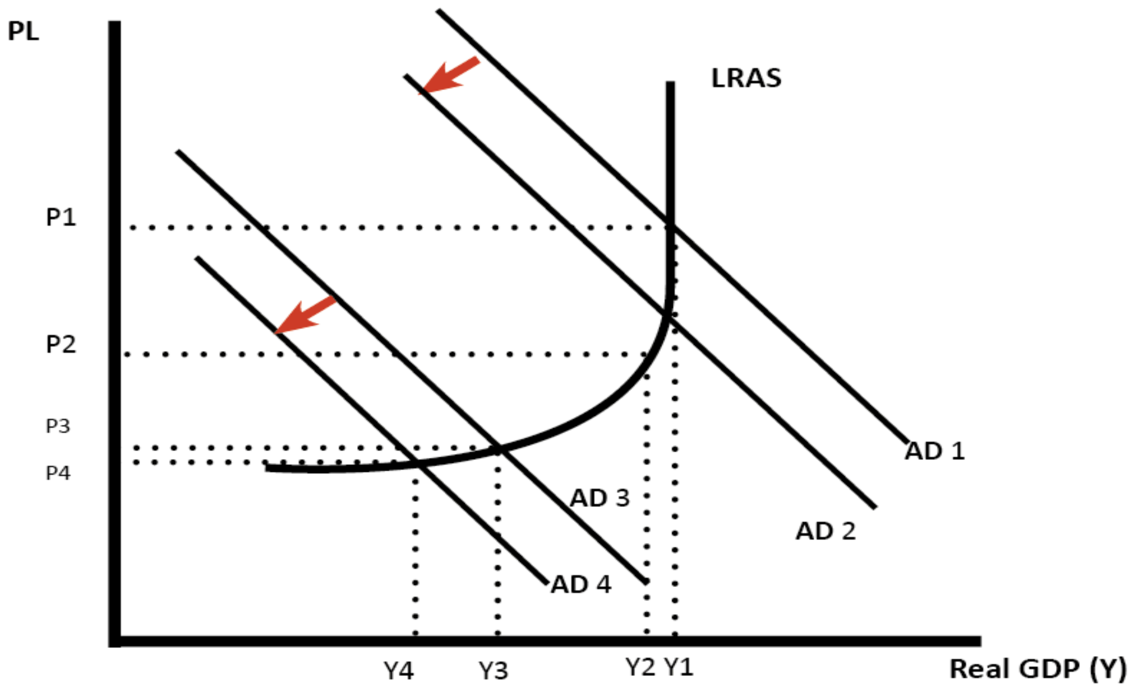
- **Depends on the elasticity of demand** for imports and exports. The Marshall Lerner condition states an appreciation will only worsen current account, if
  PED (exports) + PED (imports) >1.

- **It depends on other components of AD**. An appreciation won't cause a fall in AD, if consumer spending is growing strongly. Consumer spending is a bigger component of AD than net exports.

- **Time lags.** Often, demand is inelastic in the short term and becomes more elastic over time. Therefore, an appreciation could have a bigger impact over time.

- **It depends on productivity growth.** If the exchange rate appreciates because firms are becoming more productive, then they will remain competitive. If the exchange rate appreciates due to speculation, firms are more likely to become uncompetitive. For example, countries like Germany and Japan have prospered, even in periods of an appreciating currency.

- **It depends on the state of the economy.** If the economy is growing strongly and is near full capacity, a rise in the exchange rate could help reduce inflationary pressure and keep growth sustainable. If there is already spare capacity, then an appreciation could lead to a recession.



The effects of an appreciation depend on the state of the economy. A fall in AD to AD2 reduces inflation, with little effect on real GDP. But, at AD3 to AD4, there is a big fall in real GDP.