ISSN 2278 – 0211 (Online)

The Impact of Current Account Imbalances on Exchange Rate Movements

Ayooluwa Tomiwa Animashaun
Graduate Student, Department of Economics, Finance and Accounting,
Fort Hays State University, Hays, Kansas, US
Abraham Mensah
MBA Finance Graduate Student, Department of Economics, Finance and Accounting,
Fort Hays State University, Hays, Kansas, US

Abstract:
Current account imbalances and exchange rates engage in a captivating tango, where deficits weaken currencies (boosting exports), and surpluses strengthen them (potentially hindering exports). However, this dance has two steps: fluctuating exchange rates also influence imbalances, impacting import demand and, ultimately, the trade gap. This intricate interplay affects not just economies but policymakers, businesses and individuals globally. Understanding this connection is crucial, as imbalances left unchecked can disrupt exchange rate stability and lead to financial turmoil. Policy measures and structural reforms aimed at balancing imports and exports are vital steps in ensuring the global market tango remains harmonious.

Keywords: *Current accounts, exchange rates, exports, deficits*

1. Introduction

Exchange rate fluctuations and current account imbalances stand out as two phenomena that are intricately woven together in the complex web of global economic relations. Current account imbalances—a measure of the difference between a country's imports and exports—along with net foreign income have become a recurring theme in the modern global economy. These imbalances have raised questions about their possible effects on exchange rate swings and global economic stability, especially given the enormous deficits accrued by the US and the sizable surpluses amassed by nations like Germany and China.

An important factor influencing international trade and investment flows is exchange rates or the relative prices of various currencies. Assuring that exports stay competitive in international markets and imports meet domestic demand is essential to maintaining a country's external account balance. Differential economic growth, interest rate differentials, and central bank policies are some of the variables that might cause exchange rates to become volatile. Exchange rate changes and current account imbalances interact in a complicated and multidimensional way. On one hand, imbalances in the current account can have a significant effect on exchange rates. If there is a persistent deficit—defined as an excess of imports over exports—the value of a nation's currency may decline. By increasing exports' competitiveness on international markets, this depreciation may help reduce the trade imbalance. On the other hand, a sustained surplus, driven by a greater amount of exports than imports, may cause a country's currency to increase, which may impede export growth and increase the trade surplus.

Nevertheless, it is important to acknowledge that fluctuations in exchange rates exert a significant influence on current account balances. In instances where a currency undergoes depreciation, the cost of imports rises considerably. Consequently, this could potentially dampen domestic demand for foreign goods and services, leading to a contraction in trade deficits and an overall enhancement of the current account balance. Conversely, if a currency experiences appreciation, imports become more affordable, which inevitably stimulates greater domestic demand for imported products. This surge in import expenditure ultimately contributes to an expansion of trade deficits and subsequently leads to the deterioration of the current account balance.

A number of additional macroeconomic factors, including differences in interest rates, capital inflows and outflows, and differences in economic growth, further exacerbate the link between current account deficits and exchange rate movements. A complex and dynamic interplay of economic dynamics can result from these factors interacting with exchange rates and current account deficits. Policymakers, companies, and individuals all need to understand the complex relationship between current account deficits and exchange rate swings. It is imperative for policymakers to acknowledge the possible ramifications of current account deficits on exchange rates and implement suitable steps to mitigate them. Companies must think about how exchange rate swings might affect their operations and pricing policies. People must understand how changes in currency rates may affect their ability to make investments and their purchasing power.

2. Methodology

The relationship between current account imbalances (CAIs) and exchange rate movements has been extensively studied by economists for many years. There is a general consensus that there is a significant relationship between the two and that CAIs can have a large impact on exchange rates. The gap between a nation's imports and exports of goods and services and its net foreign income from dividends and interest constitutes a current account imbalance. By exporting more than it imports, a nation with a current account surplus generates net foreign revenue. On the other hand, a nation with a current account deficit imports more than it exports and has net income payments to foreign countries. A current account imbalance can be caused by a variety of circumstances, such as:

- Variations in national savings rates: Economies that have higher savings rates typically have current account surpluses because they export more than they import.
- Variations in economic growth rates: Nations experiencing quicker growth typically have current account deficits because they import more than they export.
- Exchange rates: By affecting exports' competitiveness in international markets, a nation's exchange rate can have an impact on its current account balance.

An exchange rate is the price of one currency in terms of another currency. Exchange rates are determined by a supply-and-demand mechanism.

- The price of a currency will rise or appreciate in response to strong demand.
- The price of a currency will decline or depreciate when there is a large supply of it.

3. Findings/Evidence

The difference between a nation's net foreign revenue, including interest and dividends, and its imports and exports of commodities and services constitutes a current account imbalance. A nation with a current account surplus generates net foreign income by exporting more than it imports. On the other hand, a nation with a current account deficit exports less than it purchases and pays net income to foreign countries.

The following are a number of factors that can contribute to a current account imbalance:

- Variations in national savings rates: Economies that have higher savings rates typically have current account surpluses because they export more than they import.
- Variations in economic growth rates: Nations experiencing quicker growth typically have current account deficits because they import more than they export.
- Exchange rates: By affecting exports' competitiveness in international markets, a nation's exchange rate can have an impact on its current account balance.

Exchange rates represent the price of one currency in terms of another, and they are determined by supply and demand.

- A currency's value will rise when there is a high demand for it.
- A highly circulating currency will depreciate or lose value.

Current account imbalances can have a full-size effect on exchange rates. A country with a current account deficit will generally see its currency depreciate, while a country with a current account surplus will commonly see its currency appreciate. This is due to the fact that a current account deficit leads to an increased demand for foreign currency, as importers would need to get more foreign currency to pay for their imports. This accelerated demand for foreign currency increases the price of foreign currency, causing the domestic currency to depreciate.

Exchange rates can be significantly impacted by current account imbalances. The general trend is for a country's currency to devalue when it has a current account deficit and to appreciate when it has a current account surplus. This is due to the fact that a current account deficit causes importers to need to buy more foreign currency in order to pay for their imports. The price of foreign currency rises due to its increased demand, depreciating the domestic currency. On the other hand, when there is a current account surplus, exporters earn more foreign currency from their exports, which increases the availability of foreign currency. Due to the increasing availability of foreign currency, the value of the home currency increases, and the price of foreign currency decreases.

4. Empirical Evidence

The idea that current account imbalances significantly affect exchange rates is supported by a wealth of empirical evidence. Examples of such evidence are stated below.

- Rogoff and Kuttner (2005) conducted a study and found out that a country's currency depreciates by 0.7 to 1.0 percent for every percentage point increase in its current account deficit to GDP ratio.
- According to a study conducted by Obstfeld and Rogoff (2005), current account imbalances play a significant role in understanding the US dollar's movements during the previous 50 years.
- According to the IMF (2007), developing market nations' currency rates can be significantly impacted by current account imbalances.

5. Conclusion

Currency rates are greatly impacted by current account imbalances. Currency depreciation is a common occurrence in countries that experience deficits in their current account, whereas currency appreciation is common in those with current account surpluses. This is because when importers want to make payments for their purchases in an

economy experiencing a current account deficit, they must buy more foreign currency. This will lead to an increase in the demand for foreign currency, thereby raising its price and depreciating the value of the home currency.

In contrast, because exporters receive more foreign exchange from their exports, a current account surplus increases the supply of foreign currency. The appreciation of the home currency results from the greater supply of foreign money driving down its price. The possible effects of current account imbalances on exchange rates must be recognized by policymakers, who must then take the necessary action to rectify them. Exchange rate variations may have an impact on a business's operations and pricing strategy; therefore, examine these consequences. People should be conscious of the possible effects that fluctuations in exchange rates may have on their ability to make investments and purchases.

Imbalanced current accounts are a difficult problem with no simple answers. To solve them, nevertheless, a variety of policy initiatives are available. Among them are:

- Fiscal policy: By using fiscal policy, governments can lower their budget deficits, which can increase domestic savings and lower demand for imports.
- Monetary policy: By increasing interest rates, central banks can draw in foreign capital inflows and lessen current account deficits.
- Exchange rate policy: By intervening in the foreign exchange market, governments can affect the value of their own currency. However, the exchange rate policy should be reserved for the last option due to the possibility of unforeseen outcomes.

Current account imbalances can be reduced by a variety of structural elements in addition to policy measures. Among them are:

- Increasing productivity: Investing in R&D and education can help countries become more productive. This can lessen their dependence on imports and increase the competitiveness of their products in international markets.
- Increasing household consumption and investment is one way that nations could increase domestic demand. By doing this, their current account balances may increase, and their dependency on exports may be lessened.
- Increasing export competitiveness: By lowering trade obstacles, expediting customs processes, and making infrastructure investments, nations can increase the competitiveness of their exports.

Addressing current account imbalances is important for global economic stability. Large and persistent current account imbalances can lead to exchange rate volatility, financial market instability, and even global economic crises. By taking appropriate policy measures and addressing underlying structural issues, countries can help reduce current account imbalances and promote global economic stability.

6. References

i. IMF. Research Dept. (2007). World Economic Outlook, October 2007: Globalization and inequality: Globalization and inequality. *World Economic Outlook*. https://doi.org/10.5089/9781589066991.081
ii. IMF. (2007). "Global imbalances: A saving glut?" World Economic Outlook, September, pp. 117–166.
iii. Obstfeld, M., & Rogoff, K. S. (2005). Global current account imbalances and exchange rate adjustments. *Brookings Papers on Economic Activity*, *2005*(1), 67–146. https://doi.org/10.1353/eca.2005.0020
iv. Obstfeld, M., and K. Rogoff. (2005). "The global current account deficit: Sustainability and adjustment." In the US current account and the world economy, pp. 1–54. Princeton University Press.
v. Obstfeld, M., & Rogoff, K. S. (2005). Global current account imbalances and exchange rate adjustments. *Brookings Papers on Economic Activity*, *2005*(1), 67–146. https://doi.org/10.1353/eca.2005.0020
vi. Obstfeld, M., & Rogoff, K. (2007). The Unsustainable U.S. Current Account Position Revisited. *G7 Current Account Imbalances*, 339–376. https://doi.org/10.7208/chicago/9780226107288.003.0010
vii. Rogoff, K., and K. Kuttner. (2005). "Current account imbalances: Will adjustment be orderly?" In The US current account and the world economy, pp. 55–102. Princeton University Press.
viii. Sarno, L. (2005). Viewpoint: Towards a solution to the puzzles in exchange rate economics: Where do we stand? *Canadian Journal of Economics/Revue Canadienne d'économique*, *38*(3), 673–708. https://doi.org/10.1111/j.0008- 4085.2005.00298.x