International trade & globalization, pt. 2

EC 103–003

Marcio Santetti
Spring 2023

Motivation

Housekeeping

Required readings:

- `OpenStax, ch. 10`
  - Sections `10.1`, `10.2`, and `10.3`.

Exchange rate demand & supply

We saw that, in a **floating** exchange rate regime, the value of an exchange rate is determined by its **demand**.

This demand may take place in the **goods** market, in the **asset** market, and in the **foreign exchange** market.

But where does the **supply** of foreign exchange come from?

Foreign currencies are supplied by foreign *households*, *firms*, and *governments* who want to purchase goods, services, and assets in the local currency.

- If a Swedish bank wants to purchase US government bonds, it first must *sell* Swedish kronas, and exchange it for US dollars.
- This way, Swedish kronas are *supplied* in the foreign exchange market, as US dollars are *demanded*.

Exchange rate demand & supply

Thousands of transactions like the ones we've explored so far happen on a daily basis in the international trade market, influencing a country's GDP.

But how are these transactions recorded?

- Through a country's **balance of payments**.

> The **balance of payments** records a country's transactions in goods, services, and assets with the rest of the world. It also records a country's supply and demand of foreign exchange.

The balance of payments has two main components:

- The **current** account;
- The **financial** account.

The balance of payments

The balance of payments

Let us start with the **current** account.

The current account has **four** components:

- (1): *Exports* of goods and services;
- (2): *Imports* of goods and services;
- (3): *Income* transfers and payments;
- (4): *Unilateral* transfer payments.

The balance of payments

(1) **Exports** include goods and services *sold* to the rest of the world.

(2) **Imports** include goods and services *bought* from the rest of the world.

The difference between (1) and (2) is the country's **trade balance**.

- It can also be called **net exports**. (`Official US data`.)

(3) **Income** transfers and payments include payments made to/received by one country for the use of *factors of production* (esp. labor and capital) used in a different country.

- These include profits, wages, interest, and dividends.

(4) Lastly, **unilateral transfer payments** involve local citizens or the local government sending remittances and/or humanitarian help to other countries, as well as foreigners making these transfers to the local nation.

- These payments receive nothing in return.

The balance of payments

Net exports + **Net** investment income + **Net** transfer payments = **Balance on current account**.

- When money **flows out** of a country, the operations receive a *negative* sign.
- When money **flows into** a country, the operations receive a *positive* sign.

The balance on current account will be **negative** if a country has *spent* more on foreign goods and services, *sent out* investment income, and *made* more transfer payments than it has earned by *selling* goods and services, *receiving* investment income, and *receiving* transfer payments from abroad.

Otherwise, it will be **positive**.

The balance of payments

`A look at official US data`

`Balance on current account chart`

The balance of payments

The **financial** account is made of international *lending* and *borrowing*, as well as *asset sales*.

It has three main divisions:

- **Portfolio investment**: involves only *financial assets* (stocks, bonds, etc.)
- **Foreign Direct Investment (FDI)**: involves changes in the control of *real* assets, such as land, buildings, or businesses.
- **Other investment**: involves mainly *new bank loans*.

In addition, the financial account may include **foreign exchange reserves**.

These include *foreign-currency assets* held by the country's **central bank**.

The US as a debtor nation

The US as a debtor nation

A country's **net wealth position** will be determined by whether it has a **positive** or **negative** current account balance.

A country with **positive** current account balance can be considered a **creditor** nation.

In the case of the US economy, it sustained a current account *surpluses* until mid-1970s.

- A *creditor* nation!

Then, ever since, the US has become a *debtor* nation, showing successive current account deficits.

What does this fact imply?

Next time: Aggregate demand & supply