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
  \[
  (X - M) = Y - (C + I + G) \quad \text{(income - spending)}
  \]
  \[
  (X - M) = (S - I) + (T - G) \quad \text{(private+public saving)}
  \]
  \[\Rightarrow\] C/A deficit implies the nation is in debt
  \[\Rightarrow\] 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 exchange.
  - 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