Week #10

Help

Lecture Ten: Exchange Rates, The Balance of Payments, and Trade Deficits

This lecture explains how exchange rates and our international monetary system work and illustrates how fiscal and monetary policies may-or may not-be used in a global economy. The discussion takes place largely within the context of America's chronic trade deficits.

Beginning in the early 1980s, America began running huge trade deficits. Over the years, these trade deficits have led to an accumulated net foreign debt of trillions of dollars, making the U.S. the largest debtor nation in the world.

To many observers, America's chronic trade deficits are every bit as dangerous as its chronic budget deficits. Others, however, see the trade deficits simply as an opportunity to buy inexpensive foreign goods and enjoy a higher standard of living that Americans could otherwise not achieve.

To understand the roots and scope of the trade deficit problem, we must first learn some basic "balance of payments" accounting. Then, we will describe how exchange rates work and how the international monetary system is structured.

Once we get these fundamentals down, we can then talk about the important impacts that domestic fiscal and monetary policies can have on foreign capital markets and the trade deficit. From this discussion, we will also come to understand more fully the important link between the budget and trade deficits and why it is increasingly important for the nations of the world to coordinate their fiscal and monetary policies in a global economy.

Key Questions for Lecture Ten: Exchange Rates, The Balance of Payments, and Trade Deficits

1. What is the basic trade identity equation?

2. What are the three major components of the Current Account? Which is the biggest?

3. Define an exchange rate.

4. Explain the three major reasons why exchange rates change.

5. Describe the gold standard. When and why did it collapse?

6. Explain the gold specie flow mechanism.

7. What was the major difference between the gold standard and the Bretton Woods system? When and why did Bretton Woods collapse?

10. Describe the current international monetary system.

11. What is an exchange-rate intervention?

12. What are the three major causes of the chronic trade deficits of the United States?

13. Illustrate the multiplier link.

14. Suppose that America wants to reduce its trade deficit with Japan. What might the United States encourage Japan to do?

15. Illustrate the monetary link.

16. Explain some of the difficulties of coordinating macroeconomic policies between countries.

17. Illustrate the benefits of global coordination.

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