Notes — Week 14

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Period 3

1. Open Economy
   - $AD = C + I + G + \boxed{NX} \longleftarrow$ focus of this chapter
2. Four Factors in an Open Economy:
   (a) Balance of Payments
   (b) Exchange Rates
   (c) Role of Central Bank
   (d) Barriers to Trade
3. Some Basics:
   - Countries don't trade with each other — people do
   - Financial capital (money) flows all around the world seeking the highest possible return
   - In the 21^{st} century, making a financial investment in another country is a simple click away
   - People want to be paid in their domestic currency
4. Balance of Payments Accounts — A summary of the country's transactions with other countries. There are two main types of transactions:
   (a) People trading currently produced goods or services for money
   (b) People trading pre-existing assets for money
5. Capital Account — Flow of currently produced goods and services
   - Net exports
   - Net financial investment income (income and dividend income)

- Net transfers (remittances and foreign aid)

6. Financial Account — Flow of Financial Capital (Pre-existing Assets)
    - Real assets
    - Financial assets

7. A deficit in one will be matched by a surplus in the other: $CA + FA = 0$

8. Debits and Credits
    - Debit (-) — Any transaction that requires foreign currency (*i.e.* imports, money outflows)
    - Credit (+) — Any transaction that earns foreign currency (*i.e.* exports, money inflows)

9. Foreign Exchange
    - An increase in the demand for one currency results in an increase in supply for another

10. Determinants of Demand for Currency
    - Tastes and preferences
    - Price Level — Inflation tends to depreciate currencies (don't conflate domestic monetary policy and foreign exchange markets)
    - National income and relative income changes
    - Interest rates
    - Speculation/expectations

11. Role of Central Bank
    - Three ways central bank impacts foreign exchange
        (a) Direct intervention in foreign exchange markets, buying or selling reserve currencies to influence exchange rates
        (b) Manipulation of interest rates
            - Domestic monetary policy and foreign exchange are separate worlds
            - Increasing money supply impacts foreign exchange, but NOT simply because supply of money has increased (in Unit 5 we learned causes inflation)
            - Link is monetary policy impact on interest rates, and how this attracts or discourages foreign purchases of financial assets and hence demand for the currency, and, hence, exchange rate

(c) Inflation tends to cause currency to depreciate
    - Exports become less competitive (Canadians want to buy less American maple syrup), causing demand for currency to decrease
    - Imports become relatively cheaper (Americans want to buy more Canadian maple syrup), causing supply of currency to increase

12. Barriers to Trade
    - National Security
    - Infant industry
    - Saves jobs

13. How is Trade Restricted?
    - Tariffs
    - Quotas (VER's)
    - Export subsidies
    - Informal barriers (*e.g.* "standards")