Explain why you agree, disagree, or partially agree with each of the following statements. The credit you earn will depend 100% on the EXPLANATION you provide. Each question is worth 12.5 points.

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1. STATEMENT: Suppose domestic saving equals 15 and domestic investment equals 10. Then, assuming the official settlements balance equals 0 and the statistical discrepancy also equals 0: (a) the current account balance equals 4; and (b) the capital account balance equals -3.

SOLUTION: DISAGREE. First, recall that:

Domestic Saving - Domestic Investment = Current Account Balance.

So, since domestic saving equals 15 and domestic investment equals 10, the current account balance is 5 (15 - 10 = 5). Next, recall that:


So, net capital flows, which equal the negative of the capital account balance, also equal 5, which implies that the capital account balance is -5. Another way to determine the capital account balance is to recall that, with the official settlements balance and statistical discrepancy both equalling 0, the sum of the current account balance plus the capital account balance is 0. So, since the current account balance is 5, the capital account balance must be -5.

2. STATEMENT: Consider the purchase of a $10,000 U.S. treasury bond by a Japanese citizen from a U.S. brokerage firm. This enters the U.S. balance of payments account as a negative entry in the ‘unilateral transfers’ category of the capital account.

SOLUTION: DISAGREE. First, the ‘unilateral transfers’ category is in the current account, not the capital account.

Second, both parts of the double-entry bookkeeping record of this transaction appear in the capital account. In particular: (a) the payment for the treasury bill is a credit, or a capital inflow, in the ‘foreign assets in the United States’ category, since the foreign resident now owns a U.S. financial asset; (b) the payment received by the brokerage firm is a debit, or capital inflow, in the ‘U.S. assets abroad category,’ because the brokerage firm acquires a foreign deposit.

3. STATEMENT: A current account deficit in the U.S. driven by a negative trade balance (i.e., the ‘balance on merchandise trade’ is negative) is necessarily bad, because it results in increased foreign ownership of previously U.S.-owned assets.

SOLUTION: DISAGREE. By definition, if the current account balance is negative, the level of domestic saving is less than domestic investment. So, a current account deficit simply indicates that some portion of domestic investment is financed by capital inflows from abroad. In the absence of additional information, there is no basis for concluding whether this is inherently bad. Much depends upon exactly what type of activities this capital inflow is financing.
4. STATEMENT: If a country experiences a current account deficit in a given year, it is necessarily a ‘debtor nation.’

SOLUTION: Disagree. The current account balance is a reflection of activity for one year, while a country’s net creditor/debtor status is a summary measure of activity for all past years up to the given year in question. In particular, the current account deficit shows the CHANGE, on net, to the stock of foreign assets held by domestic residents and the stock of domestic financial assets held by foreign residents in a particular year. A country’s status as either a ‘net creditor’ or ‘net debtor’ is a reflects its total claims on foreigners and the total claims of foreigners on the nation as a result of all past activity up to the given year in question.

5. STATEMENT: Suppose that over some period of time, the U.S. dollar exchange rate relative to the British pound goes from 1.40 $/£ to 1.26 $/£. Then, over this time period the dollar depreciates by 12%.

SOLUTION: DISAGREE. In this scenario the dollar actually appreciates, since a British pound ends up buying fewer dollars ($1.40 down to $1.26). The rate of depreciation of the British pound against the dollar is \((1.40 - 1.26)/1.40 \times 100 = 10\)%, i.e., 10%, so the dollar appreciates relative to the British pound by 10%.

6. STATEMENT: Suppose the U.S.-dollar-per-currency rate for the British pound is 1.65 $/£ and the U.S.-dollar-per-currency rate for the Japanese yen is 0.008 $/¥. Then, the yen-pound cross rate is 200 ¥/£.

SOLUTION: DISAGREE. The yen-pound cross rate is computed by dividing the dollar-pound rate by the dollar-yen rate, i.e., \(1.65/0.008 = 206.25\) ¥/£.

7. STATEMENT: Suppose that between 2001 and 2002, the U.S. dollar appreciates relative to the euro by 10.3%. Further, assume that over this time period the inflation rate in the U.S. is 3.3% and the inflation rate in the euro-using countries is 4.1%. Then, the real exchange rate of the dollar relative to the euro increases more than the nominal exchange rate.

SOLUTION: DISAGREE. The appreciation of the real exchange rate of the dollar relative to the euro will be less than 10.3%, since the positive differential between the inflation rate in the euro-using countries and the U.S. offsets some of the nominal appreciation.

8. STATEMENT: Suppose the Danish krone-per-U.S.-dollar rate in New York in 8.050 Dkr/$, the British pound-per-U.S.-dollar rate in New York is 0.65 £/$, and the Danish krone-per-pound rate in London is 12.10 Dkr/£. Then, if:

(a) $1 million worth of Danish krone are bought in New York;
(b) the Danish krones bought in New York are used to purchase British pounds in London; and
(c) then the British pounds bought in London are used to buy U.S. dollars in New York;

the profit earned by this triangular arbitrage opportunity equals $5,324.

SOLUTION: DISAGREE. In step (a), Dkr8,050,000 are bought in New York. In step (b), the Dkr8,050,000 are used to buy £665,289 in London (divide 8,050,000 by the Danish krone-per-pound rate in London of 12.10). In step (c), the £665,289 are used to buy $1,023,522 in New York (divide 665,289 by the British pound-per-U.S.-dollar rate in New York of 0.65). So, this triangular arbitrage opportunity yields a profit of $23,522.