

Topic 2: Balance of Payments

(Reading: Eun and Resnick Chs. 2 & 3)

THINGS TO NOTE:

1. I have set **more** questions than can be covered in a 2-hour session. The questions to be covered in the tutorial are indicated by an asterisk (*) in the file that **only** contains questions.

The rest should be viewed as **extra** practice problems – we get requests for extra problems, and these are in response to those requests.

2. Tutorial Solutions will be posted at the end of the week.
 3. I have also included exam questions from previous years that I have written. These are clearly marked as such in the “questions” file. These should give you an indication how I tend to write questions.
 4. Questions 13 and 14 are non-typical of this topic and is included to show how material covered in this topic is relevant. These issues should be familiar to Economics majors.
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1. Define the balance of payments (BOP).
2. The US has experienced continuous Current Account (CA) deficits since the early 1980s. What do you think are the main causes of the deficit? What would be the consequences of continuous US CA deficits?
3. In contrast to the US, Japan has realised continuous CA surpluses. What could be the main causes for these surpluses? Is it desirable to have continuous CA surpluses? (*)
4. Explain how a country can run an overall BOP deficit or surplus. (*)
5. If you add up all the current accounts of the countries of the world, the sum should be zero. Yet it is not so. Why do you think this is the case? (*)
6. Explain official reserve assets and its major components.

7. Explain how each pair of transactions will be classified and recorded in the debit and credit of the Australian BOP (*)

Remember that each transaction is recorded twice, once as an *inflow* and the other as an *outflow*.

	Credit	Debit
Japanese purchase of Australian T-bonds		
Japanese payment using a Sydney bank account		
Australian citizens having a meal at Arpège, a three Michelin star restaurant in Paris		
Paying for the meal with American Express		
Gift to extended family in Buenos Aires		
Sale of your Petrobras shares		
Export of software by Atlassian		
Being paid for the service by the firm's Australian bank a/c		

8. Suppose Lufthansa buys \$400 million worth of Boeing jets in 1996 and is financed by the US Exim bank (Export-Import bank) with a five-year loan that has no principal or interest payments due until 1997. What is the net impact of this sale on the US current account, capital account and overall balance of payments for 1996? (*)
9. How does the trade deficit affect the current account balance? (*)
10. Suppose Brazil starts welcoming foreign investment with open arms. How is this policy likely to affect the value of the *real*? The Brazilian current account balance? (*)
11. What will strong economic growth do for the Australian balance on current account? What will a recession do? (*)
12. The devastating earthquake that hit Kobe, Japan on 17th January 1995 was estimated to cause about \$100 billion in damage to the Japanese economy. What is the likely effect of this earthquake on Japan's 1995 current account? On its capital account? Explain. (*)
13. Explain how the balance of trade (BOT) approach to exchange rate determination works? What are the disadvantages of this approach?

14. Explain how capital flows can be incorporated into the balance of trade approach to exchange rate determination?
15. The Balance of Payments of Bamako showed the following entry for 1998: a capital account surplus of 50, a deficit in the services account of 15 and a trade deficit of 45. The change in the official reserves was zero. What was the balance of the unilateral transfers of Bamako? (*) **[Past exam question]**
16. Suppose Australia imposes import restrictions on Chinese made washing machines. What is likely to happen to the Australian current account deficit? (*)
17. What are the five basic mechanisms for establishing exchange rates and how does each work?