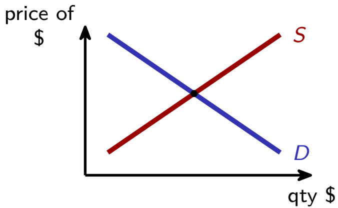
Open Economy: Trade & Finance

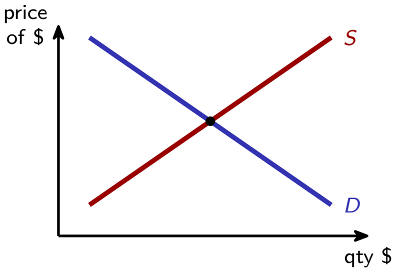
AP Macroeconomics ▪ Unit 6

AP Macroeconomics



What we will cover

1. Balance of payments accounts
2. Exchange rates
3. The foreign exchange market
4. What moves the exchange rate
5. Exchange rates and net exports
6. Real rates and capital flows



Balance of payments

Every cross-border transaction is recorded in the **balance of payments** 国际收支, split in two:

- **current account** 经常账户 – trade in goods, services, income
- **financial account** 金融账户 – buying and selling of assets

> A current-account deficit is offset by a financial-account surplus – dollars that leave for imports return as foreign asset purchases.

Trade flows show up in the current account

Balance of payments

the current account

- trade in **goods** (physical exports & imports)
- trade in **services** (tourism, banking)
- **primary income** (wages, profit, interest)
- **secondary income** (transfers, aid)

Exchange rates

An **exchange rate** 汇率 is the price of one currency in another (e.g. yuan per dollar). Most float freely.

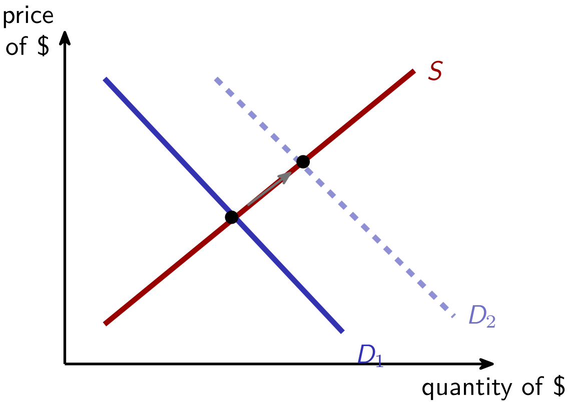
- **Appreciation** 升值: worth more
- **Depreciation** 贬值: worth less

Worked example

$\$1 = 7$ yuan. If $\$1 = 8$ yuan, the dollar appreciates (buys more yuan) and the yuan depreciates.

Currencies trade in the foreign-exchange market

The foreign exchange market



In the **foreign exchange market** 外汇市场:

- demand for $ – foreigners buying exports or assets
- supply of $ – residents buying foreign goods

> More demand ($D_1 \to D_2$) $\Rightarrow$ the currency appreciates.

What moves the exchange rate

Anything that changes demand for (or supply of) a currency moves its rate:

Interest rates
利率
higher rates draw investors $\Rightarrow$ appreciate

Inflation
通货膨胀
higher inflation $\Rightarrow$ dearer goods $\Rightarrow$ depreciate

Income
收入
higher income $\Rightarrow$ more imports $\Rightarrow$ depreciate

> Contractionary monetary policy raises rates – and tends to strengthen the currency.

Exchange rates and net exports

An exchange-rate move feeds into **net exports** 净出口 ($NX = X - M$) and so into **aggregate demand** 总需求:

Stronger currency $\Rightarrow X\downarrow, M\uparrow$
$\Rightarrow NX\downarrow \Rightarrow$ AD left

Weaker currency $\Rightarrow X\uparrow, M\downarrow$
$\Rightarrow NX\uparrow \Rightarrow$ AD right

> A very strong currency can slow an economy – its exports get too dear.

A $-priced machine at 900 euros becomes 1000 euros when the dollar appreciates – Europe buys fewer.

Exchange rates and net exports

Appreciation	**Depreciation**
(currency rises in value)	*(currency falls in value)*
exports dearer, imports cheaper → exports fall, imports rise	exports cheaper, imports dearer → exports rise, imports fall

Real rates and international capital flows

Money chases the best return, so **real interest rates** 实际利率 drive **capital flows** 资本流动:

real rate ↑ above the world

↓

capital inflow 资本流入 – foreigners buy assets

↓

buy the currency ⇒ it appreciates

> The stronger currency then makes exports dearer, pushing the current account toward deficit.

So a financial-account surplus (capital in) offsets a current-account deficit – the two accounts tie together.

Unit 6 – key takeaways

1 Balance of payments

current and financial accounts offset each other

2 Exchange rates

appreciation = worth more; one rises as another falls

3 Forex market

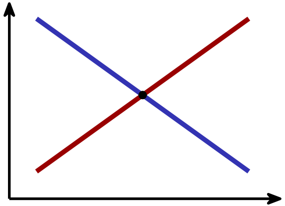
more demand for a currency makes it appreciate

4 Net exports

a stronger currency lowers NX and shifts AD left

Check yourself

1. A current account deficit is offset by what?
2. The dollar buys more yuan. Did it appreciate or depreciate?
3. A country raises interest rates. What happens to its currency?
4. A stronger currency shifts AD which way?



Answers **1.** a financial account surplus **2.** appreciate **3.** it appreciates **4.** left