# Gov 1780: International Political Economy

Section 8
18 Mar 2021

# Agenda

Exam information

Today we are going to walk through the **fundamentals of how exchange rates and balance of payments work**.

Breakout rooms: answering your biggest questions.

# Exam information

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Midterm exam will be open from **April 1st, 9am EST** - **April 4th, 9am EST**

Final exam will be open from **May 6th, 9am EST - May 9th, 9am EST**

- 90 minute timed exam to be opened and then submitted on Canvas
- Choose eight terms from a list, define them, and explain their relevance to International Political Economy (two paragraph responses per term, approximately)

# Exchange rates, explained.


The United States has a comparative advantage in producing oil. Spain has a comparative advantage in producing olive oil.

# Exchange rates, explained.


With demand for foreign goods comes demand for foreign currency. Spain demands $s to buy oil. U.S. demands € to buy olive oil.

# Exchange rates, explained.



**1$ = .84€**

In a **fixed exchange-rate system,** what should we expect to happen to this exchange rate?

# Exchange rates, explained.


**1$ = .84€**

It should remain the same: one currency is 'pegged' to the value of another. Many countries currently operate with fixed exchange rates, 'pegged' to another currency.

# Exchange rates, explained.


**1\$ = .84€**

In a **floating exchange-rate system,** what should we expect to happen to this exchange rate?

# Exchange rates, explained.


**1$ = .84€**

The exchange rate will fluctuate based on supply and demand for each currency. Some floating currencies include the U.S. dollar, euro, and the Japanese yen.

# Exchange rates, explained.


If demand for the Euro is high, then Euros become more expensive to obtain relative to other currencies.

# Exchange rates, explained.


**What might increase demand for Euros relative to other currencies?**

# Exchange rates, explained.


Relatively higher interest rates set by the European Central Bank (ECB), extremely high demand for Spanish goods, or ECB intervention.

# Exchange rates, explained.

Government intervention to increase exchange rates might include selling bonds or buying one's own currency to reduce supply.

The latter policy option - intervening in foreign exchange markets to influence currency supply - can be pursued on a **managed float system.**

# Exchange rates, explained.

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Even the ECB leaves this option available to exercise when necessary:

"In the absence of any formal agreements or general guidelines, the Eurosystem may decide, where necessary, to conduct foreign exchange interventions. The Eurosystem may conduct such interventions either on its own (i.e. unilaterally) or as part of a coordinated intervention involving other central banks (i.e. concerted action)."

- European Central Bank

# Balance of payments, explained.

Now that we have a better idea about how exchange rates work, let's move on to balance of payments.

For those of you interested in doing a DEEP dive on definitions and accounting, see this link for extremely thorough guidance provided by the IMF.

# Balance of payments, explained.

Current account

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Let's now use the United States as an example.

**What kinds of transactions are recorded in the current account?**

# Balance of payments, explained.

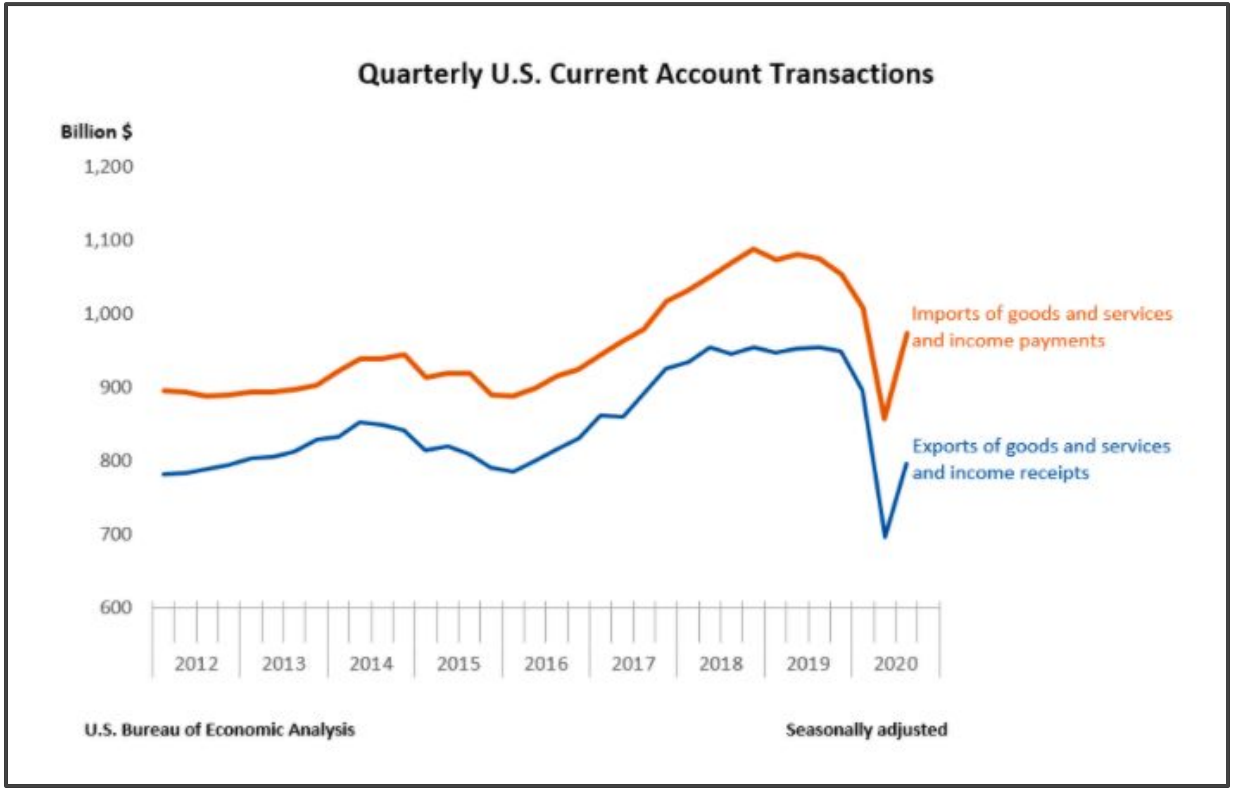
Current account

**Trade in goods**
Imports
Exports
**Trade in services**
Imports
Exports
**Primary income**
receipts
payments
**Secondary income**
receipts
payments

Non-financial transactions between a country and the rest of the world. These include trade in goods, services, primary income, and secondary income.

# Balance of payments, explained.

Here's a practical example drawing directly from U.S. Bureau of Economic Analysis data.



# Balance of payments, explained.

Current account

**Trade in goods**
Imports −
Exports +
**Trade in services**
Imports −
Exports +
**Primary income**
receipts
payments
**Secondary income**
receipts
payments

Financial account

??

**What kinds of transactions are recorded in the financial account?**

# Balance of payments, explained.

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| Current account | Financial account | Capital account |
| --- | --- | --- |
| **Trade in goods**<br>Imports −<br>Exports +<br>**Trade in services**<br>Imports −<br>Exports +<br>**Primary income**<br>receipts<br>payments<br>**Secondary income**<br>receipts<br>payments | **Acquisition of financial assets**<br>direct investment assets<br>portfolio assets<br>other assets<br>**Incurrence of liabilities**<br>direct investment liabilities<br>portfolio liabilities<br>other liabilities | |

Capital flows between the U.S. and the rest of the world. These include the purchases of foreign assets (acquisition or capital outflow) and foreign purchases of Spanish assets (liability or capital inflow).

# Balance of payments, explained.

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| Current account | Financial account | Capital account |
|---|---|---|
| **Trade in goods**<br>Imports −<br>Exports +<br>**Trade in services**<br>Imports −<br>Exports +<br>**Primary income**<br>receipts<br>payments<br>**Secondary income**<br>receipts<br>payments | **Acquisition of foreign assets**<br>direct investment assets<br>portfolio assets −<br>other assets<br>**Foreign acquisition of U.S. assets**<br>direct investment assets<br>portfolio assets +<br>other assets | |

Capital outflows, which occur when foreign assets are acquired, register as negative. Capital inflows, which occur when U.S. assets are acquired by foreigners, register as positive.

# Balance of payments, explained.

| Current account | Financial account | Capital account |
| --- | --- | --- |
| **Trade in goods**<br>Imports −<br>Exports +<br>**Trade in services**<br>Imports −<br>Exports +<br>**Primary income**<br>receipts<br>payments<br>**Secondary income**<br>receipts<br>payments | **Acquisition of foreign assets**<br>direct investment assets<br>portfolio assets −<br>other assets<br>**Foreign acquisition of U.S. assets**<br>direct investment assets<br>portfolio assets +<br>other assets | |

**What is the difference between the financial account and the capital account?**

# Balance of payments, explained.

Current account

**Trade in goods**
Imports
Exports
**Trade in services**
Imports
Exports
**Primary income**
receipts
payments
**Secondary income**
receipts
payments

Financial account

**Acquisition of foreign assets**
direct investment assets
portfolio assets
other assets
**Foreign acquisition of U.S. assets**
direct investment assets
portfolio assets
other assets

Capital account

**Capital transfers**
Debt forgiveness
other transfers (eg. migrants' transfers)

**Acquisition/ disposal of nonproduced, nonfinancial assets**
trademarks
leases
goodwill

While the **financial account** handles capital inflows and outflows related to asset acquisitions, the **capital account** primarily reflects transfers in which the ownership of an asset (other than cash or inventories) changes from one party to another.

# Balance of payments, explained.

## Current account

**Trade in goods**
Imports
Exports
**Trade in services**
Imports
Exports
**Primary income**
receipts
payments
**Secondary income**
receipts
payments

## Financial account

**Acquisition of foreign assets**
direct investment assets
portfolio assets
other assets
**Foreign acquisition of U.S. assets**
direct investment assets
portfolio assets
other assets

## Capital account

**Capital transfers**
Debt forgiveness
other transfers (eg. migrants' transfers)

**Acquisition/ disposal of nonproduced, nonfinancial assets**
trademarks
leases
goodwill

Current account balance + Capital account balance + financial account balance = balance of payments

# Balance of payments, explained.

| Current account | Financial account | Capital account |
|---|---|---|
| **Trade in goods**<br>Imports<br>Exports<br>**Trade in services**<br>Imports<br>Exports<br>**Primary income**<br>receipts<br>payments<br>**Secondary income**<br>receipts<br>payments | **Acquisition of foreign assets**<br>direct investment assets<br>portfolio assets<br>other assets<br>**Foreign acquisition of U.S. assets**<br>direct investment assets<br>portfolio assets<br>other assets | **Capital transfers**<br>Debt forgiveness<br>other transfers (eg. migrants' transfers)<br><br>**Acquisition/ disposal of nonproduced, nonfinancial assets**<br>trademarks<br>leases<br>goodwill |

Many sources (other than the IMF) refer to the financial and capital account together as the capital account.

# There is still so much left to cover.

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What is the relationship between inflation and exchange rates?

Is there a relationship between a trade deficit and a national budget deficit?

How does the Policy Trilemma actually work?

etc.

# Breakout room activity

**Take one minute to consider and write down the biggest question you still have.**

In breakout rooms, you will split off into pairs.

1. Share your big question with your partner.
2. Each person should create a slide in this deck with one's specific question as the title. Write your name in the bottom right-hand corner of the slide.
3. Use the class readings, credible online resources (IMF, governmental websites, etc.), and each other to tackle that question.
4. Present the answer on your respective slide as clearly as concisely as possible. Feel free to utilize graphs or diagrams!

# Question 1

# Question 2

# Question 3

# Question 4

# Question 5

# Question 6

# Question 7