Chapter 38: The Balance of Payments, Exchange Rates, and Trade Deficits

We now understand *why* nations trade, but *how* do they trade? How do they manage to exchange goods using a variety of currencies of different values, especially when the currency values themselves constantly change? Chapter 38 concludes this study of the international economy by exploring the movement of money and products between nations, as well as balances in payments, currency values, and net exports.

International trade refers to the sales of goods and services to other countries. International asset transactions refer to exchanges of financial assets between countries, such as sales of stock and real estate. In order for a buyer in one country to make a purchase from another country, he must first buy the currency of that country in a foreign exchange market. The exchange rate, the value of one currency in terms of another currency, is determined by supply and demand.

The balance of payments is the sum of all of the financial transactions between two countries. The balance of payments includes two primary categories: the current account and the capital/financial account. The current account includes the trade of goods and services with other countries. Funds flowing in from the sale of exports and investment income count as a credit (+), while funds flowing out from the purchase of imports and transfers of funds to foreigners count as a debit (-). A trade deficit occurs when a nation imports more than it exports. The capital/financial account primarily compares the foreign purchases of domestic assets (+) with our purchase of foreign assets (-), though a small amount of the total recognizes debt forgiveness between the countries. What is important to note is that no matter how large or small the size of the accounts, the current account and the capital/financial account *must* balance over time. While a short-run balance of payments surplus or deficit may develop, assets will eventually be transferred to balance the payments.

Exchange rates are determined by supply and demand. While the key graph for this chapter shows the market for only one currency, it is helpful to draw the markets for both currencies side by side, to see the relative changes in the value of currencies. If Americans increase imports of British products, the Americans must increase their demand for British pounds to pay for those products. The increase in demand pushes up the value of the British pound, causing it to appreciate. In order to pay for those pounds, consumers must spend dollars in the international currency market. As the supply of dollars increases (in the dollar market graph), the value of the dollar decreases, or depreciates. All currency values are relative, so if the pound appreciates against the dollar, the dollar must depreciate against the pound.

Demand for a currency can shift as a result of a change in tastes, a change in relative incomes, a change in relative inflation rates, a change in relative interest rates, changes in expected returns on financial investments, and speculation. When incomes increase or domestic inflation rates are high, consumers buy more imports, and as a result, demand for foreign currency increases. In the same way, if households expect to earn higher returns on bonds or other investments in another country, or if they expect the value of the currency itself to increase as an investment, they will increase demand for the currency.

Changes in domestic economic policies can also affect exchange rates. If the Federal Reserve reduces the money supply to counteract inflation, the increase in

interest rates can attract investment from foreigners. As those foreigners increase their demand for dollars in order to buy bonds, the international value of the dollar increases.

The flexibility of exchange rates is important because it can work to eliminate balance of payments surpluses and deficits. Consumers may purchase more imports, but their increased demand for British pounds eventually causes the pound to appreciate (and the dollar to depreciate), resulting in a decrease in the demand for British products over time. While supply and demand primarily determine exchange rates, the system is called a “managed float” because in times of crisis, the International Monetary Fund or nations themselves may take actions to manipulate currency values.

Material from Chapter 38 consistently appears in several multiple-choice questions on the AP Macroeconomics Exam. Free-response questions, in whole or in part, frequently focus on relative currency values, as well as capital and current accounts. It is most important to focus on the graphs that illustrate changes in currency values and the factors that can cause changes in demand for currencies. It is also important to recognize the factors that are included in capital and current accounts, as well as the requirement that they balance.