1. To what extent will a fall in the value of a currency improve a country’s current account position?

Answers may include:

A fall in the value of a currency is a depreciation. This means it is relatively cheaper in terms of foreign currency. This should encourage exports because they are relatively cheaper. This should boost sales abroad and lead to higher earnings in the domestic currency.

At the same time, a lower value of a currency increases the price in the domestic currency of imports. The higher price should reduce the quantity of imports demanded and if demand is price elastic it will reduce total spending on imports; if, however, demand is price inelastic the total spending on imports will increase.

The effect of a fall in the value of a currency therefore depends on the price elasticity of demand for exports and imports.

If the price elasticity of demand for exports plus imports is greater than 1 then a depreciation of the currency will improve the current account position.

If the price elasticity of demand for exports plus imports is less than 1 then the depreciation of the currency will worsen the current account position.

In the short term demand for exports and imports tends to be price inelastic as it takes times for customer to switch providers therefore the current account can get worse; over time demand should become more price elastic and therefore the position should improve. This is known as the J curve effect.

In the very long term the lower value of the currency will lead to higher import prices which will lead to cost push inflation and offset the initial gains in international competitiveness.

2. Should the USA worry about its large current account deficit?

Answers may include:

A current account deficit occurs when the spending on imported goods and services over a given period exceeds the revenue from exports. This may suggest uncompetitiveness and in a free floating exchange system is financed by inflows on the financial account. Essentially the money flowing in the financial account is being used to buy imports and the country with the deficit is incurring liabilities to the other country.

This can lead to debates and frustrations within industries about their inability to compete and they demand government protectionism to help them. This can lead to political tensions between countries (e.g. between USA and China).

Key issues include:

How long and how severe the deficit is

The underlying cause - e.g. is it caused by the China artificially depressing its currency in which case political action may be able to reverse this; if the cause is the import of key parts to build up a sector and increase its competitiveness over time what are the inflows are being used for; if they are simply used for consumption this is not helping the country become more competitive

So yes it may be important to worry if it is a sustained deficit reflecting uncompetitiveness.
and no actions are being taken to improve competitiveness.

3. Is faster growth a sensible aim for government?

*Answers may include:*
Faster growth may:
Create jobs
Increase the standard of living as measured by real GDP per person

However faster growth may have many disadvantages such as:
- Involve unwelcome environmental effects
- May lead to a poor quality of life (e.g. due to pollution and more working hours)
- May create even more social inequality
- May not make people happy

Governments are likely to consider what their voters want and respond to this. If people believe that faster growth and higher incomes are key this is likely to drive policy.