# EC 380: Lecture 14

## Global Finance: Balance of Payments

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# Prologue

# Recap

## Previously

- Contents of Balance of Payments
- Financial Account features

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- Financial Account features

## Today

- International Debt
- Investment Position
- Introducing exchange rates

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- Countries risk becoming reliant on external sources of liquidity
- A quick change in the business cycle could result in a large-scale exodus of liquidity
- Asset prices drop, indebtedness intensifies

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Supposing **balanced government budget**, savings are equal to total investment in the country plus current account net flows

# National Savings

Nation's savings (private plus public) is divided into **two uses**.

- Source of funds for **domestic investment** (I).
- If government budgets are in deficit, overall LHS down, and all else being equal, investment falls.
- Govt budget surplus increase the funds available for investment.
- Source of funds for **foreign investment**.
- If CA surplus, national savings finances purchase of domestic goods by foreign users of those goods. In return, domestic economy acquires foreign financial assets.

# National Savings

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If $\mathbf{CA} < \mathbf{0}$, financial account features net borrowing greater than net acquisition of financial assets (lending, or financial outflows).

- Negative current account $\implies$ net borrowing in the financial account, inflow of financial capital.
- Surplus countries provide savings to rest of world, enabling sale of more goods abroad than they buy.
- Financial capital outflow is investment because involves acquisition of assets that are expected to pay a future return.

# National Savings

Hence, another name for the current account balance is **net foreign investment**.

Negative balance implies that foreigners accumulate more home country assets than the home country accumulates abroad.

US has had a **CA deficit** every year since 1981. Financial crisis of 2007–2009 had a dramatic effect on savings, investment, and government budgets.

Savings rose, investment fell. Federal budgets fell into large deficits. Improvement in **CA balance** as falling due to less imports.

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We cannot say CA in deficit because **saving is too low** any more than we can say it is because **investment is too high**.

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Capital inflows associated with current account deficits are **implicit vote of confidence by foreigners**.

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**CA deficit enabled more investment than was possible otherwise**.

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In **worst-case scenario**, capital flight is followed by a depletion of international reserves and a financial crisis.

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> When Mexico slipped into **peso crisis** in late 1994 and early 1995, economists began to write about "Tequila effect" on Latin America. When Thailand's currency lost a large share of its value in 1997, media reported crisis spreading across East Asia. In both cases, the size of a CA balances was not good predictor of whether it was drawn into the crisis.

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**External debt is defined as a debt that must be paid in a foreign currency.**

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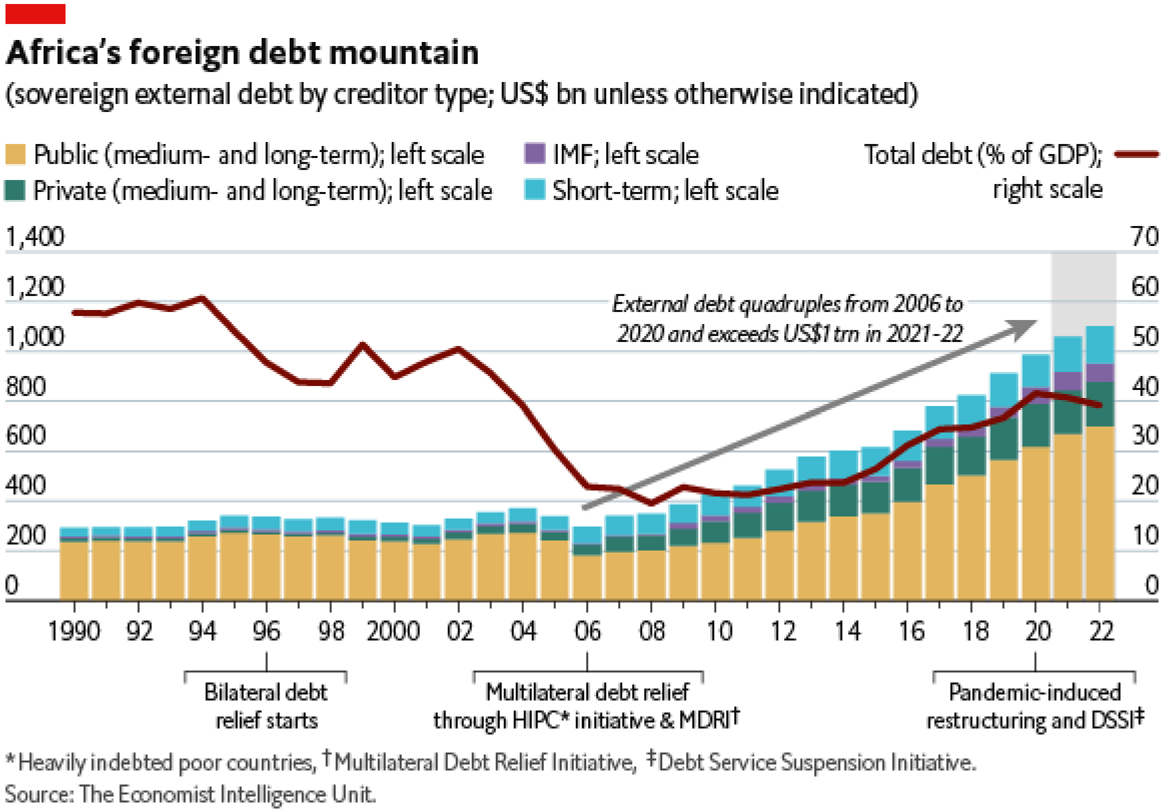

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**Low- and middle-income countries** are another matter.

Size of the external debt burden is unsustainable, given the economy's ability to make interest payments and to repay the principal.

# International Debt

Unsustainable debt occurs for many reasons.

- Sometimes, countries are **dependent on exports** of one or two basic commodities such as copper or coffee.
- Shock of a sudden drop in world commodity prices reduces value of exports and generates unexpectedly large current account deficits.
- In other cases, countries experience **natural disasters**, such as hurricanes and earthquake
- **Corruption**, too, can play a role, as autocrates empty national coffers.
- Even electoral politics may be a factor, as when officials try to gain support through **unsustainable expenditures** targeted at important constituents.

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Provide debt forgiveness for select countries that must qualify based on **high levels of poverty and debt** and a **track record of economic reform**.

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Each year a country experiences a **CA deficit**, foreigners acquire more assets locally than its residents acquire abroad.

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Quick recap:

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- In 2016, the UK voted to leave the European Union and strike up their on trade relationships
- Wanted continued access to **free trade with EU** while deviating from common tariff schedule/regulatory standards and blocking free movement of labor.
- Negotiations were largely a source of embarrassment for the UK - quickly clear they did not have sufficient **bargaining power** to achieve ideal deal.

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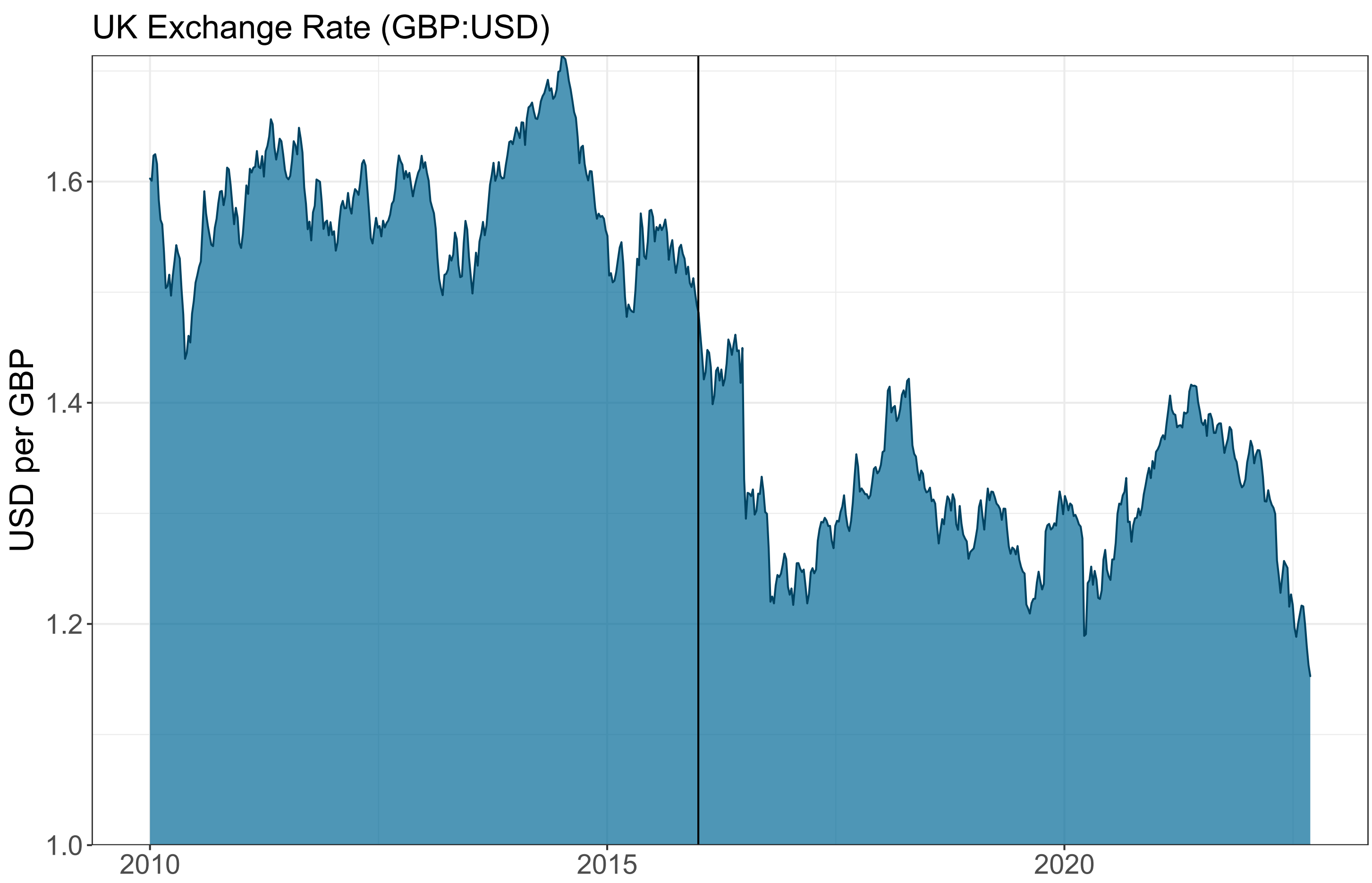

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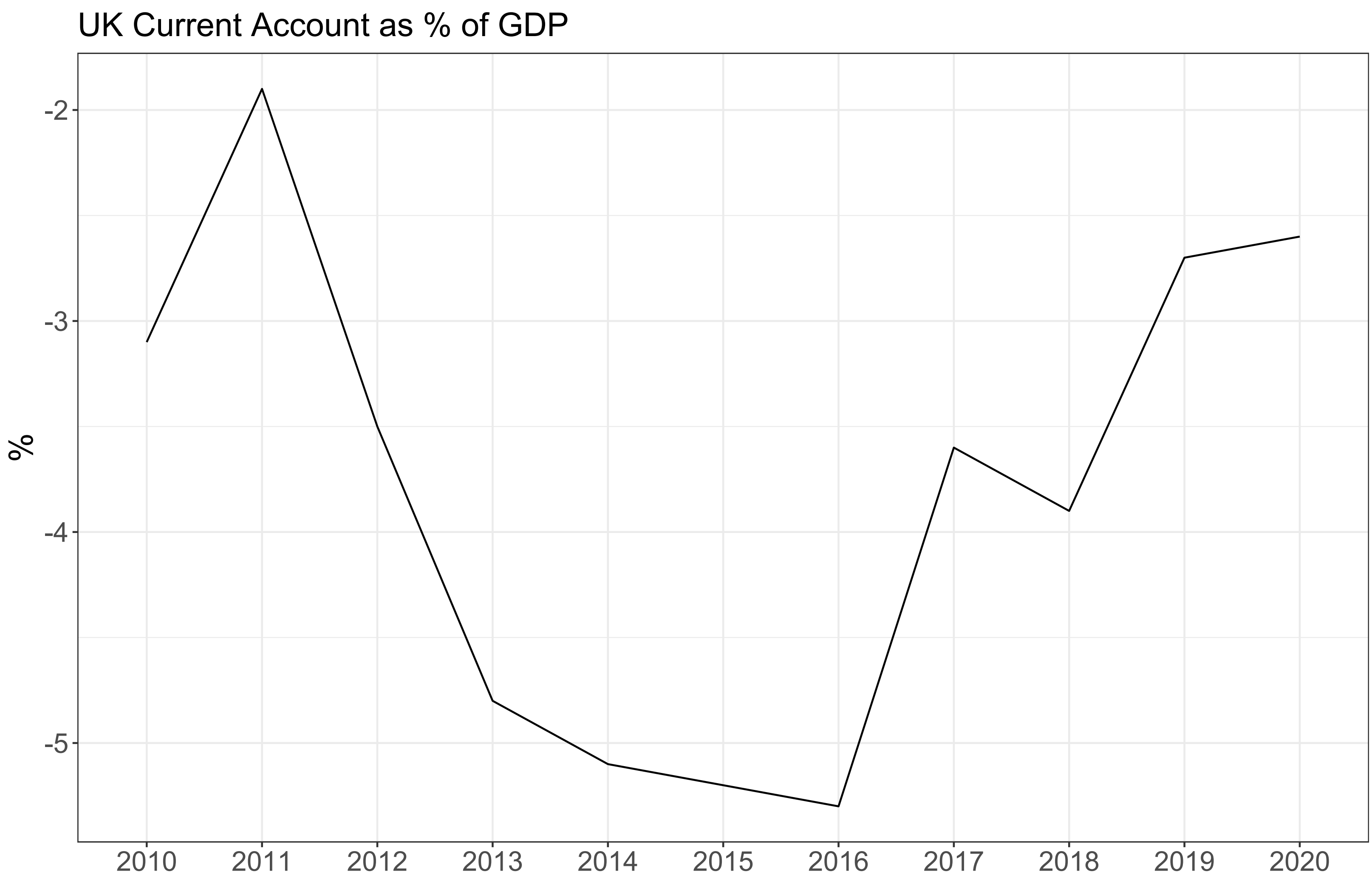

# Summary

## Recapping

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- Deficit is not a sign of economic/geopolitical weakness
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## Next time

- Exchange Rate Adjustments (SR + LR)