**Chapter 2 Exercises**

For questions 1-3, explain how each of the transactions described would be entered in the balance of payments accounts of the United States:

1. A loan of $10 million is made by a U.S. bank to the government of Honduras. The loan is funded by creating a $10 million deposit in the U.S. bank.

**The $ 10 million loan represents the acquisition of a financial claim by US residents on foreign residents. It is a capital outflow, and is entered as a debit. The deposit is the transfer of a claim on US resident to a foreign resident. It is a capital inflow, and is entered as a credit.**

2. The Honduran government uses the proceeds of the loan to buy vaccines from a U.S. firm.

**The sale of the vaccines is the transfer of something of value to a foreign resident. As an export of goods, it is entered as a credit. The transfer of the funds in the checking account to the American seller of the vaccines is an acquisition of something of value (the deposit) by a domestic resident from a foreign resident. It is entered as a debit (a capital outflow) in the US BOP accounts.**

3.A Danish firm pays $100,000 in interest to an American who holds bonds issued by that firm in a prior year. The $100,000 is deposited in a Danish bank.

**The interest earned represents the transfer of the services of capital from an American resident to a foreign resident, and is entered as a credit (a receipt of investment income). The payment of that interest in the form of the deposit in the Danish bank represents the acquisition of a financial claim by a US resident, so it is entered as a debit (a capital outflow) in the nonreserve financial account.**

4. A U.S. tourist travels to Mexico, buys $2500 worth of Mexican pesos with a check written on an American bank, and spends the full amount during the trip.

**The goods and services purchased by the tourist are imports of goods and services by US residents, and as such are entered as debits in the merchandise trade balance. The transfer of the deposit to Mexican residents amounts to the giving up of a financial claim by US residents, and is thus a credit (a capital inflow) in the nonreserve financial account of the US BOP accounts.**

5. An American charity gives $100,000 worth of food to a non-governmental organization (NGO) in Darfur.

**This is an unrequited transfer to a foreign resident. The food given up by the US is an export of goods, entered as a credit in the merchandise trade balance. The countervailing entry is the transfer itself, considered to consist of the import of “goodwill” – a valuable commodity – by US residents, and thus entered as a debit under unilateral transfers.**

6. A foreign student pays tuition of $25,000 to a domestic university. The payment is made from a bank account that the student’s parents have in a bank in their own country.

**The American university has transferred something of value (educational services) to a foreign resident, and this is therefore a U.S. service export. The claim acquired by the American university on the foreign bank is a debit (a capital outflow) in the U.S. nonreserve financial account.**

7. An overseas subsidiary of a domestic firm remits $1 million in profits to its parent company by writing a check drawn on its account on a domestic bank

**The U.S. parent company has given up $ 1 million worth of capital services (a credit under net investment income) and acquired a claim on a foreign bank (a debit on nonreserve financial account).**

8. The domestic central bank acquires a deposit in a foreign commercial bank worth the equivalent of $10 million by paying for it with a check drawn on a domestic commercial bank.

**The domestic central bank acquires a claim on a foreign commercial bank (a debit), which must appear in ORS. The U.S. commercial bank gives up a claim on itself to a foreign commercial bank (a capital inflow), which appears as a credit in the nonreserve financial account.**

9. A U.S. resident imports $1 million of wine from the Republic of Georgia, paying with a check drawn on a U.S. bank. The Georgian exporter uses the funds to purchase Georgian currency from the Georgian central bank.

**The first transaction gives rise to a debit under U.S. goods imports and a credit in the US nonreserve financial account, since the US resident gives up something of value to a foreign commercial bank. In the second transaction, a US commercial bank acquires something of value (the deposit) from the Georgian exporter (a debit in the US nonreserve financial account) and gives up something of value (once again, the deposit) to the foreign central bank, a credit in the United States’ ORS.**

10. If only one sub-account of the balance of payments account could be published, which do you think it should be, and why?

**It should probably be the current account, because it determines the change in the country’s international investment position, which is a component of its national wealth.**

11. The United States maintains a floating exchange rate, but many countries peg their exchange rates against the US dollar. Assuming that the Fed never intervenes in the foreign exchange market, would you expect the official reserve settlements balance (ORS) of the U.S. balance of payments to always be zero? Explain why or why not.

Would your answer be different if the country in question were Uganda (which also maintains a floating exchange rate) rather than the United States? Why or why not?

**The official reserves settlements balance records changes in the domestic central bank’s financial claims on nonresidents as well as in foreign central banks’ claims on domestic residents. Even if the Fed never intervenes in the foreign exchange market, *ORS* for the United States need not be zero, because dollar assets are held as reserves by many foreign central banks, so changes in those holdings would affect *ORS* for the United States. In the case of Uganda, however, foreign central banks do not hold claims on residents of Uganda, so if the central bank of Uganda did not intervene in foreign exchange markets, *ORS* would tend to be zero for Uganda.**

12. As you will learn in Chapter 7, during the period when the Bretton Woods exchange rate regime was in place, loans made to countries by the International Monetary Fund were supposed to finance "temporary deficits" in the balance of payments without changing their exchange rates. Since the balance of payments accounts definitionally sum to zero, this must have referred to some sub-account of the balance of payments accounts. Which one did it refer to, and why was that particular sub-account, instead of some other, of concern to the IMF?

**It must have referred to the “overall” balance of payments, because this measures the changes in the central bank’s stock of foreign exchange reserves, and thus the bank’s ability to intervene in the foreign exchange market to buy its own currency and keep it from losing value. Since IMF members were not supposed to change their exchange rates, their central banks were obliged to intervene in the foreign exchange market to keep the exchange rate from appreciating or depreciating.**

13. The United States is currently (as of 2008) running a current account deficit of over 5 percent of GDP. Should this be a source of concern to American policymakers? Explain why they should or should not be worried about it. Whatever your answer to this question, can you conceive of real-world circumstances under which you would have given a different answer? What would those circumstances be, and why?

**The current account deficit represents an increase in U.S. indebtedness to the rest of the world, and thus a reduction in U.S. national wealth. It is not a source of concern under one of two conditions: if the money is invested in capital that yields a rate of return at least as large as the interest paid to foreigners or, if the funds are consumed, if the future consumption foregone when the debt is repaid is worth less to U.S. residents than the additional consumption today. It would be a source of concern if the funds are used for consumption that is worth less than the additional future consumption that will have to be given up to repay the debt.**

14. An important open-economy macroeconomic identity relates the current account surplus to the difference between domestic saving and investment. Some observers have interpreted this as implying that every $1 reduction in the fiscal deficit would reduce the current account deficit by $1. Based on what you've learned so far, would you agree or disagree? Explain.

**Disagree. The identity expresses the current account surplus as the sum of the excess of private saving over investment and the fiscal surplus. A $1 increase in the fiscal surplus would only increase the current account surplus by $1 if the excess of private saving over investment were to remain unchanged. One needs a model to know whether this will indeed happen. The identity would always hold, whether it happens or not.**

15. What does the “absorption approach” imply about the macroeconomic changes that would have to accompany a reduction in the current account deficit in the United States?

**It implies that if the U.S. is to achieve a reduction in its current account deficit it will either have to increase its GNP or reduce its absorption. Any macro policy intended to reduce the deficit must operate through one or both of these channels**.