

Answers to Questions from Chapter 12

(2) Equation 2 can be written as $CA = (S_p - I) + (T - G)$. Higher U.S. barriers to imports may have little or no impact upon private savings, investment, and the budget deficit. If there were no effect on these variables, then the current account would not improve with the imposition of tariffs or quotas. It is possible to tell stories in which the effect on the current account goes either way. For example, investment could rise in industries protected by the tariff, worsening the current account. (Indeed, tariffs are sometimes justified by the alleged need to give ailing industries a chance to modernize their plant and equipment.) On the other hand, investment might fall in industries that face a higher cost of imported intermediate goods as a result of the tariff. The point of the question is that a prediction of the manner in which policies affect the current account requires a general-equilibrium, macroeconomic analysis.

- (3) a. The purchase of the German stock is a debit in the U.S. financial account. There is a corresponding credit in the U.S. financial account when the American pays with a check on his Swiss bank account because his claims on Switzerland fall by the amount of the check. This is a case in which an American trades one foreign asset for another.
- b. Again, there is a U.S. financial account debit as a result of the purchase of a German stock by an American. The corresponding credit in this case occurs when the German seller deposits the U.S. check in its German bank and that bank lends the money to a German importer (in which case the credit will be in the U.S. current account) or to an individual or corporation that purchases a U.S. asset (in which case the credit will be in the U.S. financial account). Ultimately, there will be some action taken by the bank which results in a credit in the U.S. balance of payments.
- c. The foreign exchange intervention by the French government involves the sale of a U.S. asset, the dollars it holds in the United States, and thus represents a debit item in the U.S. financial account. The Korean citizens who buy the dollars may use them to buy American goods, which would be an American current account credit, or an American asset, which would be an American financial account credit.
- d. Suppose the company issuing the traveler's check uses a checking account in France to make payments. When this company pays the French restaurateur for the meal, its payment represents a debit in the U.S. current account. The company issuing the traveler's check must sell assets (depleting its checking account in France) to make this payment. This reduction in the French assets owned by that company represents a credit in the American financial account.
- e. There is no credit or debit in either the financial or the current account since there has been no market transaction.
- f. There is no recording in the U.S. Balance of Payments of this offshore transaction.

(6) A current account deficit or surplus is a situation which may be unsustainable in the long run. There are instances in which a deficit may be warranted, for example to borrow today to improve productive capacity in order to have a higher national income tomorrow. But for any period of current account deficit there must be a corresponding period in which spending falls short of income (i.e., a current account surplus) in order to pay the debts incurred to foreigners. In the absence of unusual investment opportunities, the best path for an economy may be one in which consumption, relative to income, is smoothed out over time.

The reserves of foreign currency held by a country's central bank change with nonzero values of its official settlements balance. Central banks use their foreign currency reserves to influence exchange rates. A depletion of foreign reserves may limit the central bank's ability to influence or peg the exchange rate. For some countries (particularly developing countries), central-bank reserves may be important as a way of allowing the economy to maintain consumption or investment when foreign borrowing is difficult. A high level of reserves may also perform a signaling role by convincing potential foreign lenders that the country is credit-worthy. The balance of payments of a reserve-currency center (such as the United States under the Bretton Woods system) raises special issues covered in Chapter 18.

(10) The U.S. receives a substantially higher rate of return on its assets held abroad than foreigners are earning on U.S. assets. One reason is that a substantial amount of foreign assets are in low interest rate treasury bills.