



# The Ultimate Unit 6 Cheat Sheet

Everything you need to know about balance of payments accounts, exchange rates, and the foreign exchange market

## Balance of Payments Accounts

**Balance of Payments Accounts:** a summary of all international transactions (trade in goods/services and flow of assets) for a country in a given year.

**Current Account:** an account that measures the international trade in goods and services, net income from abroad, and net unilateral transfers.

- **Unilateral Transfers:** Payments from one country to another that do not correspond to the purchase of any good, service, or asset (e.g., foreign aid).
- **Income from Abroad:** income earned by a country's citizens in foreign countries

**Trade Balance:** the difference between a country's total exports and total imports of goods and services.

- **Trade Surplus:** Exports > Imports
- **Trade Deficit:** Imports > Exports

**Capital Account:** an account that measures the purchase and sale of financial assets, such as stocks, bonds, and real estate, between a country and the rest of the world.

**Capital Inflows / Outflows:** the movement of financial assets (money) into or out of a country.

- EX: Chinese banks purchase US government bonds (Inflow for the US)
- EX: US investors buy stock in Chinese companies (Outflow for the US)

Current Account	Capital (Financial) Account
<ul style="list-style-type: none"> <li>• Net exports</li> <li>• Net unilateral transfers</li> <li>• Net income from abroad</li> </ul>	<ul style="list-style-type: none"> <li>• Net inflows of financial investment</li> </ul>

**Remember:** These two accounts balance each other out. If the current account is in deficit, the financial account will be in surplus

## Exchange Rates

**Exchange Rate:** The price of one country's currency in terms of another country's currency.

**Currency Appreciation:** An increase in the value of one currency relative to another currency.

**Currency Depreciation:** An decrease in the value of one currency relative to another currency.

## The Forex Market

**The Foreign Exchange Market:** The global marketplace where currencies are traded and exchange rates are determined by the interaction of supply and demand

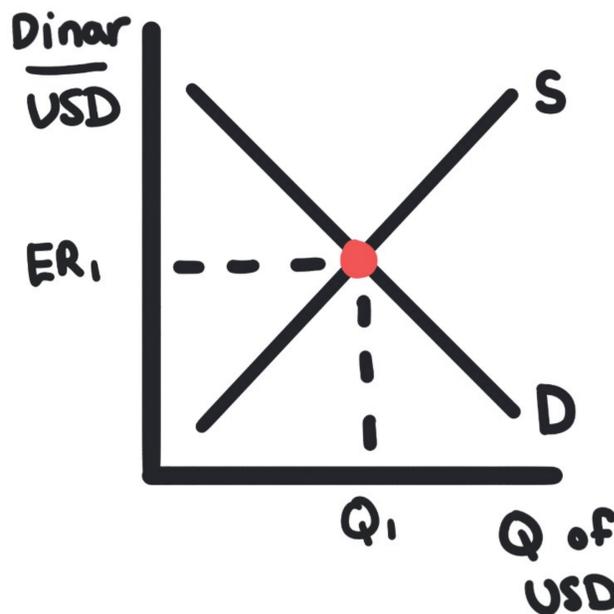
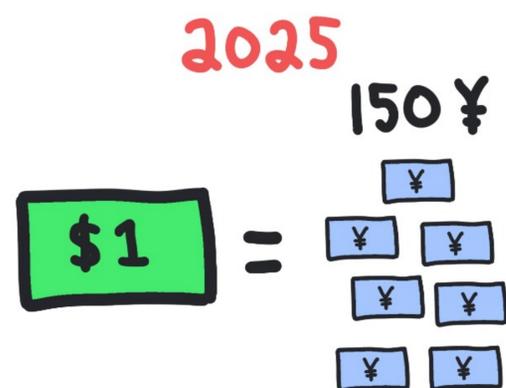
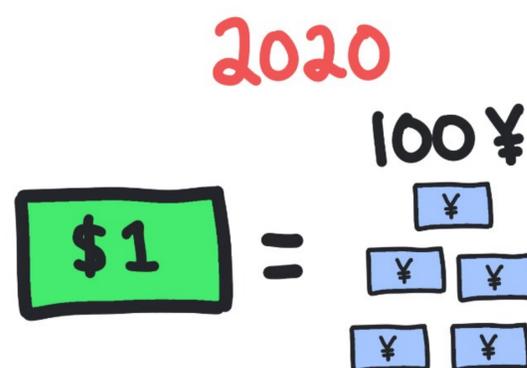
**Demand for Currency:** A downward-sloping curve showing the quantity of a currency demanded at various exchange rates.

- demand for a foreign currency is made up of foreigners (Kuwaiti citizens who want USD)

**Supply of Currency:** An upward-sloping curve showing the quantity of a currency supplied at various exchange rates.

- supply of a a foreign currency is made up of domestic holders of a currency (US citizens willing to sell USD to Kuwaiti buyers)

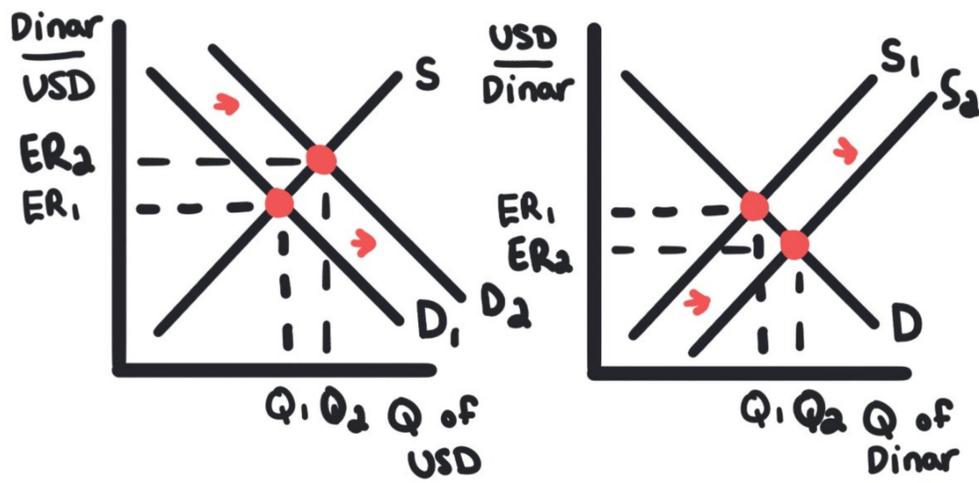
*In 2020, 1 USD could get you 100 Yen. In 2025, the same dollar could get you 150 Yen. The USD appreciated, while the yen depreciated.*



**Graphing Tips:**

- Make sure the currency on the x-axis is the same as the currency on the bottom of your y-axis currency ratio
- This currency ratio shows how many Kuwaiti Dinar you can get with one US dollar

**Important:** Since in the Forex market, one currency is traded for another, and increase in demand for a currency will always be accompanied by an increase in supply of the other (you must GIVE your currency to GET the other)



**Understanding the Shifts:**

- Suppose that Kuwaiti investors seek out higher interest rates by buying US bonds. To do this, they need US dollars
- The graph on the left shows an increase in demand for USD and an appreciation of the dollar
- The graph on the right shows an increase in supply of the Kuwaiti Dinar and a depreciation of the Dinar

Use the list of shifters below to brainstorm other possible causes of the changes seen on these foreign exchange market graphs!

**Forex Supply & Demand Shifters:**

**1. Tastes and Preferences**

- Scenario: American consumer goods become more popular in Europe
- Forex Shifts: Demand for USD increases, Supply of Euros increases
- Result: USD appreciates, Euro depreciates

**2. Relative Income Levels**

- Scenario: The Chinese economy is booming and consumers are purchasing more foreign goods with their newfound wealth
- Forex Shifts: Demand for foreign currency increase, Supply of Chinese Yuan increases
- Result: Foreign currency appreciates, Chinese Yuan depreciates

**3. Relative Price Levels (Inflation)**

- Scenario: US inflation rises faster than other nations, making US goods more expensive relative to other options
- Forex Shifts: Demand for USD decreases, Supply of foreign currency decreases
- Result: USD depreciates, foreign currency appreciates

**4. Relative Interest Rates**

- Scenario: British interest rates rise relative to Canada, meaning Canadian investors are interested in buying British government bonds
- Forex Shifts: Demand for British Pound increase, Supply of Canadian Dollar increases
- Result: British Pound appreciates, Canadian Dollar depreciates

**Policy & Forex**

To keep it simple, policy action impacts RIR, and the RIR affects the value of the currency in the Forex market

**Policy Action** → RIR ↑ → **Currency Appreciation**

**Policy Action that Causes Appreciation:**

- Expansionary Fiscal Policy
- Contractionary Monetary Policy

**Policy Action** → RIR ↓ → **Currency Depreciation**

**Policy Action that Causes Depreciation:**

- Contractionary Fiscal Policy
- Expansionary Monetary Policy

**Forex & Net Exports**

When a country's currency appreciates, its exports become more expensive for foreigners and imports become cheaper for its citizens.

**Appreciation** → **Net Exports** ↓

When a country's currency depreciates, its exports become cheaper for foreigners and imports become more expensive for its citizens.

**Depreciation** → **Net Exports** ↑

Therefore, whether appreciation or depreciation is good or bad depends on whether you are an exporter, importer, consumer, etc.

**RIR & Capital Flow**

Investors constantly seek the highest Real Rate of Return on their savings.

**RIR** ↑ → **Capital Inflow**

Foreigners want those high-return assets → They must buy that country's currency first → Demand for Currency ↑ → Currency Appreciates.

**RIR** ↓ → **Capital Outflow**

Investors move their money out to find higher returns elsewhere → They sell the domestic currency to buy foreign ones → Supply of Currency ↑ → Currency Depreciates.

**Knowledge Check**

Check your answers at [apdojo.com/ultimateCramSheet/answer-keys](https://apdojo.com/ultimateCramSheet/answer-keys)

- Suppose Northlandia is currently running a deficit in the current account. Is Northlandia's financial account in deficit, surplus, or neither? Explain.
- The central bank of Southlandia implements contractionary monetary policy. Trace the impact of this policy on RIR, capital flows, and the value of Southlandia's currency.

3. Will domestic exporters benefit or suffer from an appreciation of their country's currency? Explain

4. If the Japanese Yen depreciates against the US Dollar, what is the expected impact on Japan's Net Exports (NX) and its Current Account?

5. Draw two graphs that show the foreign exchange market for the Canadian Dollar (CAD) and the Mexican Peso. Suppose the Mexico's national income rises relative to Canada. Show the impact of this change on the forex market.