QUESTIONS - CHAPTER 18 BALANCE OF PAYMENTS

Question 18.1

“If there is more money flowing into a country than there is flowing out, that country has a positive balance of payments; if, on the other hand, more money flows out than in, the balance of payments is negative.” Source: Wikipedia encyclopaedia, January 2006 (http://en.wikipedia.org/wiki/Balance_of_payments).

18.1A Is the definition above correct? Explain.

In this book, we follow the accounting principle that this balance equals to zero. In practice, different definitions for the balance of payments exist. They sometimes exclude reserve assets or short-term capital account transactions from the balance, such that imbalances are possible. Consider the following quote: “The US is able to attract funds from the rest of the world to finance its balance of payments deficit”.

18.1B Explain the quote with the help of equation 18.9. What happens when the US is unable to attract funds from the rest of the world?

Suppose that the Chinese central bank publishes a report that blames expected balance of payments surplus reductions on lower trade tariffs (taxes on imports) and higher oil prices.

18.1C Which Balance of Payments definition does the Chinese central bank probably use?

Explain how tariff reductions and higher oil prices can contribute to a lower surplus.

When a country has a deficit in its balance of payments, politicians and the press often portray this as a cause of major concern. This concern is groundless for two reasons: (1) there never is a deficit, and (2) it wouldn't necessarily hurt if there were a deficit.

18.1D Explain for both reasons whether you agree or disagree.

18.1E Can you explain why politicians and the press are often concerned?

Question 18.2

The developments of the Chinese and US current account balance since 1990 are shown in the graph below. The current account is a flow variable. It represents the build-up of net foreign claims by an economy. Many US politicians blame China for their country’s growing current account deficit and negative international investment position.
18.2A Why do US politicians blame China for their deficit, while the Chinese current account surplus is initially fairly small compared to the US deficit?

18.2B The current account balance is not exactly equal to changes in the international investment position. Can you explain why this is so?

18.2C The Chinese and US economies both attract a lot of foreign direct investment (FDI). Does this represent a capital inflow or outflow?

18.2D If the current account remains unchanged, which offsetting capital account transactions can occur to maintain a balance of payments (use Figure 18.3)?

18.2E Suppose the US government wants to improve relations with China and does so by giving emergency assistance after a flooding of the Yangtze River. How does this affect the Chinese balance of payments?

Question 18.3
Suppose that you live in the hermetically closed nation of North Korea. The economy has no outside economic links with the rest of the world. You save money in the bank and know that North Korean banks have the highest interest rates in the world.

18.3A What do you know about the saving and investment relationship in North Korea?
18.3B As a saver, do you favour capital mobility? Explain.

18.3C Do you expect the relationship between saving and investment to change after capital market integration? What will happen to the North Korean current account? Explain.

18.3D What impact does the Feldstein-Horioka puzzle have on your answer to 18.3C?

Question 18.4
Are the statements below true or false? Explain.

18.4A If a country has a current account balance, it does not export capital.

18.4B The purchase of Costa Rican equity in Costa Rica by a Japanese investor, paid with Japanese Yen, implies a net capital inflow for Costa Rica.

18.4C The build-up of foreign exchange reserves by China is only possible because of its large capital inflows.

Question 18.5
The brief discussion on capital flows and returns in chapter briefly highlights the benefits of capital account liberalisation and makes a strong set of predictions. Yet, a lot more can be said on this subject.

18.5A Search the internet for the “Lucas paradox”. What is this paradox?

Locate the paper “Why doesn’t capital flow from rich to poor? An empirical investigation” by Laura Alfaro, Sebnem Kalemli-Ozcan and Vadym Volosovich.

18.5B Which two main theoretical explanations are given for the existence of the Lucas paradox?

18.5C What is the view of Reinhart and Rogoff on this issue?

18.5D Which factor is dominant in explaining the paradox according to the authors? Which empirical examples do they give?

18.4E Which explanation do you consider most plausible?