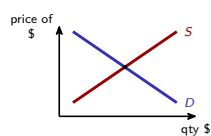


Open Economy: Trade & Finance

AP Macroeconomics ■ Unit 6

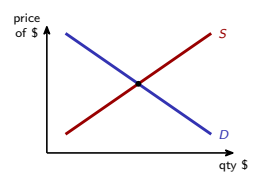
AP Macroeconomics



Open Economy: Trade & Finance

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



1 Balance of payments

Open Economy: Trade & Finance

└ Balance of payments

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

2 Exchange rates

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└ Exchange rates

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

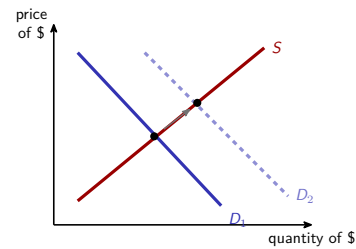
\$1 = 7 yuan. If \$1 = 8 yuan, the dollar **appreciates** (buys more yuan) and the yuan **depreciates**.



Currencies trade in the foreign-exchange market

3 Forex 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 ($D_1 \rightarrow D_2$) $\Rightarrow$ 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.

4 Net exports

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.

5 Capital flows

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.

6

Recap

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

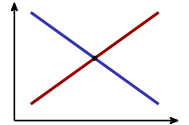
more demand for a currency makes it appreciate

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