

Lecture 4

- The foreign exchange market
- Exchange rate and BOP

The Foreign Exchange Market

- Definition:

- ◆ $e = \text{local currency/foreign currency}$
 $= \$/\text{£}$ (US\$ per foreign currency)

- ◆ e depreciates:

- ◆ if e increases, then per foreign currency worth more US\$

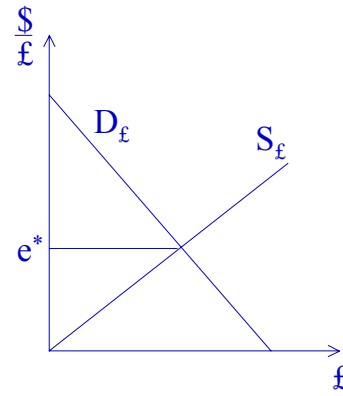
- ◆ e appreciates:

- ◆ if e decreases, then per foreign currency worth less US\$

- Diagram for the foreign exchange market

Demand/Supply for Foreign Currency

- Factors affect demand and supply (private/public): e.g.
 - ◆ \uparrow import/export
 - ◆ \uparrow buy foreign/US bonds/stocks
 - ◆ \uparrow foreign travelers
- Effect on e^* :
 - ◆ S-curve shifts out:
 - ◇ e^* smaller, appreciation
 - ◆ D-curve shifts out:
 - ◇ e^* larger, depreciation



Balance of Payments Summary Statement for US
(Transactions a to g)

I.		
Exports of goods		0
Imports of goods		-7000
Balance of trade		-7000
Exports of services		0
Imports of services		-2000
Balance on goods and services		-9000
Investment income receipts from abroad		+1000
Investment income payments abroad		0
Balance on goods, services, and investment income		-8000
Unilateral transfers received		+2000
Unilateral transfers made		0
Balance on current account		-6000
II.		
Net increase (+) in foreign long-term private assets in US		+8000
Net increase (-) in long-term private assets abroad		-5000
III.		
Net increase (+) in foreign short-term private assets in US		+3800
(+7000+5000-1000-8000+800)		
Net increase (-) in short-term private assets abroad		-800
Official reserve transactions balance (BOP Def. 2)		0
IV.		
Net increase (+) in foreign short-term reserve assets in US (-800+800)		0
Net increase (-) in official (reserve) assets abroad		0
Balance on capital account		+6000
	Balance of Payments (BOP Def. 1)	0

BOP and the Exchange Rate

- Under flexible exchange rates:
 - ◆ No central bank interventions to offset market outcome so no change in foreign reserves ($\Delta R=0$)
 - ◆ BOP is always zero under the both definitions
- Under fixed exchange rates: BOP by Def. 2 is
 - ◆ in deficit if £ demand exceeds supply ($\Delta R < 0$)
 - ◆ in surplus if £ supply exceeds demand ($\Delta R > 0$)

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(Transactions a to f)

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III.		
Net increase (+) in foreign short-term private assets in US		+3800
(+7000+5000-1000-8000+800)		
Net increase (-) in short-term private assets abroad		0
Official reserve transactions balance (BOP Def. 2)		800
IV.		
Net increase (+) in foreign short-term reserve assets in US		-800
Net increase (-) in official (reserve) assets abroad		0
Balance on capital account		+6000
	Balance of Payments (BOP Def. 1)	0