**Balance of Payments Review**

**Capital Account**- real assets which include investments like a stock, bonds/securities, a land use property (if someone bought a building, a business, a house, a hotel, a factory, a store, a mine, a farm, etc.)

**Current Account-** goods and services of all types (imports and exports), interest, money transfers, basically any type of transaction that is not the purchase of a real asset

Current/Capital Account Flows

To figure out if you subtract or add to current accounts (what’s a debit vs a credit) use the rule that if money flows in to the country it’s a credit, out is a debit

**Credits**- adds to the account (money is flowing into the US), in current accounts an export would be a credit

**Debits**- subtracts from the account (money is flowing out of the US) so for current accounts an import subtracts from the account and is a debit

Capital Flow Chain Rules

1. An increase in Interest Rates attracts capital because interest rates represent rates of return and you want your investment to get a high rate of return so you invest in countries where the interest rates are rising or are high.

$$IR\uparrow Capital Flows in\uparrow $$

1. An appreciation of a currency has the opposite effect of an increase in Interest Rates. When a country’s currency appreciates, it’s assets are becoming more expensive, so we invest less in those countries and more in countries that see their currency depreciating.

$$\$ Appreciates\uparrow Capital Flows in \downright $$

1. If the money flows in, the goods must be flowing out because current and capital accounts balance.

$$Capital Flows\uparrow Exports \downright $$

1. Remember the order of the question really impacts answers when you have to shift multiple things in the ForEX/Balance of Payments Model

If you were asked what would happen if Interest Rates rose in the US and to show the impact on capital flows first then the FOREX market, then US current accounts it would work like this:

$$IR in US\uparrow Capital Flows in US\uparrow \$ Appreciates\uparrow US X\downright $$

If they ask what happens if a major technology increase causes US manufacturing to rise, tell what happens to current accounts, FOREX market, and US capital accounts it works like this:

$$US X \uparrow \$ Appreciates\uparrow Capital Flows in US\downright $$

So in both of these examples the dollar appreciates but the current account and capital accounts do not behave the same way. Do the question and use your logic in the order they ask the question.

**Foreign Exchange Review**

1. When the demand for one currency rises the supply for the other currency will rise as well.

Why? When people are grabbing one currency it leaves a pile of the other currency left over.

1. Remember the bottom rule of labeling. If you are talking about the market for the dollar and exchanging with the Euro. You label your quantity axis quantity of dollars, and your price axis with Euro/dollar. So the dollar goes on the bottom of the graph along the q axis and at the bottom of price per statement.



1. Foreign Exchange Determinants mirror each other in impact

The 3 determinants for both supply and demand are

* Interest rates
* Exchange rates
* Expected future exchange rate

The determinants listed below would:

Cause Demand↑ Cause Supply↓

IR↑ IR ↑

ER ↑ ER ↑

EFER$\uparrow $ EFER$\uparrow $