

## SECTION 8: Open Economy: International Trade & Finance

### Need to Know

The **Current Account**, consists of international transactions that don't create liabilities.

**Balance Of Payments on the Current Account** is a summary of the country's transactions; often referred to as the **Current Account**:

1. **Balance of Payments on Goods & Services** - the difference between the value of exports (-) and the value of imports (+) during a given period
2. **Factor Income** - \$ received from the factors of production – land, labor, and capital. Factor income on the use of land is called **rent**, income generated from labor is called **wages** and income generated from capital is called **profit**
3. **International Transfer Payments** - made without any exchange of goods or services

The U.S. Balance of Payments in 2008 (billions of dollars)

|   | Payments from foreigners | Payments to foreigners | Net         |
|---|--------------------------|------------------------|-------------|
| 1 Sales and purchases of goods and services | \$1,827                  | \$2,523                | -\$696      |
| 2 Factor income                             | 765                      | 646                    | 119         |
| 3 Transfers                                 | —                        | —                      | -128        |
| <b>Current account (1 + 2 + 3)</b>          |                          |                        | <b>-705</b> |
| 4 Official asset sales and purchases        | 487                      | 530                    | -43         |
| 5 Private sales and purchases of assets     | 47                       | -534                   | 581         |
| <b>Financial account (4 + 5)</b>            |                          |                        | <b>538</b>  |
| <b>Total</b>                                | <b>—</b>                 | <b>—</b>               | <b>-167</b> |

Source: Bureau of Economic Analysis.

The merchandise trade balance, (**trade balance**) is the **difference between a country's exports and imports of goods alone**—not including services.

Transactions that involve the sale or purchase of **assets** (investment in business, real estate, bonds and stocks) and therefore do create future liabilities, are considered part of the **Balance of Payments on Financial Account**; often referred to as the **Financial Account** or capital account.

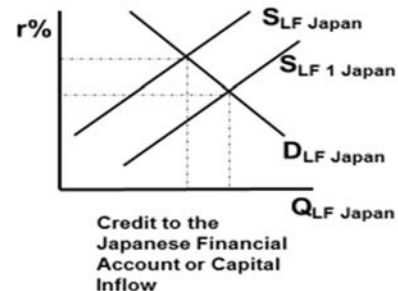
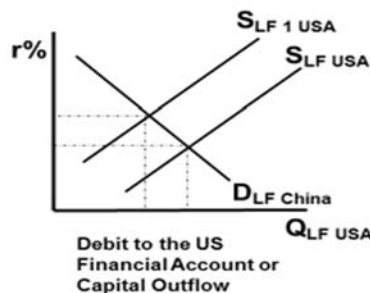
The financial account is a measure of **capital inflows**, of foreign savings that are available to finance domestic investment spending.

The basic model of the loanable funds market is used to model the flow of financial capital from one nation to another.

The flow of financial capital is a two-way street.

### Modeling the Financial Account

Savings will flow toward higher returns



It's a basic rule of balance of payments accounting that **the current account and the financial account must sum to zero**:

$$\text{Current account (CA)} + \text{Financial account (FA)} = 0 \quad \text{or} \quad \text{CA} = -\text{FA}$$

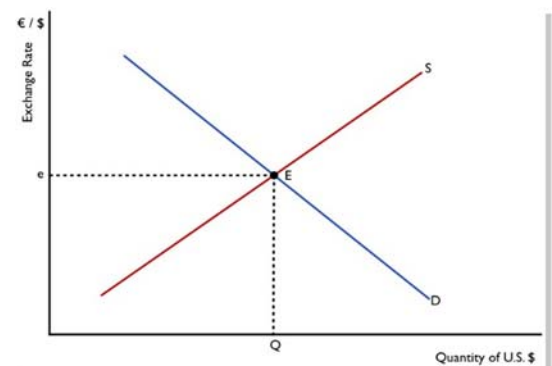
What ensures that the balance of payments really does balance?

The **exchange rate**, which is determined in the **foreign exchange market (FOREX)**

The price of a currency, or exchange rate, is determined in the market with the forces of supply and demand. If I want euros, I demand them. And in order to acquire euros, I must supply dollars to the exchange market.

Why does the Demand for Dollars slope downward?

- As the price of a dollar falls (**its value depreciates**) it takes fewer euros to buy one dollar.
  - Consumers in Europe will find U.S. goods to be less expensive.
  - U.S. exports to Europe will rise, and more dollars will be demanded to pay for those goods.



Why does the Supply of Dollars slope upward?

## SECTION 8: Open Economy: International Trade & Finance

- As the price of a dollar rises (**its value appreciates**) one dollar buys more euros.
  - Consumers in the U.S. will find European-made goods to be less expensive.
  - U.S. imports from Europe will rise, and more dollars will be supplied to pay for those goods.

An increase in capital flows into the U.S. leads to a stronger dollar, which then creates a **decrease in U.S. net exports**.

A decrease in capital flows into the U.S. leads to a weaker dollar, which then creates **an increase in U.S. net exports**.

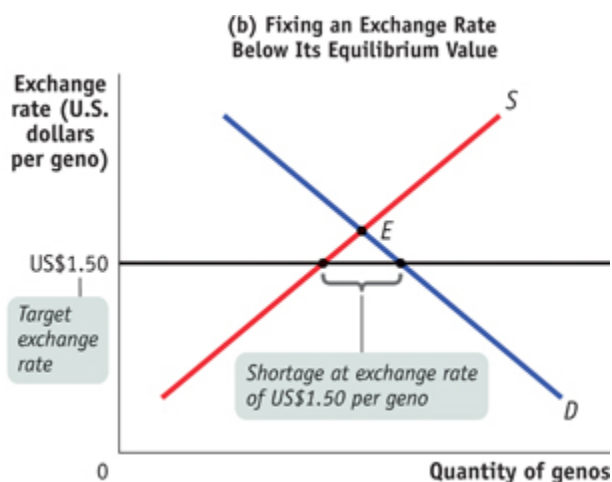
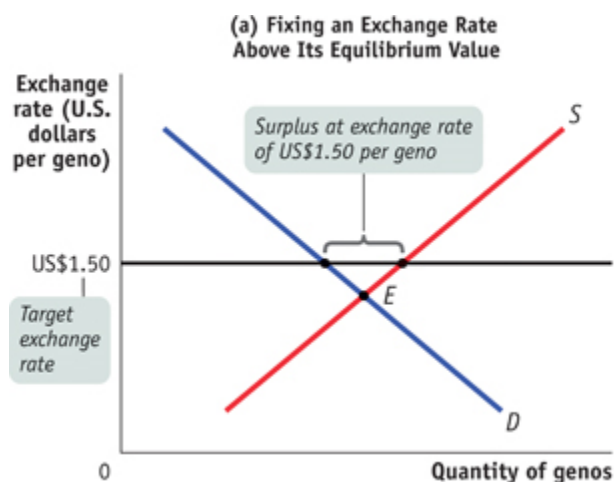
The equilibrium exchange rate is the exchange rate at which the quantity of a currency demanded in the FOREX is equal to the quantity supplied

- **Real Exchange Rates**, exchange rates adjusted for international differences in aggregate price levels.  
Real exchange rate = Mexican pesos per U.S. dollar  $\times$  (PUS/PMex)
- The **Purchasing Power Parity** between two countries' currencies is the **Nominal Exchange Rate** at which a given basket of goods and services would cost the same amount in each country.

### An Exchange Rate Regime Is A Rule Governing Policy Toward The Exchange Rate.

There are two main kinds of exchange rate regimes:

- A country has a **Fixed Exchange Rate** when the government keeps the exchange rate against some other currency at or near a particular target. For example, Hong Kong has an official policy of setting an exchange rate of HK\$7.80 per US\$1.
  - This is called **exchange market intervention**. The government must have dollars for this purchase, which is why governments keep **foreign exchange reserves**, or stocks of foreign currencies, so that they can engage in these types of price supports.
  - Favorable aspects
    - Facilitates trade by creating certainty about the exchange rate
    - Acts as a check on inflationary policies
  - Unfavorable Aspects
    - Requires large foreign currency reserves
    - May divert monetary policy
    - Distorts incentives
    - Opportunity for corruption
- A country has a **Floating Exchange Rate** when the government lets the exchange rate go wherever the market takes it. (Britain, Canada, and the United States)
  - Ability to pursue independent monetary policy
  - Monetary policy results in changes in exchange rates and leads to other macroeconomic effects
  - Changes in interest rates have a direct effect in the exchange rates and influence net exports
  - Floating exchange rates should lessen the impact of foreign shocks



## SECTION 8: Open Economy: International Trade & Finance

