

Chapter 36

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Last Word

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Exchange Rates, the Balance of Payments, and Trade Deficits

Key Terms



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Chapter Objectives

- **How Currencies of Different Nations are Exchanged When International Transactions Take Place**
- **About the Balance Sheet the United States Uses to Account for the International Payments it Makes and Receives**
- **How Exchange Rates are Determined in Currency Markets**
- **The Difference Between Flexible Exchange Rates and Fixed Exchange Rates**
- **The Causes and Consequences of Recent Record-High U.S. Trade Deficits**

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Financing International Trade

- **U.S. Export Transactions** – create foreign demand for US \$
- **U.S. Import Transactions** – create domestic demand for foreign currency
- **Balance of Payments** – the sum of all transactions between two nations (net exports, interest on debt, tourism, etc.)
- **The Current Account** – summarizes US trade of goods and services (net exports).
- **Balance on Current Account**=
 - + balance of goods and services (exports – imports)
 - + net investment income (interest/dividend balance)
 - + net transfers (private and public \$, foreign aid)***** Any \$ flow out of the US is neg, \$ flow into US is pos.**



WS 36.1

Financing International Trade

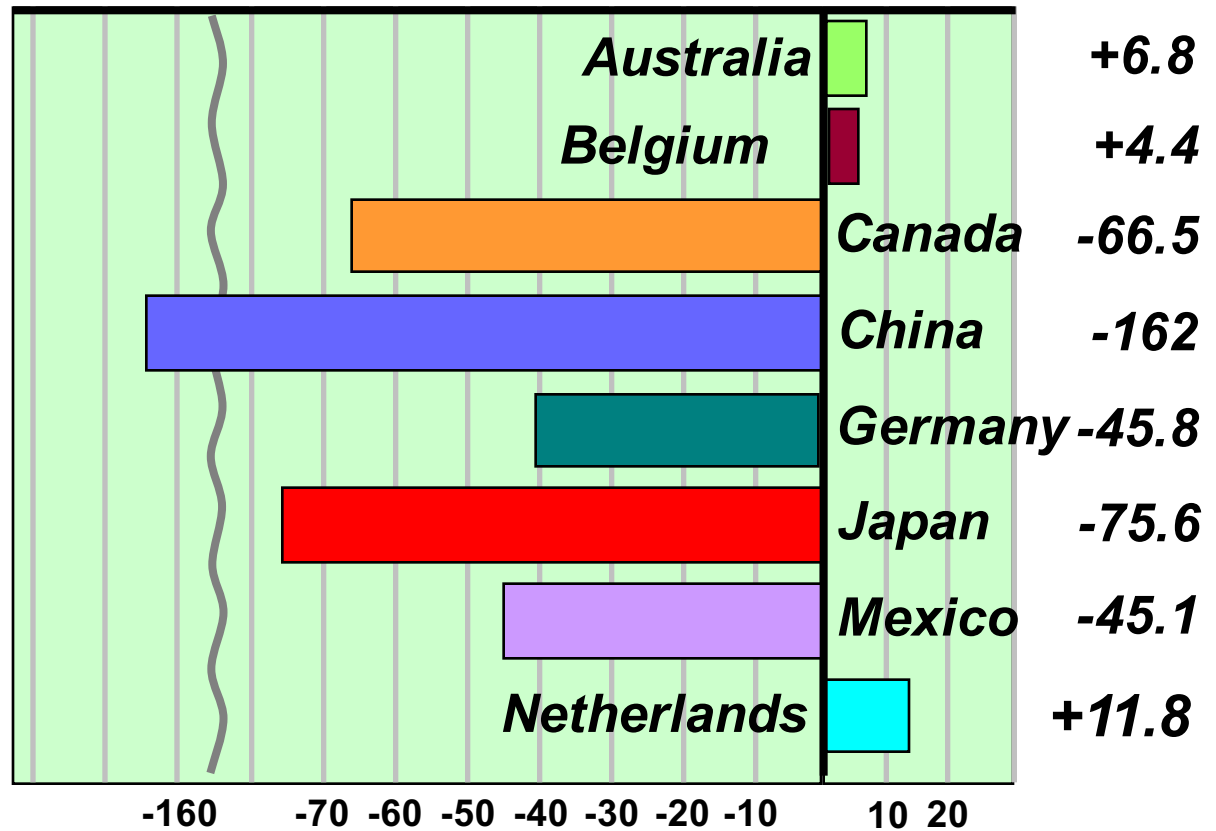


GLOBAL PERSPECTIVE

U.S. Trade Balances in Goods and Services Select Nations, 2004

Good and Services Deficit

Goods and Services Surplus



Source: BEA

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Capital and Financial Account

- **Capital Account** – net debt forgiveness b/w US and foreign nations (+ if other nations owe us more than we owe them)
- **Financial Account** – purchase or sale of real financial assets (ex. Factories, Bonds)
 - If foreigners buy our stuff + (exports)
 - If we buy foreign stuff – (imports)
- **Balance on the Capital and Financial Account** – (sum of both + or -)
 - **Balance-of-Payments Deficits and Surpluses** –
 - Current account + capital and financial account = 0
 - If need be, gov will use official reserves to correct for surpluses or deficits

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Flexible Exchange Rates

G36.1

- Flexible or Floating Exchange Rates — supply and demand determine the exchange rates without gov intervention
- Fixed Exchange Rate system — governments determine exchange rates and make adjustments to keep them fixed
- Depreciation — more units of one currency are needed to buy another
 - \$1=1Euro...\$2 = 1 Euro
- Appreciation — less units of one currency are needed to buy another
 - 10 pesos = \$1...7pesos = \$1

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Flexible Exchange Rates

- **Determinants of Exchange Rates**
 - **3 general rules:**
 - **1. If Demand for currency \uparrow = appreciation, If Demand \downarrow = depreciation**
 - **2. If Supply of currency \uparrow = depreciation, If Supply \downarrow = appreciation**
 - **3. If a nation's currency appreciates, another nation's will depreciate relative to it**

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Determinants of Exchange Rates

- Changes in Tastes (preference for one nation's goods over another's)
- Relative Income Changes (growth of one nation's NI will depreciate it's currency)
- Relative Price-Level Changes (Inflation= depreciation, deflation= appreciation)
 - Purchasing-Power-Parity Theory (PPP)
Comparing the value of two market baskets will show the exchange rate
- Relative Interest Rates – High interest rates attracts investment and appreciates currency
- Speculation – expectations of appreciation cause investors to purchase a currency which leads to appreciation!

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Flexible Exchange Rates

The Market for Foreign Currency (Pounds)

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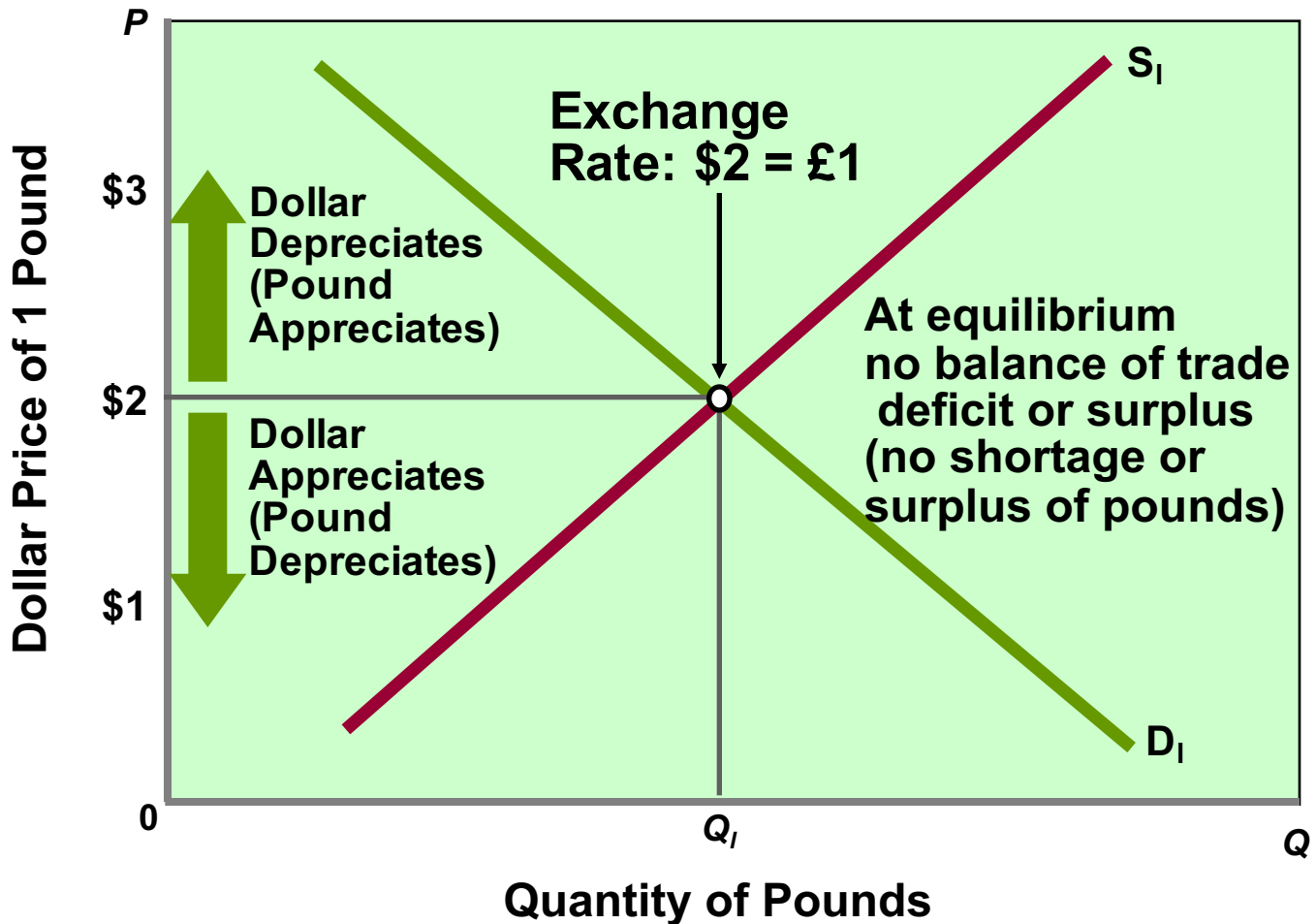
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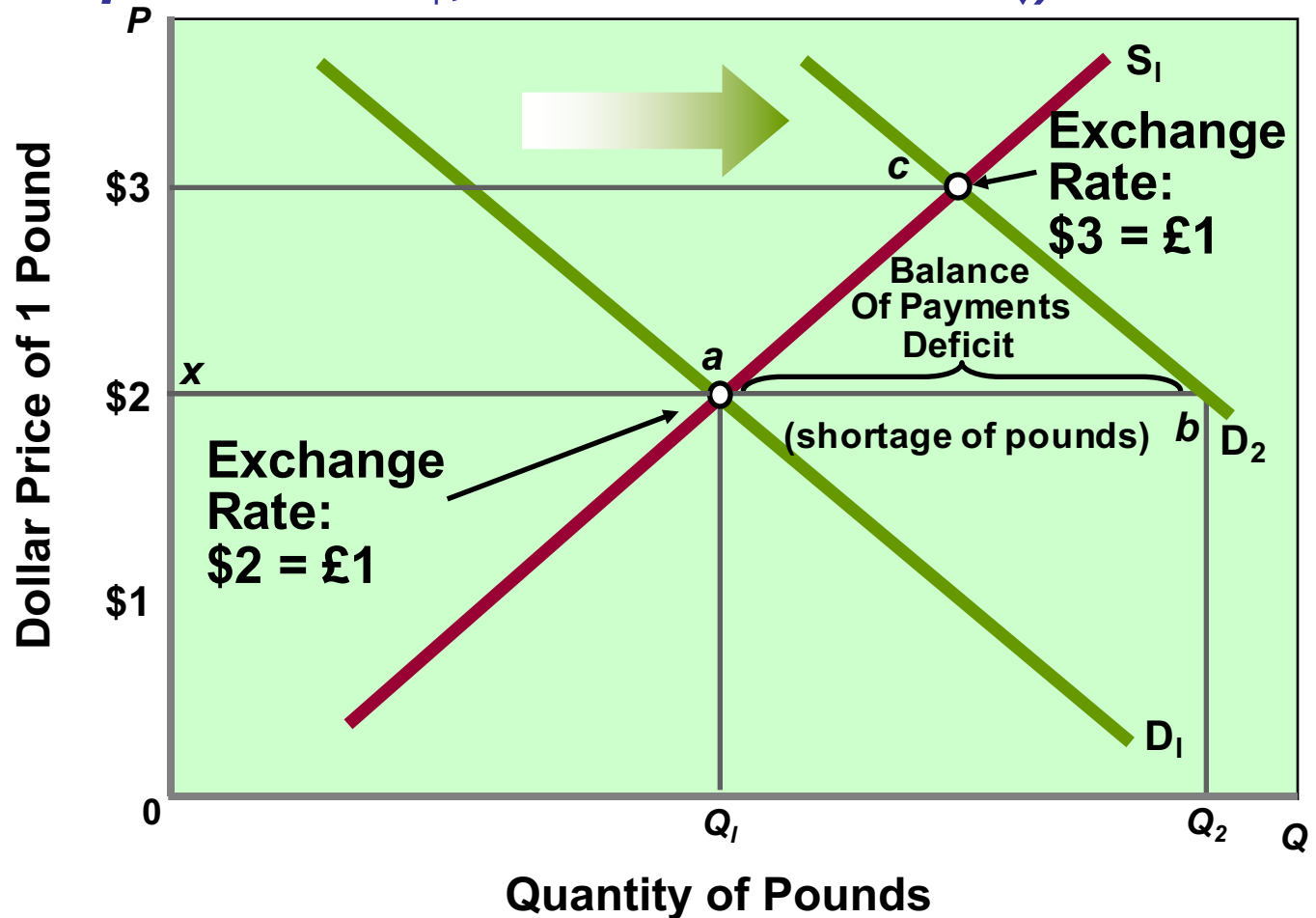
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Flexible Exchange Rates

The Market for Foreign Currency (Pounds)

*D1 → D2 (British goods are the new fad,
U.S. price level ↑, U.S. interest rates ↓)*



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Flexible Exchange Rates

- Flexible Rates and the Balance of Payments – self correcting for deficits or surpluses between nations!
- Disadvantages of Flexible Exchange Rates – Uncertainty alters expectations and changes economic behavior and can lead to instability!
- Terms-of-Trade Changes – trade agreements are in constant state of flux!

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Fixed Exchange Rates

- Use of Reserves - Currency Interventions used by central banks in order to correct for balance of payments deficits or surpluses
- Trade Policies – nations can try to increase or decrease imports or exports to maintain a fixed exchange rate
- Domestic Macroeconomic Adjustments
 - Contractionary monetary or fiscal policy results in \downarrow AD and \uparrow interest rates and reduce or eliminate a U.S. balance of payments deficit
 - Expansionary monetary or fiscal policy results in \uparrow AD and \downarrow interest rates reduces or eliminates a U.S. balance of payments surplus

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International Exchange-Rate Systems

- **The Gold Standard: Fixed Exchange Rates**
 - Devaluation
 - Gold Flows
 - Domestic Macroeconomic Adjustments
 - Collapse of the Gold Standard

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International Exchange-Rate Systems

- **The Bretton Woods System**
 - International Monetary Fund (IMF)
 - IMF and Pegged Exchange Rates
 - Official Reserves
 - Gold Sales
 - IMF Borrowing
 - Fundamental Imbalances: Adjusting the Peg
 - Demise of the Bretton Woods System

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International Exchange-Rate Systems

- **The Current System:
The Managed Float**
 - **Managed Floating
Exchange Rates**
 - **In Support of the
Managed Float**
 - **Concerns With the
Managed Float**

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Recent U.S. Trade Deficits

- **Causes of Trade Deficits**
- **Implications of U.S. Trade Deficits**
 - Increased Current Consumption
 - Increased U.S. Indebtedness

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Speculation in Currency Markets

Negative or Positive Influence on Currency Markets and Trade

Last Word

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Last Word

- **Currency Purchases to Purchase Goods and Services**
- **Contributing to Currency Market Fluctuations**
- **Speculator's Role and Activities**
- **Smoothing Short-Term Fluctuations**
- **Absorbing Risk**
- **Futures Market at Work**
- **Positive Role Played Overall**

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- balance of payments
- current account
- balance on goods and services
- trade deficit
- trade surplus
- balance on current account
- capital and financial account
- balance on capital and financial
- balance-of-payments deficits and surpluses
- official reserves
- flexible- or floating-exchange-rate system
- fixed-exchange-rate system
- purchasing-power-parity theory
- currency interventions
- exchange controls
- gold standard
- devaluation
- Bretton Woods system
- International Monetary Fund (IMF)
- managed floating exchange rates

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Course Review...

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Final Discussions...

Thanks!

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