Macroeconomics A; EI060

Quiz

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1 Components of the current account

Question: What are the various ways in which a country can earn money from the world?

Answer: These ways are the components of the current account.

The first way to earn money is to sell goods and services to foreigners. These are exports that enter the trade balance.

The second way is to have assets already invested abroad, and earn dividend or interest on them. This earnings enter the primary income on investment balance.

The third way is to live in a country and work abroad, earning a salary. This enters the primary income on labor balance.

The fourth way is to have a relative living and working abroad sending us money (remittances). This enters the secondary income balance.

The secondary income also includes other channels. For instance, a person who worked abroad and then moved to our country for retirement, and earns a pension, effectively is a resident earning a transfer income from abroad, which enters the secondary income balance.

2 Transactions in the financial account

Question: Consider two transactions and explain how they enter the current account and the financial account.

1. A Swiss firm sells goods for a value of 100 to an American customer, who has an account in a Swiss bank. He pays by wiring from that account to the Swiss account of the Swiss firm.

2. A German investors sells a Swiss government bond for a value of 50 to a Swiss investor. The Swiss investor has a German bank account. The Swiss investors pays for the bond using a bank transfer to the German account of the German investor.

Answer: The impact are as follows.

1. As a good is sold to a foreigner, we have an export of 100 in the current account (trade balance). As the American customer has an account in a Swiss bank, he holds a claim on a Swiss resident. This claim is reduced by the payment. It is a negative value in "liabilities to non-residents", i.e. a negative gross inflows. We thus have -100 in gross banking inflows, which is +100 in net banking outflows (gross outflows - net inflows).

2. This activity does not lead to any earning of spending of money abroad, so the current account is not affected at all. We initially had a German claim on a Swiss bank, and a Swiss claim on a German bank. The sale of the bond moves its ownership from a non-resident to a resident. It is therefore a negative value in "liabilities to non-residents", that is -50 in gross portfolio investment inflows, i.e. +50 in net portfolio investment outflows. At the same time, the Swiss claim on the German bank is gone, so we have a -50 gross banking outflows, i.e. -50 net banking outflows. So all in all, the financial account shows +50 in net portfolio investment outflows and -50 net banking outflows, which cancel out in total.

3 Valuation effects

Question: Explain what valuation effects are. Do they enter the current account or the financial account, and why?

Answer: The valuation effects are gains or losses on existing financial investment due to movement in asset prices, or the exchange rate (which affects the Swiss franc value of a given amount in foreign currency).

These effects do not enter the current account or the financial account. The reason is that they entail no transaction: nothing is sold or bought.

The parallel with a person's investment account in stocks is as follows: the monthly statement shows how much money has been added to (or taken from) the account, which is the equivalent of the financial account, and how much was gained or lost on the investment because of market movements, which is a capital gain or loss. The end of period balance corresponds to the investment position.

4 Pattern of capital flows

Question: Explains the main patterns of international capital flows since the early 2000's

Answer: We have several phases.

Until 2007, capital flows were large and growing. This was driven by growing banking flows, mostly between advanced economies (not so much between advanced and emerging economics). Europe played a large role, as banks there grew their operations in other European countries.

In 2007-8, flows stops. In fact, ban king flows went in reverse turning from positive to negative. This turnaround was again mostly within advanced countries.

Since then, flows have remained broadly steady, at level well below the ones before 2007.

While flows have become smaller, the stocks (investment positions) have kept growing, albeit less rapidly than before. This growth also reflect the rising values of financial assets, generating capital gains.

5 Global imbalances

Question: What are global imbalances? How have they evolved?

Answer: Imbalances reflect the fact that countries which have a current account surplus tend to always do so, and similarly with countries having a deficit. The world is thus not a pattern where countries sometimes save and sometime borrow.

Before 2007, the dispersion of current account balances across countries increases, as both deficit and surpluses grew (deficit mostly in the US). This pattern became small after the crisis, with surpluses and deficit remaining at lower values, even though the persistence (countries with deficit tend to have them always) remained.

While the dispersion of current account balances narrowed, that of net international investment positions remained sizable.