THE INSTITUTE OF CHARTERED ACCOUNTANTS OF SRI LANKA

ECONOMICS 5

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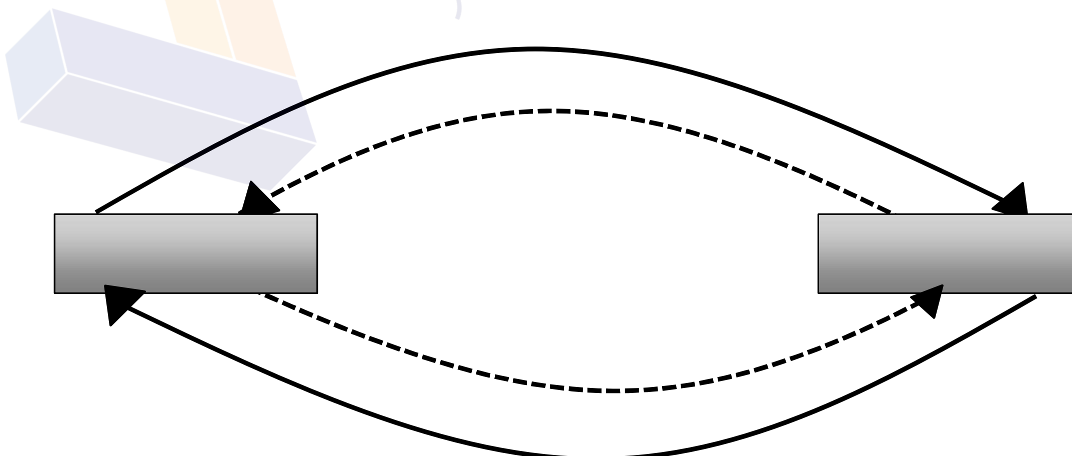
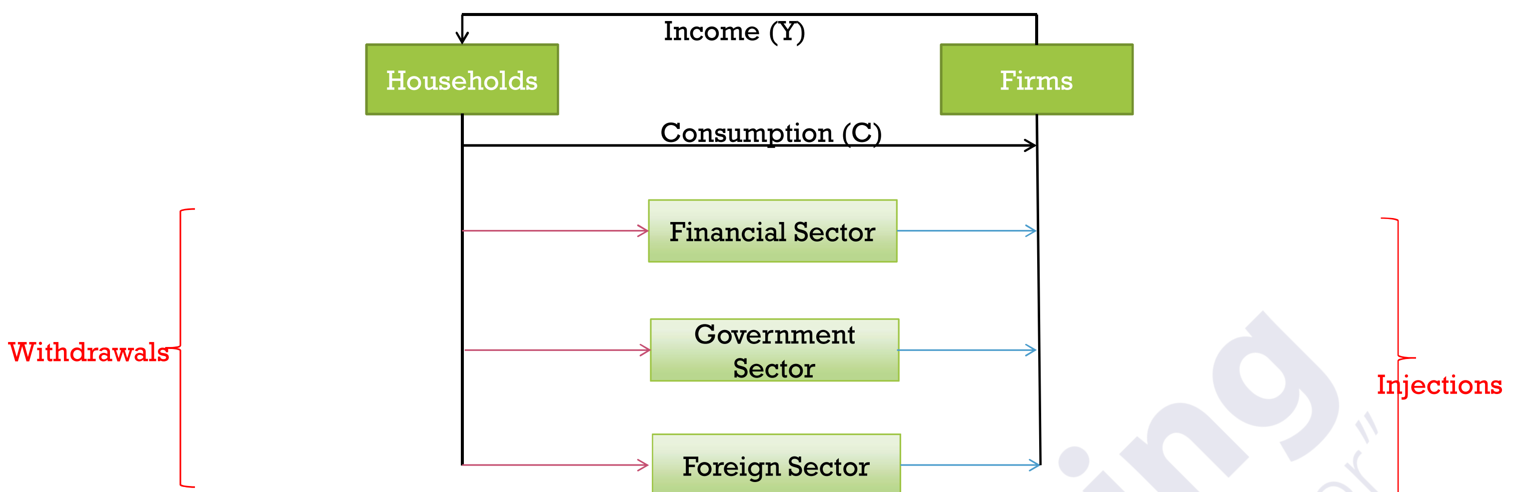
- Macro economics is the study of the aggregated effects of the decisions of individual economic units (such as households or businesses). It looks at a complete national economy, or the international economic system as a whole.
- Macro economic policy describes the policies and actions a government takes to control economic issues, such as economic growth, inflation, employment and trade performance

Income & Expenditure floor



WITHDRAWALS AND INJECTIONS



'Saving' simply means withdrawing money from circulation. Think of it as cash kept in a money box rather than being put into a bank to earn interest. Whereas 'investment' covers expenditure on capital items such as plant, machinery, roads and houses.

The multiplier in the national economy

The **multiplier** involves the **process of circulation of income** in the national economy, whereby an injection of a certain size leads to a much larger increase in national income. **An initial increase in expenditure will have a snowball effect**, leading to further and further expenditures in the economy.

Eg: The Government spending on the construction of roads

The government would spend money paying firms of road contractors, who in turn will purchase raw materials from suppliers, and sub-contract other works. All these firms employ workers who will receive wages that they can spend on goods and services of other firms. The new roads in turn might stimulate new economic activity, for example amongst road hauliers, house builders and estate agents.

Depending on the size of the multiplier, an increase in investment would therefore have repercussions throughout the economy, increasing the size of the national income by a multiple of the size of the original increase in investment

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Aggregate demand

- The total demand in the economy for goods and services is called the aggregate demand and it is made up of several components of the circular flow. These components include consumption, investment, government spending and exports minus imports. Put simply, the aggregate demand curve represents the sum of all of the demand curves for individuals and businesses in a country. A shift of AD may be due to a factor such as an increase or decrease in consumer confidence.

Aggregate supply

The aggregate supply (AS) refers to the ability of the economy to produce goods and services. Aggregate supply is positively related to the price level. This is because a price rise will make more profitable sales and encourage organisations to increase their output. The aggregate supply curve slopes upwards from left to right and does not shift in the short term

Full-employment national income

If one aim of a country's economic policy is full employment, then the ideal equilibrium level of national income will be where AD and AS are in balance at the full employment level of national income, without any inflationary gap – in other words, where AD at current price levels is exactly sufficient to encourage firms to produce (AS) at an output capacity where the country's resources are fully employed.

Inflationary gaps *When the economy fully employed resources, AD exceeds the AS*

In a situation where resources are already fully employed, there may be an **inflationary gap** since increases in demand will cause price changes, but no variations in real output. A shift in demand or supply will not only change the national income, it will also change price levels. the government can use contractionary fiscal policy to control inflation and bring down the AD

Deflationary gap when the economy not fully utilized its resources, AD is short of AS

In a situation where there is unemployment of resources there is said to be a deflationary gap. Prices are fairly constant and real output changes as aggregate demand varies. A deflationary gap can be described as the extent to which the aggregate demand function will have to shift upward to produce the full employment level of national income. The government uses expansionary fiscal policy**.**

Stagflation

In the 1970s there was a problem in many countries with stagflation: a combination of unacceptably high unemployment, unacceptably high inflation and low/negative economic growth. One of the causes was diagnosed as the major rises that took place in the price of crude oil. The cost of energy rose and this had the effect of rendering some production unprofitable. National income fell, and both prices and unemployment rose. Any long-term major increase in costs (a price shock) is likely to have this effect.

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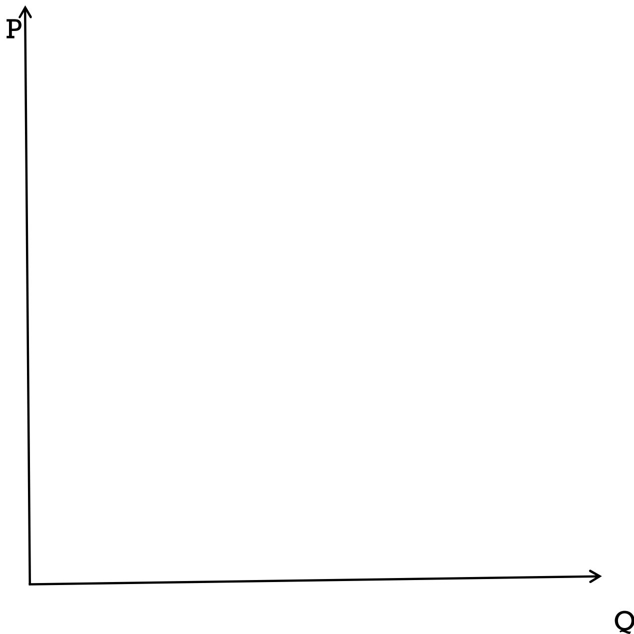
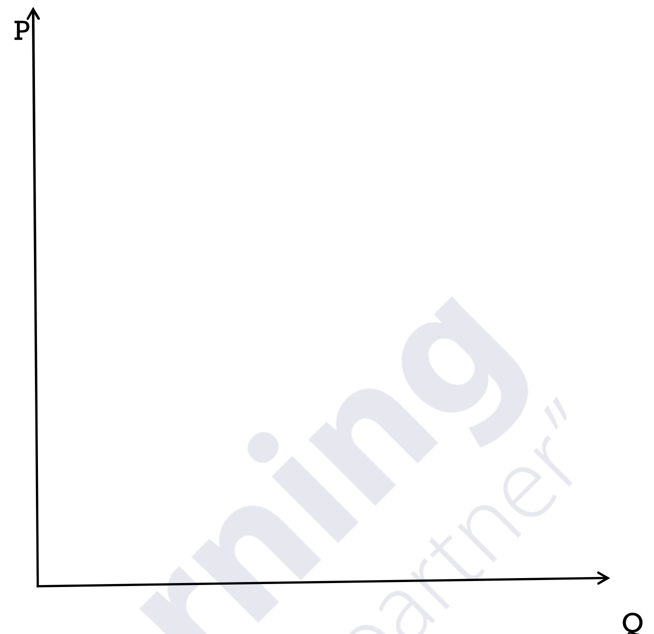


Inflationary Gap



Deflationary Gap

National income / Net National Product (NNP)

The National Income include rent, employment income, interest and profit, which are known as factor incomes because they are earned by the factors of production

- Land earns rent
- Labour earns wages
- Capital earns interest
- Entrepreneurship earns profit

The term **NET** means after deducting an amount for Capital consumption or depreciation of fixed assets

The term **GROSS** means before deducting an amount for Capital consumption or depreciation of fixed assets

Gross domestic product (GDP)

Most national income is derived from economic activity within the country. Economic activity is referred to as total domestic income or domestic product. It is measured gross, ie before deducting an amount for capital consumption or depreciation of fixed assets; the term gross domestic product therefore refers to the total value of income/production from economic activity.

Gross national product (GNP)

Some national income arises from overseas investments, while some of the income generated within the home country is earned by non-residents. The difference between these items is Net Property Income from abroad. Gross National Product (GNP) is therefore the gross domestic product (GDP) plus the Net Property Income from Abroad.

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Gross Domestic Product (GDP) = xxx

Plus

Net Property Income from abroad = x

Gross National Product (GNP) = xxxx

Minus

Capital consumption & depreciation of fixed assets = (x)

Net National Product (NNP) = xxx

Nominal GNP and real GNP

Nominal GNP is the value of all the national income at this year's prices. Real GNP is valued at the prices of a base year. Real GNP strips out the effect of inflation on national income levels, and makes it simpler to establish trends in national income over time, ie to discover whether the economy is actually expanding in terms of what it is producing or earning.

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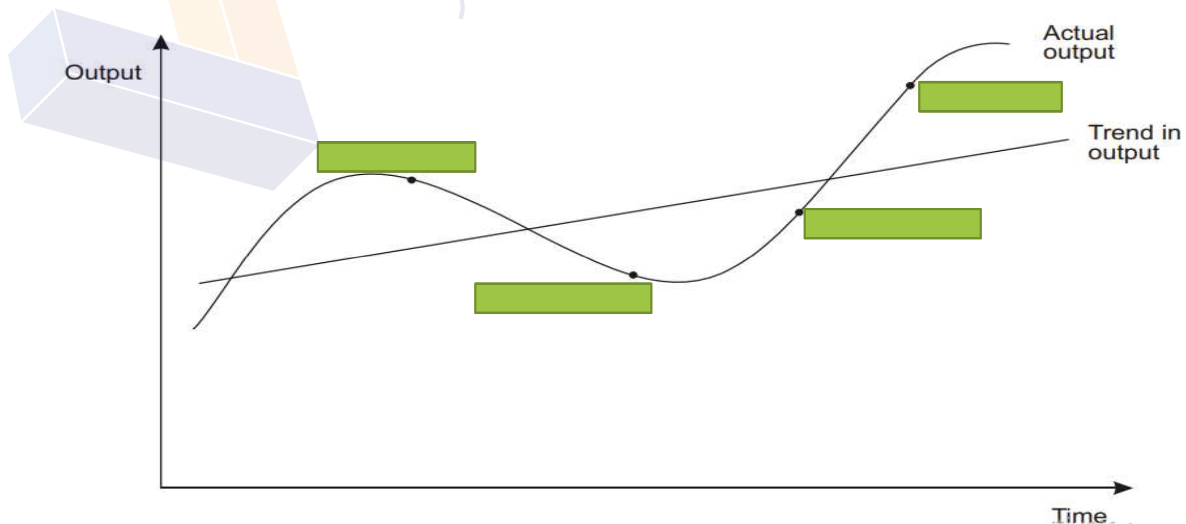
Phases in the business cycle

Four main phases of the business cycle can be distinguished.

□ □

□ □

Recession tends to occur quickly; recovery is, typically, a slower process.



Inflation is the term given to an increase in price levels generally. It is also manifest in the decline in the purchasing power of money.

Why is a high rate of price inflation harmful and undesirable?

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-
-
-
-

Causes of inflation

- Demand-pull factors –
- Expectations -
- Cost-push factors –
- Excessive growth in the money supply –
- Import cost factors -

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- **Government policies towards inflation**

Perceived cause of inflation	**Policy to control inflation**
Demand-pull (high consumer demand)	Take steps to reduce demand in the economy, - Higher taxation to cut consumer spending - Lower the government expenditure - Higher interest rates
Cost-push factors (higher wage costs and other costs)	Take steps to reduce production costs and price rises. - Deregulation of labour markets - Encouraging greater productivity in industry - Applying controls over wage and price rises.
Import cost push factors	Take steps to reduce the quantities or the price of imports by trying to achieve a change in the exchange rate.
Excessively fast growth in the money supply	Take steps to reduce the rate of money supply growth - Cutting government borrowing - Control or reduce bank lending, - Trying to achieve a balance of trade surplus - Maintaining interest rates at Higher level, so it discourage money supply
Expectations of inflation	Pursue clear policies which indicate the government's determination to reduce the rate of inflation.

Inflation and interest rates

A government may adopt a policy of high interest rates as a means of trying to reduce the rate of inflation, when inflation is being caused by a boom in consumer demand (with demand rising faster than the ability of industry to increase its output to meet the demand).

(a) When interest rates go up, there will be an initial increase in the rate of inflation.

(b) If interest rates are high enough, there should eventually be a reduction in the rate of growth in consumer spending. This reduction should occur for the following reasons.

(i) People who borrow must pay more in interest out of their income. This will leave them less income, after paying the interest, to spend on other things. (The government would not want wages to rise)

(ii) High interest rates might discourage people from borrowing, and so there would be less spending with borrowed funds.

(iii) High interest rates should encourage more saving (Fixed and other savings) with individuals therefore spending less of their income on consumption.

(iv) High interest rates will tend to discourage the values of non-monetary assets, such as houses.

The rate of unemployment

The rate of unemployment in an economy can be calculated as:

Flows into unemployment are:

(a) Members of the working labour force becoming unemployed

-
-
-

(b) People out of the labour force joining the unemployed

-
-

Flows out of unemployment are:

-
-
-

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Consequences of unemployment

- **Loss of output**. If labour is unemployed, the economy is not producing as much output as it could. Thus, total national income is less.
- **Loss of human capital**. If there is unemployment, the unemployed labour will gradually lose its skills,.
- **Increasing inequalities in the distribution of income**. Unemployed earn less than employed people; so the poor get poorer.
- **Social costs**. Unemployment brings social problems of personal suffering and distress, and increases in crime such as theft and vandalism.
- **Increased burden of welfare payments**. This can have a major impact on government fiscal policy.

Causes of unemployment

- **Real wage unemployment** - The supply of labour exceeds the demand for labour, but real wages do not fall for the labour market to clear. Another cause of this type of unemployment is the minimum wage rate, when it is set above the market clearing level.
- **Frictional** - Difficulty in matching quickly workers with jobs. caused by a lack of knowledge about job opportunities. Frictional unemployment is temporary, lasting for the period of transition from one job to the next. (A worker moves to a new city and has to find a new job)
- **Seasonal** - Occurs in certain industries (building, tourism & farming) Demand for labour fluctuates in seasonal patterns throughout year.
- **Structural** - This occurs where long-term changes occur in the conditions of an industry. Structural unemployment is caused by a mismatch in the demographics of workers and the types of jobs available, either when there are jobs available that workers don't have the skills for, or when there are workers available but no jobs to fill.
- **Technological** - This is a form of structural unemployment, which occurs when new technologies are introduced. (a) Old skills are no longer required. (b) There is likely to be a labour-saving aspect, with machines doing the job that people used to do.
- **Cyclical or demand deficient** - (a) During recovery and boom years, the demand for output and jobs is high, and unemployment is low. (b) During decline and recession years, the demand for output and jobs falls, and unemployment rises to a high level.

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Economic Growth

- Actual economic growth is the annual percentage increase in national output, which typically fluctuates in accordance with the trade cycle. Potential economic growth is the rate at which the economy would grow if all resources (eg people and machinery) were utilised. Sri Lanka recorded a GDP growth of 8% in 2011, the highest growth rate in three decades.
- (2020 – (3.6%) / 2019 – 2.28%/ 2018 – 3.2% / 2017 – 3.5%)

- Actual growth in the long run is determined by two factors.
  - The growth in potential output (the aggregate supply)
  - The growth in aggregate demand

Increase resources inputs

Increase productivity

- The causes of growth in potential output (AS)

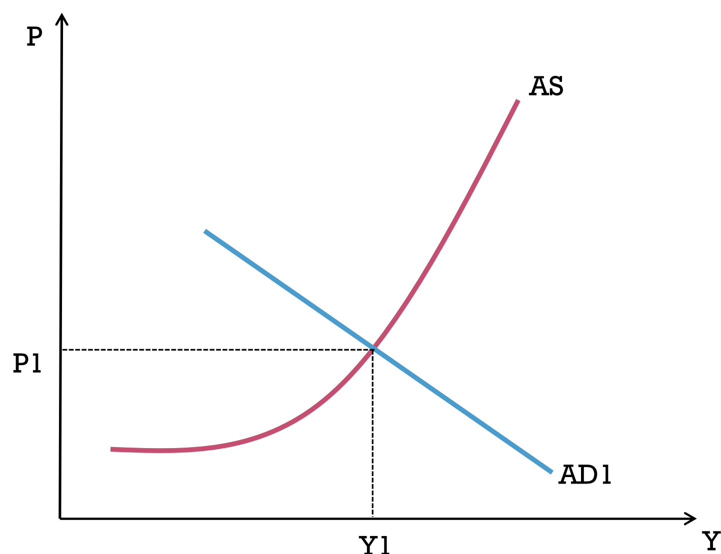
(a) There may be increases in the amount of resources available.

- Land and raw materials. Land is virtually in fixed supply, but new natural resources are continually being discovered.
- Labour (the size of the working population). The output per head will be affected by the proportion of the population which is non-working.
- Capital (eg machinery).

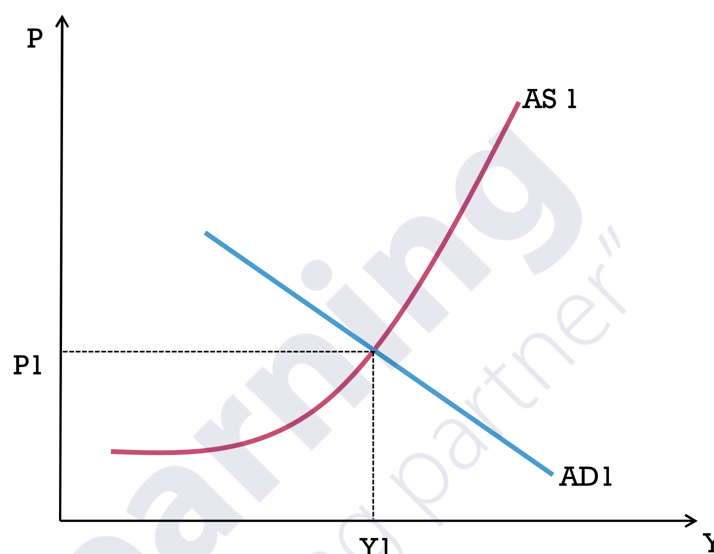
(b) Increases in the productivity of resources may result from technological progress or changed labour practices (Skilled labor). The technology can be used as a capital savings and labor savings.

Sustained economic growth depends heavily on an adequate level of new investment, which will be undertaken if there are expectations of future growth in demand.

Demand Increase



Supply Increase



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Advantages of Economic Growth

- Economic growth should lead to a higher income per head which can, in turn, lead to higher levels of consumption and a better standard of living.
- A country with economic growth is more easily able to provide welfare services, without creating intolerable tax burdens on the community. (Government income increase, Education and health etc.)
- Decrease unemployment due to the increase of public sector and private sector investment.

Disadvantages

- Growth implies faster use of natural resources. Without growth, these resources would last longer.
- Much economic activity tends to create pollution, such as acid rain and nuclear waste. It leads to emissions which threaten to produce disruptive climatic changes.
- There is a danger that some sections of the population, unable to adapt to the demands for new skills and more training, will not find jobs in the developing economy. This structural unemployment might create a large section of the community which gains no benefit from the increase in national income.
- In order to achieve growth, firms need to invest more and this requires financing. This finance can only come from higher savings, which in turn require the population to consume less. In the short run, therefore, higher growth requires a cut in consumption.

Government policies

four main objectives of economic policy,

(a) To achieve **economic growth**, and growth in national income per head of the population - Growth implies an increase in national income in real terms. Increases caused by price inflation are not real increases at all.

(b) To control price **inflation** (to achieve stable prices).

(c) To achieve full **employment**. (Full employment does not mean that everyone who wants a job has one all the time, but it does mean that unemployment levels are low.)

(d) To achieve a **balance between exports and imports** (on the country's balance of payments accounts) over a period of years. The wealth of a country relative to others, a country's creditworthiness as a borrower, and the goodwill between countries in international relations might all depend on the achievement of an external balance over time.

Governments use '**Fiscal**' or '**Monetary**' policies to manage these objectives, Fiscal policy relates to taxation, public borrowing and spending. Monetary policy relates to government policy on the money supply, interest and exchange rates and the availability of credit.

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Fiscal policy

government policy on taxation (Revenue), public borrowing and public spending (Expenditure). A feature of fiscal policy is that a government must plan what it wants to spend, and so how much it needs to raise in income or by borrowing.

Elements (Components) of the Fiscal Policy

(a) **Expenditure**. The government, at a national and local level, spends money to provide goods and services, such as a health service, public education, a police force, roads, public buildings and so on, and to pay its administrative work force. It may also, perhaps, provide finance to encourage investment by private industry, for example by means of grants

(b) **Revenues**. Expenditure must be financed, and the government must have income. Most government income comes from taxation & some income is obtained from direct charges to users of government services.

(c) **Borrowing**. To the extent that a government's expenditure exceeds its income, it must borrow to make up the difference. Where the government borrows from has an impact on the effectiveness of fiscal policy

Stimulating demand

- Suppose, for example, that the government wants to stimulate demand in the economy. If the government kept its own spending at the same level, but reduced levels of taxation, it would stimulate demand in the economy: firms and households would have more of their own money, after tax, for consumption or saving/investing.

(a) It can increase demand directly by government spending more itself – eg on the health service or education, and by employing more people itself.

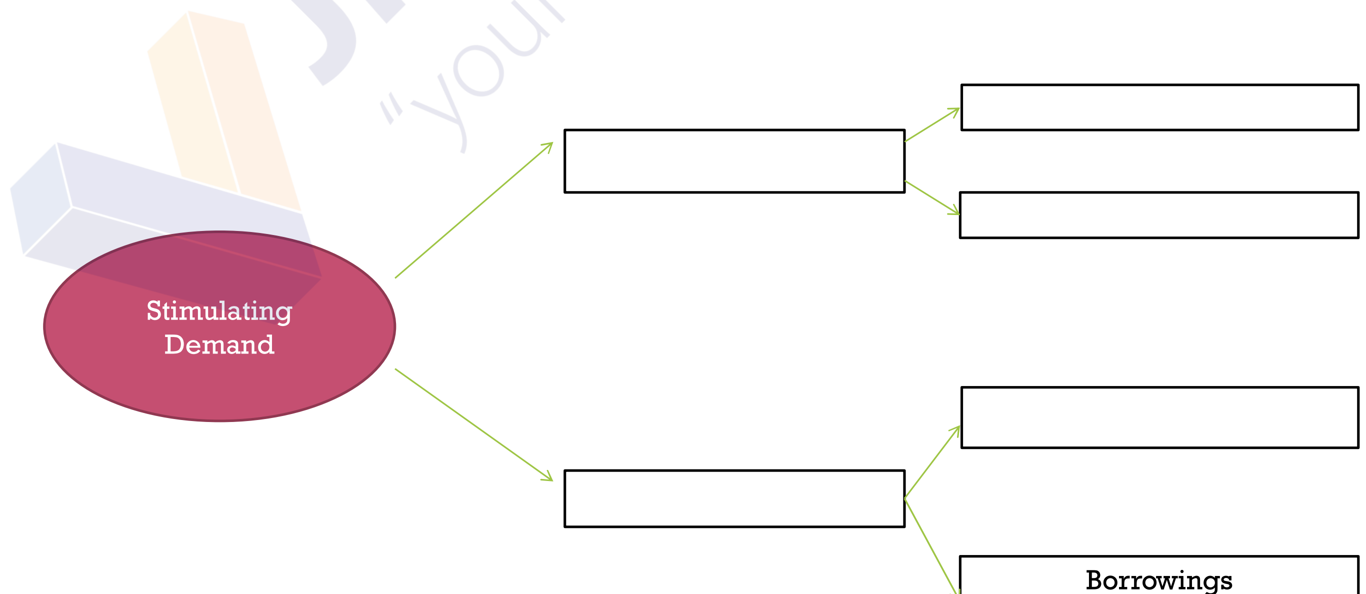
(i) This extra spending could be financed by higher taxes, but this would reduce spending by the private sector of the economy because the private sector's after-tax income would be lower.

(ii) The extra government spending could also be financed by extra government borrowing.

(b) It can increase demand indirectly by reducing taxation and so allowing firms and individuals more after-tax income to spend (or save).

(i) Cuts in taxation can be matched by cuts in government spending, in which case total demand in the economy will not be stimulated significantly, if at all.

(ii) Alternatively, tax cuts can be financed by extra government borrowing.



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Expenditure changes and tax changes are not mutually exclusive options, of course. A government has several options.

(a) Increase expenditure and reduce taxes, with these changes financed by a higher Public Sector Net Cash Requirement (PSNCR), A higher fiscal deficit.

(b) Reduce expenditure and increase taxes, with these changes reducing the size of the PSNCR

© Increase expenditure and partly or wholly finance this extra spending with higher taxes. Increase both.

(d) Reduce expenditure and use these savings to reduce taxes.

When a government's income exceeds its expenditure, we say that the government is running a budget surplus. This may be a deliberate policy, known as **contractionary policy** to reduce the size of the money supply by taking money out of the economy. When a government's expenditure exceeds its income, so that it must borrow to make up the difference, there is a PSNCR and we say that the government is running a budget deficit. When the government is injecting money into the economy, this is known as **expansionary policy**

	Fiscal Policy	Monetary Policy
Contractionary Policies	• •	• •
Expansionary Policies	• •	• •

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Expansionary Policies

- To illustrate how the government can use fiscal policy to affect the economy, consider an economy that's experiencing a recession. The government might issue tax stimulus rebates to increase aggregate demand and fuel economic growth.
- The logic behind this approach is that when people pay lower taxes, they have more money to spend or invest, which fuels higher demand. That demand leads firms to hire more, decreasing unemployment, and to compete more fiercely for labor. In turn, this serves to raise wages and provide consumers with more income to spend and invest.

Contractionary Policies

- Contractionary fiscal policy is when the government either cuts spending or raises taxes. It gets its name from the way it contracts the economy. It reduces the amount of money available for businesses and consumers to spend.
- In the face of mounting inflation and other expansionary symptoms, a government can pursue contractionary fiscal policy, perhaps even to the extent of inducing a brief recession in order to restore balance to the economic cycle. The government does this by increasing taxes, reducing public spending, and cutting public-sector pay or jobs.

Where expansionary fiscal policy involves deficits, contractionary fiscal policy is characterized by budget surpluses.

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Functions of taxation

- To raise revenues for the government as well as for local authorities and similar public bodies.
- To cause certain products to be priced to take into account their social costs. (For example, smoking entails certain social costs, such as hospital care.)
- To redistribute income and wealth.
- To protect industries from foreign competition. If the government levies a duty on all imported goods, much of the duty will be passed on to the consumer in the form of higher prices, making imported goods more expensive

- A direct tax is paid direct by a person to the revenue authority. A direct tax can be levied on income and profits, or on wealth. Direct taxes tend to be progressive or proportional; they are also usually unavoidable (must be paid by everyone).
- An indirect tax is collected by the revenue authority from an intermediary (a supplier) who then passes on the tax to consumers in the price of goods they sell. Indirect taxes are of two types.
  - A specific tax is charged as a fixed sum per unit sold.
  - An ad valorem tax is charged as a fixed percentage of the price of the good.

Monetary policy: government policy on the money supply, the monetary system, interest rates, exchange rates and the availability of credit.

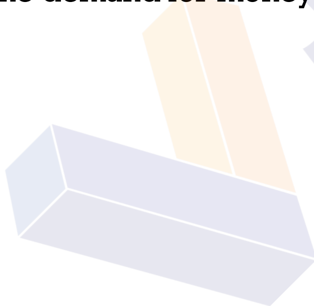
Monetary policy can be used as a means of achieving ultimate economic objectives for inflation, the balance of trade, full employment and real economic growth. To achieve these **ultimate objectives**, the authorities will set **intermediate objectives** for monetary policy, such as the level of interest rates, growth in the money supply, the exchange rate for sterling, the expansion of credit and the growth of national income.

Interest rates as a target for monetary policy

The authorities might decide that interest rates – the 'price' of money – should be a target of monetary policy. This would be appropriate if it is considered that there is a direct relationship between interest rates and the level of expenditure in the economy, or between interest rates and the rate of inflation. A rise in interest rates will raise the price of borrowing in the internal economy for both companies and individuals. If companies see the rise as relatively permanent, rates of return on capital investments will become less attractive and capital investment plans may be curtailed by businesses. Corporate profits will fall as a result of higher interest payments. Companies will reduce inventory levels as the cost of having money tied up in inventory rises Individuals should be expected to reduce or postpone consumption in order to reduce borrowings, and should become less willing to borrow for house purchase. Although it is generally accepted that there is likely to be a connection between interest rates and investment (by companies) and consumer expenditure, the connection is not a stable and predictable one; interest rate changes are only likely to affect the level of expenditure after a considerable time lag.

The money supply as a target of monetary policy

the money supply is an intermediate target of economic policy, principally to control of inflation. This is because that an increase in the money supply will raise prices and incomes and this in turn will raise the demand for money to spend.



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The exchange rate as a target for monitory policy

(a) If the exchange rate falls (Fx rate depreciation), exports become cheaper to overseas buyers and so more competitive in export markets. Imports will become more expensive and so less competitive against goods produced by manufacturers at home. A fall in the exchange rate might therefore be good for a domestic economy in some ways, by giving a stimulus to exports and reducing demand for imports.

(b) An increase in the exchange rate (Fx rate appreciation) will have the opposite effect, with dearer exports and cheaper imports. If the exchange rate rises and imports become cheaper, there should be a reduction in the rate of domestic inflation, but cheaper imports may adversely affect domestic demand and production, leading to redundancies. A fall in the exchange rate, on the other hand, tends to increase the cost of imports and thus adds to the rate of domestic inflation.

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Targets and indicators / Monitory Policy indicators

An economic indicator provides information about economic conditions and might be used as a way of judging the performance of government.

(a) A **leading indicator** is one which gives an advance indication of what will happen to the economy in the future. It can therefore be used to predict future conditions. For example, a fall in the value of sterling by, say, 2%, might be used to predict what will happen to the balance of payments and to the rate of inflation.

(b) A **coincident indicator** is one which gives an indication of changes in economic conditions at the same time that these changes are occurring. For example, if the money supply rises by 5%, this might 'confirm' that the rate of increase in GDP over the same period of time..

(c) A **lagging indicator** is one which 'lags behind' the economic cycle. Unemployment, to take an example, often continues to rise until after a recession has ended and only starts to fall again after recovery has begun. There are a number of monetary indicators.

- Interest rates, such as the banks' base rate of interest, the Treasury bill rate and the yield on long-dated government securities
- The exchange rate against another currency, for example the US dollar, or the trade-weighted exchange rate index
- The size of the government's borrowing
- Government borrowing as a percentage of gross domestic product

Balance of payments

Balance of payments accounts include a current account with trade balance, income and services and net remittances abroad sections, and a capital account (foreign direct investments and borrowing). current account transactions are sub-divided into:

- Trade balance (exports and imports)
- Income and services account
- Net remittances from abroad

A problem arises for a country's balance of payments when the country has a deficit on current account year after year, although there can be problems, too, for a country which enjoys a continual current account surplus. When a country is continually in deficit on the current account, it is importing more goods and services than it is exporting.

<u>If the current account is deficit,</u>

(a) **It may borrow more and more from abroad**, to build up external liabilities which match the deficit on current account, for example encouraging foreign investors to lend more by purchasing the government's gilt-edged securities.

(b) **It may sell more and more of its assets.** This has been happening recently in the USA, for example, where a large deficit on the US current account has resulted in large purchases of shares in US companies by foreign firms.

If a country has a surplus on current account year after year, it might invest the surplus abroad or add it to official reserves. The balance of payments position would be strong.

Item			
• Export of Goods	= xx		(Ownership of a good is transferred from a local country to a foreign country - Export)
• Import of Goods	= (xx)		(Ownership of good is transferred from a foreign country to a local country - Import)
Balance of Trade in Goods		= xx	
• Export of services	= xx		(A foreign tourist comes and enjoys the services of a local country – Export Service)
• Imports of Services	= (xx)		(A local tourist visits a foreign country, the local country is consuming the foreign services – Import)
Balance of Trade in Services		= xx	
• Income receipts	= xx		(A credit of income, when a domestic individual/ company receives money from a foreign individual or company)
• Income payments	=xx		(A debit of income, when a foreign entity receives money from an investment in the local economy)
Balance of Income		= xx	
• Cash transfers receivables	= xx		(A gift of aid from a foreign country to the domestic country)
• Cash transfers Payables	= xx		(The provision of official assistance by the local economy to a foreign economy)
Net Current Transfers		<u>= xx</u>	
Current Account		= xxxxxx	
Balance of Capital Account		= <u>xx</u>	(The capital account records the net change of **assets** and **liabilities** during a particular year)
Current Account + Capital Account		=xxxx	
Net Direct Investment	= xx		(building factories)
Net Portfolio Investment	= xx		(saving money in pension funds/investment trusts)
Net Financial Derivatives Securities, Bonds)	= xx		(A contract between 2 or more parties whose value is based on an agreed-upon underlying **financial** asset –
Reserves Assets Funding	= xx		
Errors & Omissions	= xx		
Net Financial Account		= xx	
Balance of Payment		=xxx	

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How can a government rectify a current account deficit?

The government of a country with a balance of payments deficit will usually be expected to take measures to reduce or eliminate the deficit. A deficit on current account may be rectified by one or more of the following measures.

(a) A depreciation of the currency (called devaluation when deliberately instigated by the government, for example by changing the value of the currency within a controlled exchange rate system).

(b) Direct measures to restrict imports, such as tariffs or import quotas or exchange control regulations.

(c) Supply side policies to improve the competitiveness of domestic industry and exports.

The extent of the increase in export revenue would depend on several factors

(a) The price elasticity of demand for the goods in export markets.

(b) The extent to which industry is able to respond to the export opportunities by either producing more goods, or switching from domestic to export markets.

(c) It may also depend on the price elasticity of supply. With greater demand for their goods, producers should be able to achieve some increase in prices (according to the law of supply and demand), and the willingness of suppliers to produce more would then depend on the price elasticity of supply.

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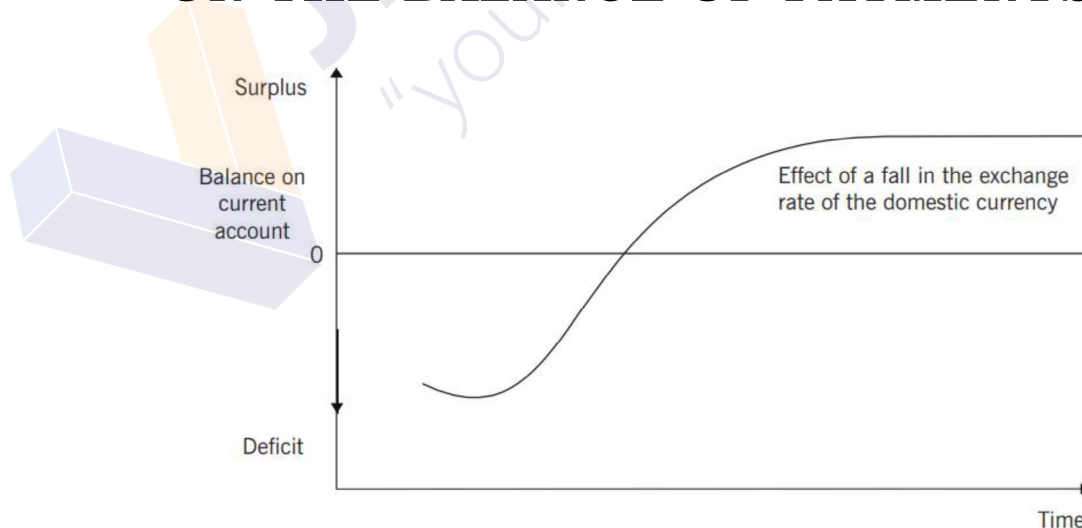
EFFECTS OF A FALL IN EXCHANGE RATE ON THE BALANCE OF PAYMENTS



How to rectify a balance of payments deficit

- Import tariffs
- Import quotas
- A total ban or embargo on imports from a certain country
- Placing administrative burdens on importers (for example increasing the documentation required or safety standards that imported goods must comply with)
- Exchange control regulations which make it difficult for importers to obtain foreign currency to buy goods from abroad
- Providing export subsidies to encourage exports, and other measures of financial support to exporters
- Exchange rate depreciation

An exchange rate is the rate at which one country's currency can be traded in exchange for another country's currency. Dealers in foreign exchange make their profit by buying currency at one exchange rate, and selling it at a different rate. This means that there is a selling rate and a buying rate for a currency.

Factors influencing the exchange rate of a currency

- The rate of inflation, compared with the rate of inflation in other countries
- Interest rates, compared with interest rates in other countries
- The balance of payments
- Speculation
- Government policy on intervention to influence the exchange rate

Other factors

(a) Total income and expenditure in the domestic economy determines the demand for goods. This includes imported goods and demand for goods produced in the country which would otherwise be exported if demand for them did not exist in the home market.

(b) Output capacity and the level of employment in the domestic economy might influence the balance of payments, because if the domestic economy has full employment already, it will be unable to increase its volume of production for exports.

(c) The growth in the money supply influences interest rates and domestic inflation.

(d) Demand for currency to invest in overseas capital investments, and supply of currency from firms disinvesting in an overseas currency, have more influence on the exchange rate, in the short term at least, than the demand and supply of goods and services.

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Reasons for a policy of controlling the exchange rate

- Rectify a balance of trade deficit, by trying to bring about a fall in the exchange rate.
- Prevent a balance of trade surplus from getting too large, by trying to bring about a limited rise in the exchange rate.
- Stabilise the exchange rate of its currency. Exporters and importers will then face less risk of exchange rate movements wiping out their profits. A stable currency increases confidence in the currency and promotes trade.

Fixed exchange rates

A government might try to keep the exchange rate at its fixed level, but if it cannot control inflation, the real value of its currency would not remain fixed. If one country's rate of inflation is higher than others, its export prices would become uncompetitive in overseas markets and the country's trade deficit would grow. Devaluation of the currency would be necessary for a recovery.

Advantages of fixed exchange rates

- **Avoid currency fluctuations** - A fixed exchange rate system removes exchange rate uncertainty and so encourages international trade.
- A fixed rate system also imposes economic discipline on countries in deficit (or surplus).
- Stability encourages investment
- Keep inflation low

Disadvantages of fixed exchange rates

- Conflict with other macroeconomic objectives
- Less flexibility
- Current account imbalances

Floating exchange rates

Floating exchange rates are at the opposite end of the fixed rates. At this extreme, exchange rates are completely left to the free play of demand and supply market forces, and there is no official financing at all. The ruling exchange rate is, therefore, at equilibrium by definition.

In practice, many governments seek to combine the advantages of exchange rate stability with flexibility and to avoid the disadvantages of both rigidly fixed exchange rates and free floating.

Managed Exchange Rates

Managed (or dirty) floating refers to a system whereby exchange rates are allowed to float, but from time to time the authorities will intervene in the foreign exchange market to:

- Use their official reserves of foreign currencies to buy their own domestic currency
- Sell their domestic currency to buy more foreign currency for the official reserves

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Advantages of floating exchange rates

- Governments do not have to spend or even hold foreign currency reserves.
- Balance of payments deficits or surpluses are automatically corrected. A deficit will result in the exchange rate falling; this will improve competitiveness, raise exports and restore equilibrium.
- Governments need not adopt economic policies that may be undesirable for other reasons to maintain exchange rates.
- It encourages efficient allocation of resources since exchange rates will reflect economic conditions.

Disadvantages of floating exchange rates

- If exchange rates appreciate too much under a floating rate system, then firms' international competitiveness may be reduced, and output and employment may fall across the economy.
- Uncertainty surrounding fluctuations in exchange rate could deter trade.
- If exchange rates fall too much, import prices, and hence inflation, will rise.
- Currency risk will be maximised under a system of floating exchange rates

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Money markets' is a term that covers a vast array of markets buying and selling different forms of money or marketable securities. The money markets are a wholesale market that provides financial institutions with a means of borrowing and investing to deal with short-term fluctuations in their own assets and liabilities.
Marketable securities are short-term highly liquid investments that are readily convertible into cash. Companies might use them to invest short-term surplus finance \

- Deposits – money in the bank accounts of banks and other financial intermediaries, which offer a range of investment periods.
- Treasury securities. These are issued by the Public Debt Department of the Sri Lanka Central Bank. **Treasury bills** have a maturity of up to one year and are sold at a discount to face value, with the effective interest being the difference between the purchase price and face value.
- Commercial paper – IOUs issued by large companies, which can be either held to maturity or sold to third parties before maturity.

Capital markets provide a source of funds for businesses (mostly companies) and an exit route for investors. Capital market: the national and international market in which a business may obtain the finance it needs for its short-term and long-term plans.

- National stock markets – Primary Market & Secondary Market
- The banking system
- Bond Markets - Treasury bonds are medium to long-term securities, with maturities of 2 to 20 years, with interest paid biannually. As these securities are guaranteed by the Sri Lankan government, they are default-risk free and thus safe investments.
- Leasing
- Debt Factoring
- International Markets

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