

An Open Economy

Your money's value is determined by a global casino of unprecedented proportions: \$2 trillion are traded per day in foreign exchange markets, 100 times more than the trading volume of all the stockmarkets of the world combined.

-- Bernard Lietaer

Balance of Payments: ROW In the Circular Flow

Goods & Services

- Exports
- Imports

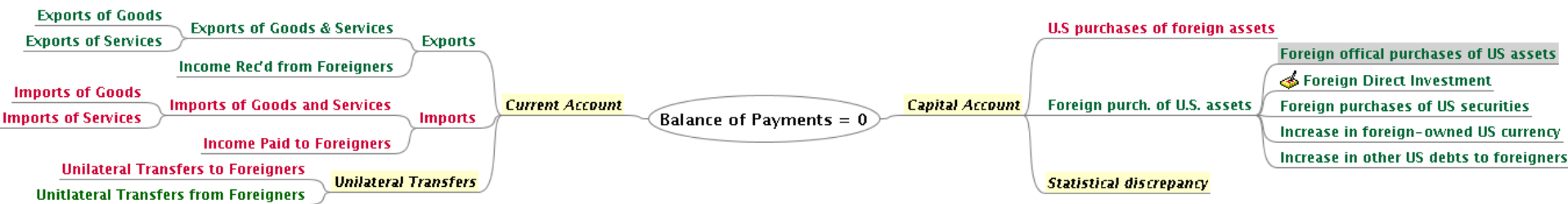
= *Current Account*
(Deficit)

Finance & Capital

- Capital Inflow
- Capital Outflow

= *Capital Account*
(Surplus)

Balance of Payments – Concept



green represents transactions where money is paid by foreigners to the U.S. (“credits”). In-flows of money.

red represents transactions where money is paid by people in the U.S. to foreigners – outflows: money is leaving the U.S

highlighted black could be either inflow or outflow depending on amounts.

Balance of Payments – An Example

Line	(Credits +; debits -)	2006
	Current account	
1	Exports of goods and services and income receipts	2,096
2	Exports of goods and services	1,446
3	Goods, balance of payments basis	1,023
4	Services	423
5	Income receipts	650
6	Imports of goods and services and income payments	-2,821
7	Imports of goods and services	-2,206
8	Goods, balance of payments basis	-1,862
9	Services	-344
10	Income payments	-615
11	Unilateral current transfers, net	-86
	Capital account	
12	U.S.-owned assets abroad (increase +)/financial outflow (-)	-1,055
13	Foreign-owned assets in the United States (increase/financial inflow (+))	1,860
14	Foreign official assets in the United States	440
15	Foreign Direct investment	181
16	U.S. securities	556
17	U.S. currency	13
18	U.S. liabilities to foreigners, not included elsewhere	236
19	Statistical discrepancy (sum of above items with sign reversed)	6
	Memoranda:	
20	Balance on goods (lines 3 and 8)	-839
21	Balance on services (lines 4 and 9)	79
22	Balance on goods and services (lines 2 and 7)	-760
23	Balance on income (lines 5 and 9)	35
24	Unilateral current transfers, net (line 35)	-86
25	Balance on current account (lines 1, 6, and 11 or lines 20, 21, and 22)	-811
26	Balance on capital account (lines 12, 13, and 19)	811

Balance of Payments – An Example

Line	(Credits +; debits -)	2006
Current account		
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Three sections.

Current Account

Capital Account

summaries or “balances” in
memoranda.

Balance of Payments – An Example

Line	(Credits +; debits -)	Year 2006	
Current account			
1	Exports of goods and services and income receipts		2,096
2	Exports of goods and services		
3	Goods	1,023	
4	Services	423	
5	Income receipts		650
6	Imports of goods and services and income payments		-2,821
7	Imports of goods and services		
8	Goods	-1,862	
9	Services	-344	
10	Income payments		-615
11	Unilateral current transfers, net		-86
Capital account			
12	U.S.-owned assets abroad		-1,055
13	Foreign-owned assets in the United States		1,860
14	Foreign official assets in the United States	440	
15	Foreign Direct investment	181	
16	U.S. securities	556	
17	U.S. currency	13	
18	U.S. liabilities to foreigners, not included elsewhere	670	
19	Statistical discrepancy (sum of above items with sign reversed)		6
Memoranda:			
20	Balance on goods (lines 3 and 8)		-839
21	Balance on services (lines 4 and 9)		79
22	Balance on goods and services (lines 2 and 7)		-760
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Next let's separate the different levels of detail

Green are debits

Red are credits.

Balance of Payments – The Memoranda Items

Line	(Credits +; debits -)	Year 2006	
Current account			
1	Exports of goods and services and income receipts X		2,096
2	Exports of goods and services		
3	Goods	1,023	1,446
4	Services	423	
5	Income receipts		650
6	Imports of goods and services and income payments M		-2,821
7	Imports of goods and services		
8	Goods	-1,862	-2,206
9	Services	-344	
10	Income payments		-615
11	Unilateral current transfers, net		-86
Capital account			
12	U.S.-owned assets abroad CAPITAL OUTFLOWS		-1,055
13	Foreign-owned assets in the United States CAPITAL INFLOWS		1,860
14	Foreign official assets in the United States	440	1,860
15	Foreign Direct investment	181	
16	U.S. securities	556	
17	U.S. currency	13	
18	U.S. liabilities to foreigners, not included elsewhere	670	
19	Statistical discrepancy (sum of above items with sign reversed)		6
Memoranda:			
20	Balance on goods (lines 3 and 8) MERCHANDISE TRADE BALANCE		-839
21	Balance on services (lines 4 and 9)		79
22	Balance on goods and services (lines 2 and 7) TRADE BALANCE		-760
23	Balance on income (lines 5 and 9)		35
24	Unilateral current transfers, net (line 35)		-86
25	BALANCE ON CURRENT ACCOUNT (lines 1, 6, and 11 or lines 20, 21, and 22)		-811
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*Capital Inflows-
Outflows
= X-M*

Re-name some items.

Balance of Payments - Dynamics

Capital Account & Current Account linked

- If one increases, the other will also, & vice-versa
- Causality not clear

U.S. Issues

- Large, persistent (30+ yrs):
 - ◆ Current account deficit
 - ◆ Capital account surplus
- Unusual for developed nation
- Possible factors:
 - ◆ Low U.S. savings rate
 - ◆ High U.S. consumption & govt spending
 - ◆ Strong dollar
 - \$ as reserve currency
 - Petro-dollars
 - Weak yen & yuan as foreign growth strategy

Foreign Exchange Rates

Forex rates are “prices”

- Represents:
- how many Y’s does 1 X buy
- Expressed two ways: reciprocals of each other

Example: suppose \$1.00 CAD = \$1.05 USD
 then \$1.00 USD = \$ 0.9524 CAD

LESSON: always pay close attention to which way the exchange rate is expressed –

Exchange Rates – An Example

CurrencyLast Trade	U.S. \$	¥en	Euro	Can \$	U.K. £	AU \$	Swiss Franc
1 U.S. \$ =	1	114.71	0.69	0.93	0.48	1.08	1.15
1 ¥en =	0.01	1	0.01	0.01	0	0.01	0.01
1 Euro =	1.45	166.33	1	1.35	0.69	1.57	1.67
1 Can \$ =	1.07	122.76	0.74	1	0.51	1.16	1.23
1 U.K. £ =	2.09	239.74	1.44	1.95	1	2.26	2.41
1 AU \$ =	0.92	105.99	0.64	0.86	0.44	1	1.07
1 Swiss Franc =	0.87	99.42	0.6	0.81	0.41	0.94	1

November 4, 2007. For more up-to-date rates, see <http://www.x-rates.com/> for rates updated daily. See [Yahoo finance](#) for up-to-the-minute rates.

Exchange Rates

What “Should” Rates Be?

- Whatever creates equilibrium
- Absolute rate is irrelevant
- Purchasing Power Parity Theory
 - ◆ “Big Mac” Index & others

Changes in Rates Matter

- Pricing of imports & exports
- Differences in inflation, interest rates, exchange rates change capital flows

Currency Exchange Needs

Wants weaker \$

- US exporter
 - ◆ buys \$USD
- Foreign Importer
 - ◆ buys \$USD
- Foreign Tourist
 - ◆ Buys \$USD

Wants stronger \$

Foreign Exporter

- sells \$USD

US importer

- sells \$USD

US Tourist

- Sells \$USD

Where Are We Now?

R.O.W. supports US consuming 5-10% more than we produce

US pays with “paper” money

- So far, R.O.W. wants \$USD
- R.O.W. finances our budget deficit
- R.O.W. uses a “dollar” standard
 - ◆ US\$ as reserve instead of gold
 - ◆ Buy Oil

What if R.O.W. changes it's mind?