Chapter 17: International Trade
Section 3

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ECONOMICS

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Objectives

1. **Explain** how exchange rates of world currencies.
2. **Describe** the effect of various exchange rate systems.
3. **Define** balance of trade and balance of payments.
4. **Analyze** the causes and effects of the U.S. trade deficit.

Key Terms

- **exchange rate**: the value of a nation's currency in relation to a foreign country
- **appreciation:** an increase in the value of a currency
- **depreciation**: a decrease in the value of a currency
- **foreign exchange market**: system of financial institutions that facilitate the buying and selling of foreign currencies
- **fixed exchange-rate system**: a system in which governments try to keep the values of their currencies constant against one another

Key Terms, cont.

- **flexible-exchange rate system**: a system in which the exchange rate is determined by supply and demand
- **balance of trade:** the relationship between the value of a country's exports and the value of its imports
- **trade surplus**: situation in which a nation exports more goods and services than it imports
- **trade deficit**: situation in which a nation imports more goods and services than it exports
- **balance of payments**: the value of all monetary transactions between a country's economy and the rest of the world

Introduction

- How do exchange rates affect international trade?
  - Appreciating currency causes prices to rise on goods produced in a country, which means exports will likely decline and consumers will purchase more imports.
  - Depreciating currency causes prices to fall on goods produced in a country, which means exports will likely increase.

Foreign Exchange

- Changing money from one nation's currency is never easy because it is seldom an even exchange, like one peso for one dollar.
  - The value of a nation's currency in relation to a foreign currency is called the exchange rate.
  - Understanding how exchange rates work enables you to convert prices in one currency to prices in another currency.

Foreign Exchange Rates

- This table shows exchange rates on a single day. Read down the first column of the chart to find out what one U.S. dollar was worth in various foreign currencies. Read across the top to find out how much a selected foreign currency was worth in U.S. dollars.
  - On this day, how much was a U.S. dollar worth in Chinese yuan? In Canadian dollars?

	U.S. $	Aust. $	U.K. £	Canadian $	Japanese ¥en	€uro	Mexican peso	Chinese yuan
U.S. $	1	.88	2.04	1.00	.008	1.42	.09	.13
Australian $	1.12	1	2.30	1.13	.009	1.60	.10	.15
U.K. £	.49	.43	1	.49	.004	.69	.04	.07
Canadian $	.99	.88	2.03	1	.008	1.42	.09	.13
Japanese ¥en	114.97	101.81	234.41	115.44	1	163.47	10.52	15.34
€uro	.70	.62	1.43	.71	.006	1	.06	.09
Mexican peso	10.93	9.68	22.29	10.98	.095	15.54	1	1.46
Chinese yuan	7.449	6.63	15.28	7.52	.065	10.65	.69	1

SOURCE: *X-rates.com* accessed on Friday, September 28, 2007 Note: These data are highly time sensitive and can change hourly.

Calculating Prices

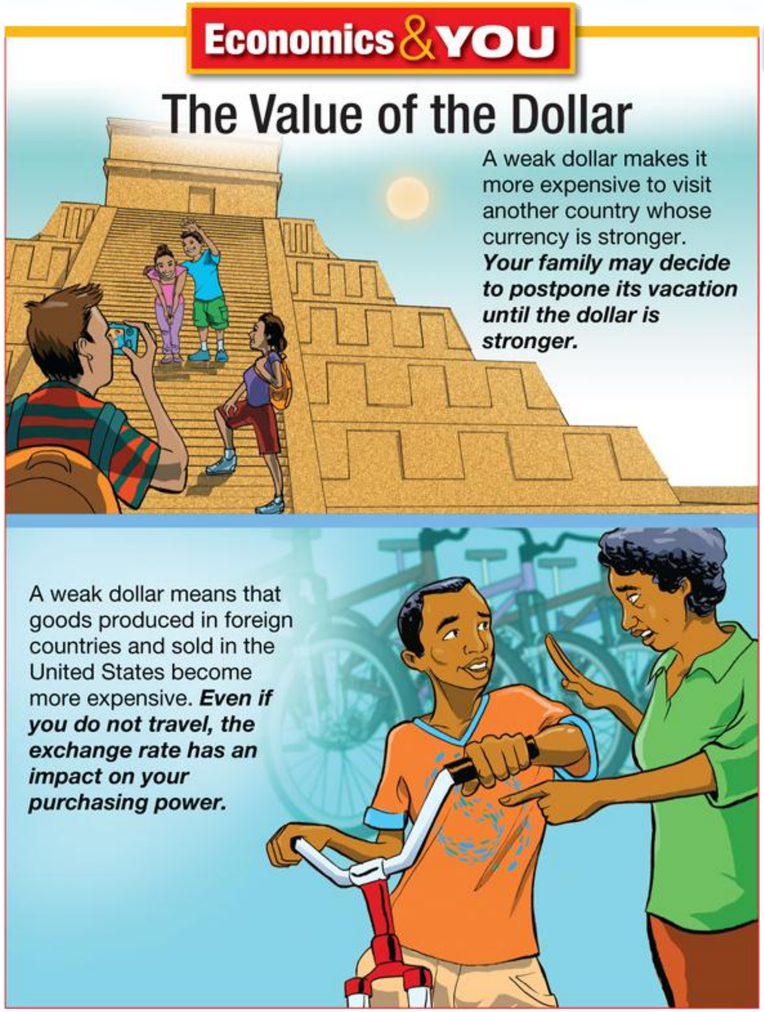
- A simple formula allows you to convert the price of an item from foreign currency to American dollars. Simply divide the price by the value of the currency per one dollar according to the exchange rate.

Appreciation

- Checkpoint: What are the likely effects of the dollar becoming stronger?
  – An increase in the value of a currency is called appreciation.
    - When a currency appreciates, it becomes "stronger."
  – When a nation's currency appreciates, its products become more expensive in other countries.
  – A strong dollar is therefore likely to lead consumers in the United States to purchase more imported goods.

Depreciation

- A decrease in the value of a currency is called depreciation, often referred to as "weakening."
- When a nations' currency depreciates, its product become cheaper to other nations.



Foreign Exchange Market

- International trade is made possible by the foreign exchange market, which consists of about 2,000 banks and other financial institutions that facilitate the buying and selling of foreign currencies.
  - These banks are located in various financial centers throughout the world and maintain close links to one another through telephone and computer.

Exchange Rate Systems

- In the United States today, all prices are in dollars and all dollars have the same value.
- Complications exist in international trade because exchange rates can shift.
  - A system in which governments try to keep the values of their currencies constant against one another is called a fixed exchange-rate system. In this system, governments intervene in order to maintain the rate.
  - Checkpoint: How are exchange rates set in a fixed exchange-rate system?

The Bretton Woods Conference

- As World War II was drawing to a close, representatives from 44 countries met in Bretton Woods, New Hampshire to make financial arrangements for the postwar world.
  - The Bretton Woods conference resulted in the creation of a fixed-rate system for the United States and much of western Europe.
  - To make the new system work, the Bretton Woods conference established the International Monetary Fund (IMF). Today, the IMF promotes international monetary cooperation, currency stability, and trade.

Flexible Exchange-Rate Systems

- By 1973, many countries, including the United States, abandoned the fixed rate-exchange system and adopted a system based on flexible exchange rates, in which the exchange rate is determined by supply and demand.
  - Today, the countries of the world use a mixture of fixed and flexible exchange rate and trade has grown rapidly.

The Euro

- Although the flexible exchange-rate system works well, some countries whose economies are closely tied together want the advantages of fixed rates.
  - One way to enjoy the advantages but avoid some of the difficulties of fixed exchange rates is to abolish individual currencies and establish a single currency, which is what 12 members of the European Union did by adopting the euro.
    - The euro helps simplify trade in member nations.

Balance of Trade

- Exchange rates can affect a nation's balance of trade.
- Nations seek to maintain a balance of trade by avoiding trade surpluses and trade deficits.
- By balancing trade, a nation can protect the value of its currency on the international market.
  - When a country continually imports more than it exports, the value of its currency falls.
  - This can be corrected either by limiting imports or by increasing the number or value of exports.

Balance of Payments

- Economists get a more complex picture of international trade by looking at balance of payments, or the value of all monetary transactions between all sectors of a country's economy and the rest of the world.
  - Income from foreign companies, government aid to foreign banks, and exchange rates must all be factored into the balance of payments

U.S. Balance of Trade

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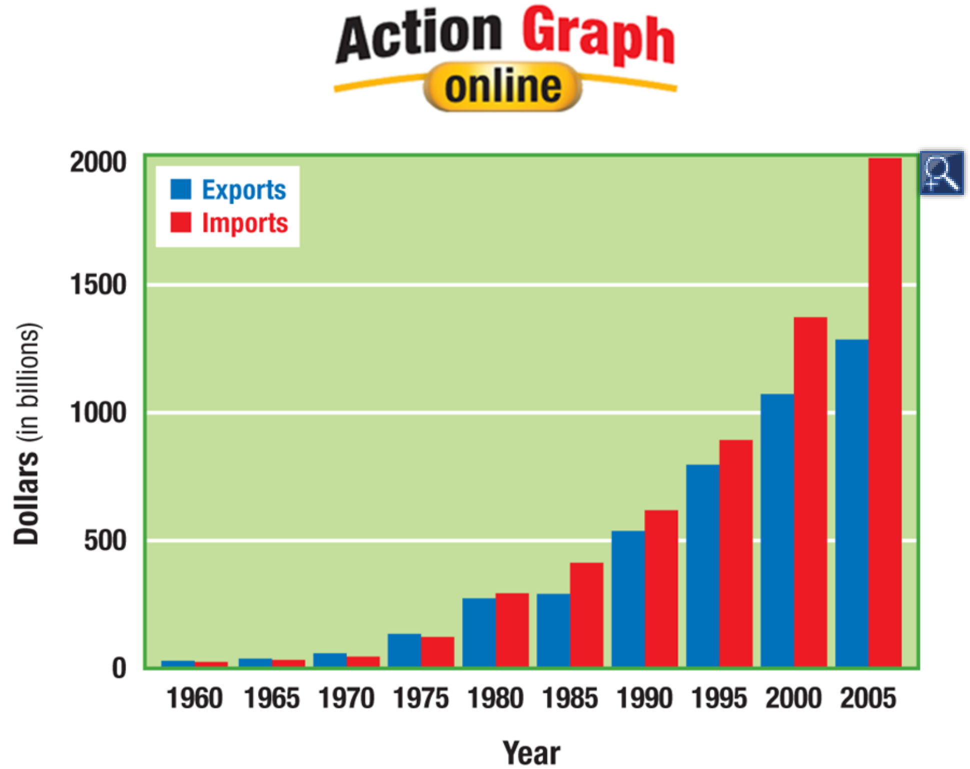
- The United States currently runs a trade deficit.
  - As a result of these deficits, people from other countries now own a large part of the U.S. economy.
  - What was the difference between imports and exports in 1980? In 2005?



SOURCE: Foreign Trade Statistics: U.S. International Trade in Goods

Effects of the Trade Deficit

- The fact that other countries own parts of the U.S. economy leads some to fear that U.S. national security is at risk and that overseas investors may be reluctant to purchase American assets, which would slow the monetary flow in the United States.
- To reduce the trade deficit, the government could depreciate the exchange rate. As a result, exports would rise and imports would fall.
  - The government could also cut back spending by adjusting its monetary or fiscal policy.

Review

- Now that you have learned about how exchange rates affect international trade, go back and answer the Chapter Essential Question.
  - Should free trade be encouraged?