



## Lecture 5

- Terminology
- Open market operations in an open economy
- Current account and national income
- Spot market vs. forward market
- Summary on BOP
- Summary on exchange rate

## Terminology

- Trade deficit
- Current account deficit
- Capital account deficit
- BOP deficit
- Budget deficit

## C/A and National Income

- C/A can be summarized as  $(X - M)$ , including goods and services (C/A in deficit if  $X < M$ )
- Basic macroeconomic identity:  
$$Y = AE = C + I + G + (X - M) \quad (\text{nation})$$
$$Y = C + S + T \quad (\text{household})$$
- Understanding the C/A balance  
$$(X - M) = Y - (C + I + G) \quad (\text{income} - \text{spending})$$
$$(X - M) = (S - I) + (T - G) \quad (\text{private} + \text{public saving})$$

⇒ C/A deficit implies the nation is in debt

⇒ K/A must be in surplus as capital inflow > outflow to finance debt

# Open Market Operations

- **Definition:**

It refers to the Fed's purchase or sale of government securities through transactions in the open market

- **Implementation of a monetary policy:**

- ◆ A contractionary monetary policy: the Fed sells bonds to reduce money supply and raise interest rate

- ◆ An expansionary monetary policy: the Fed buys bonds to raise money supply and reduce interest rate

- **Sterilization of the money supply:**

Fed buys (sell) bonds from (to) the market to increase (decrease) money supply when there is a rise (fall) in the supply/demand of foreign currency and hence a fall (rise) in foreign reserves under a fixed exchange rate.

## Spot Market vs. Forward Market

- Spot market:
  - ◆ Definition: daily or current market for e
  - ◆ Arbitrage (an example on p.435-36):
    - ◇ currencies worth less to sellers than to buyers
- Forward market:
  - ◆ Definition: a market for future transactions  
(the delivery date is more than two days)
  - ◆ Speculation vs. hedging
  - ◆ Spot rates vs. forward rates

## Summary (BOP)

- Give definitions of the major items in a BOP summary sheet
- Know the concept of double-entry bookkeeping
- Comment on the items in a BOP summary sheet, such as explain:
  - ◆ the causes of C/A deficit or surplus
  - ◆ the causes of K/A deficit or surplus
  - ◆ the relationship between C/A and K/A
  - ◆ BOP deficit or surplus and government intervention



## Summary (exchange rate)

- The function of the foreign exchange market
- Factors affecting the exchange rate
- The flexible and fixed exchange rate regimes and the balance of payments
- The operation of central banks
- Spot market vs. forward market