Revised 10/14/2008

International Economics

Study Guide 8

This Week's Reading

M: Fall Break Holiday
W: Carbaugh 10 BoP basics
F: Carbaugh 10 Balance of Payments: IMF Bootcamp.

Sample Questions

Please complete these problems before moving ahead to the sample answers section.

1. Define the following terms as precisely as you can: Balance of Payments, Current Account surplus, Capital and Financial account surplus.

2. What is the difference between the Balance of Trade and the Current Account? Why is this difference important?

3. Is a Current Account surplus a good thing? Should the nation's economic policies be organized so as to maximize its Current Account surplus? Explain using the output-absorption analysis.

4. International Finance has a language all its own. As a result, your must master the terminology before you can begin to understand the substance of FX analysis. Briefly define the following terms in your own words.

Spot exchange rate	Forward exchange rate
Bid-Ask spreads	Forward premium/discount
Appreciation/Depreciation	FX Futures and Options.
Cross rate	Arbitrage
Black market	Central Bank Intervention

Sample Answers

BEWARE! Don't read these answers until you have written *your own* answers to the sample questions!

1. Define the following terms as precisely as you can: Balance of Payments, Current Account surplus, Capital and Financial account surplus.

Here are some working definitions. Compare these with the definitions presented in both the body of the textbook and in the glossary at the end of the text.

The Balance of Payments (BoP) is the record of all of a nation's international financial transactions during a given period of time, usually a year. Money inflows are counted as credits. Money outflows are debits. The Balance of Payments contains several sub-accounts, the most important of which are the Current Account (CA) and the Capital and Financial Account (which we will call simply the Capital Account -- KA).

A Current Account surplus can be defined in at least four ways: in terms of the actual state of the CA, in terms of its implications for GDP, in terms of what it implies about the remainder of the BoP, namely the KA, and finally in terms of what it implies about resources. In terms of the CA items themselves, a CA surplus means that a nation has receive greater payments for exports of goods and services, investment income (export of capital services), and unilateral transfers than it has made payments for these same items (imports of goods and services, payment for capital services, and receipts of unilateral transfers).

Since all the items in the Current Account affect GDP either directly or, as with unilateral transfers, indirectly, it is possible to define a CA surplus as a pattern of international transactions that results in an increase in GDP (compared with a equilibrium in the CA).

Because a Current Account surplus implies a Capital Account deficit, one can, following the textbook authors, define a CA surplus nation as a net lender nation.

Finally, a nation with a CA surplus is one that does not use or "absorb" all of its current GDP (so that there are GDP resources available for export or transfer abroad). Thus a CA surplus nation has high income but a relatively lower material living standard as measured by its absorption -- the levels of consumption, investment, government spending, and import consumption that its citizens have chosen.

It may also be helpful to consider current output O versus current absorption A where absorption is equal to C, I, G, and M. A CA surplus is a situation where O>A, hence there is current production available for export.

A nation with a Capital Account surplus has experience greater receipts for sales of its assets to foreigners than it has paid for additional claims on foreign assets. In other

words, it experiences a net inflow of money as a result of a net transfer of domestic assets to foreigners. It is thus a net borrower nation in the current period having traded asset claims (KA surplus) for additional current consumption or absorption (CA deficit).

2. What is the difference between the Balance of Trade and the Current Account? Why is this difference important?

The Balance of Trade (BoT) measures only the receipts and expenditures due to transactions involving goods and services. The Current Account adds to this investment income payments and receipts (transactions involving capital services) and unilateral transfers. With the general trend to greater globalization of production and investment, it is increasingly misleading to ignore capital service payments when assessing a nation's international financial status.

An indebted LDC, for example, may be a net exporter, but use much of the export earnings to service prior debt. Thus although there might be a large Balance of Trade surplus, the Current Account surplus might be much smaller. The exports are not increasing the nation's income as much as the BoT might indicate because the funds go to pay foreign debts. The CA more clearly indicates the true situation. In the same way, with more international migration, new patterns of unilateral transfers are taking place, which the CA can measure more effectively than the BoT.

3. Is a Current Account surplus a good thing? Should the nation's economic policies be organized so as to maximize its Current Account surplus? Explain using the output-absorption analysis.

It depends, of course. Short term, transitory, or cyclical CA surpluses and deficits are not a problem and might even be helpful -- the result of balancing absorption over a business cycle, for example.

Persistent surpluses and deficits accumulate foreign claims or foreign debts, which can be a problem since nations must at least service the foreign debts and generally must also pay the principle. There are thus implications for current income and for assets and wealth.

Fundamentally, nations that have persistent CA deficits accumulate foreign debts that must be serviced. Eventually, a CA surplus must be produced to make these payments. That is, eventually output must be increased and/or absorption reduced to create a CA surplus to offset previous CA deficits. This is a problem for the deficit nation but, as Keynes realized in the 1940s and Japanese policy makers understand today, it is also a problem for the CA surplus nations.

Why is this a problem for a CA surplus nation? Because your surplus is my deficit. And if I must eventually generate a surplus to pay you, then someone else (maybe you) will

need to run a deficit. There is thus an international interest in keeping BoP imbalances manageable so as to prevent destructive competition over CA surpluses.

4. International Finance has a language all its own. As a result, your must master the terminology before you can begin to understand the substance of FX analysis. Briefly define the following terms in your own words.

- Spot vs forward exchange rate. The spot rate is the exchange rate that applies to FX transactions that are completed in the current time period -- the same day, for example, so that no significant time dimension is involved. The forward rate is the FX rate on transactions that are agreed to in one time period but that involve an exchange that is completed on a specified future date.

- Appreciation and depreciation. Changes in the relative prices of currencies. If the $ purchases relatively more € (Euro), then the $ has appreciated and the € has depreciation. We use these terms instead of just saying higher, lower, more expensive, cheaper, etc., to stress that the FX is a relative price, not an absolute price. Also, because there are so many currencies, it is possible for the $ to appreciate relative to the € but depreciate relative to the Yen, so it is important to state the specific basis of comparison in discussing FX rates.

- Bid-Ask spreads. In FX transactions there is often a difference between the FX rate when a currency is purchased (bid) or sold (ask). This spread compensates the FX dealer for direct costs, opportunity costs, and the risk associated with holding FX.

- Cross rates. We can easily look up the $/€ exchange rate and the $/Yen exchange rate. The €/Yen exchange rate, which can be derived from the first two FX rates, is called a cross rate. Cross rates are important in arbitrage transactions. If the three exchange rates above are not precisely the same, it is possible to purchase FX in one market and sell it in another and make a small but sure profit -- the basis of FX arbitrage. FX arbitrage is extremely efficient today due to the telecommunications and calculation technology available, so markets quickly are moved to consistent worldwide equilibria by profit-seeking arbitrageurs.

- Forward premium and discount. When the forward exchange rate for a currency is higher (lower) than spot rate, we say there is a forward premium (discount). There are many reasons for a forward premium or discount, so one must be very careful in interpreting this condition. The most obvious reason is that a currency is expected to appreciate in the near future (hence forward premium) or to depreciate (discount). In this situation, the forward rate is a leading indicator of spot rate movements. The forward rate, however, is often used as part of an investment strategy called *covered interest arbitrage*, which takes advantage of international interest rate differences. A nation with relatively higher real risk adjusted interests.