EC 380: Lecture 15

Global Finance: Balance of Payments

Philip Economides
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Prologue

Recap

Previously

- Contents of Balance of Payments
- Financial Account features

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Today

- International Debt
- Investment Position

Limits on Financial Flows

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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. Falling import levels represented improvement in **CA balance**.

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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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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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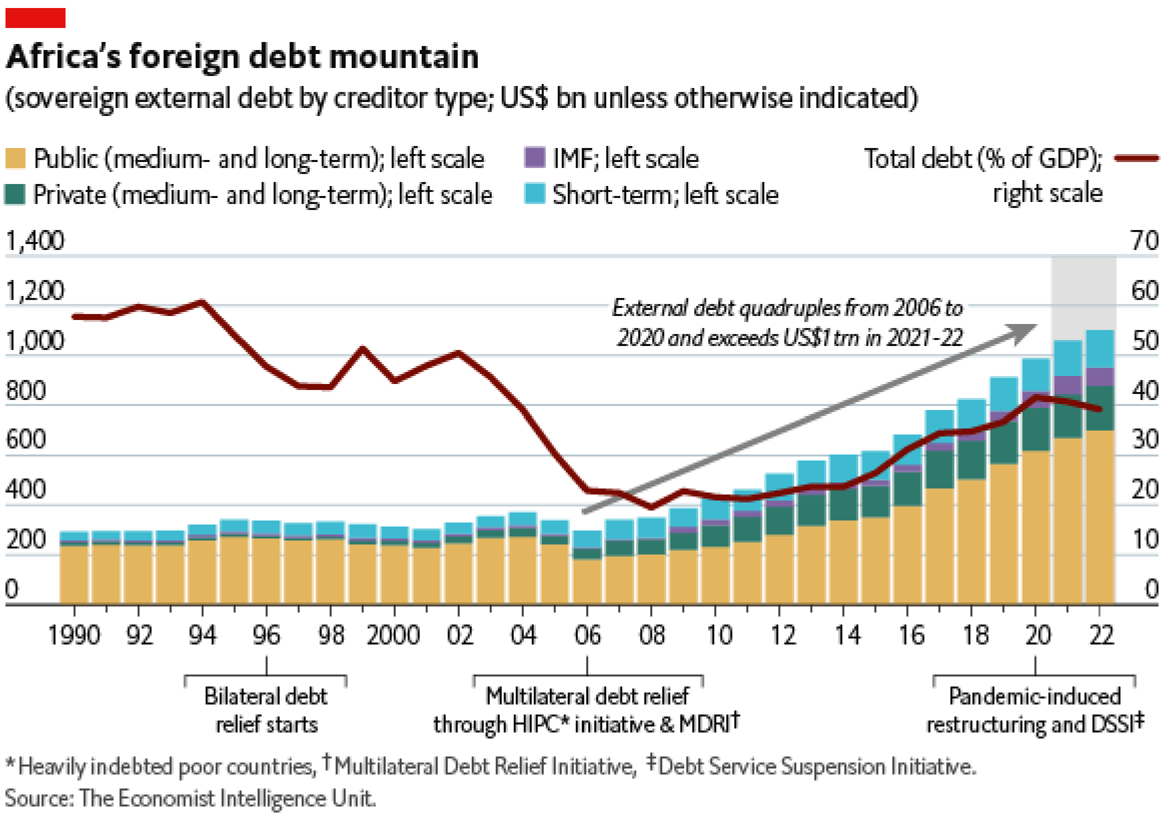

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Low- and middle-income countries are another matter.

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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Drawbacks

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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.

Brexit Investment Position

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Quick recap:

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- 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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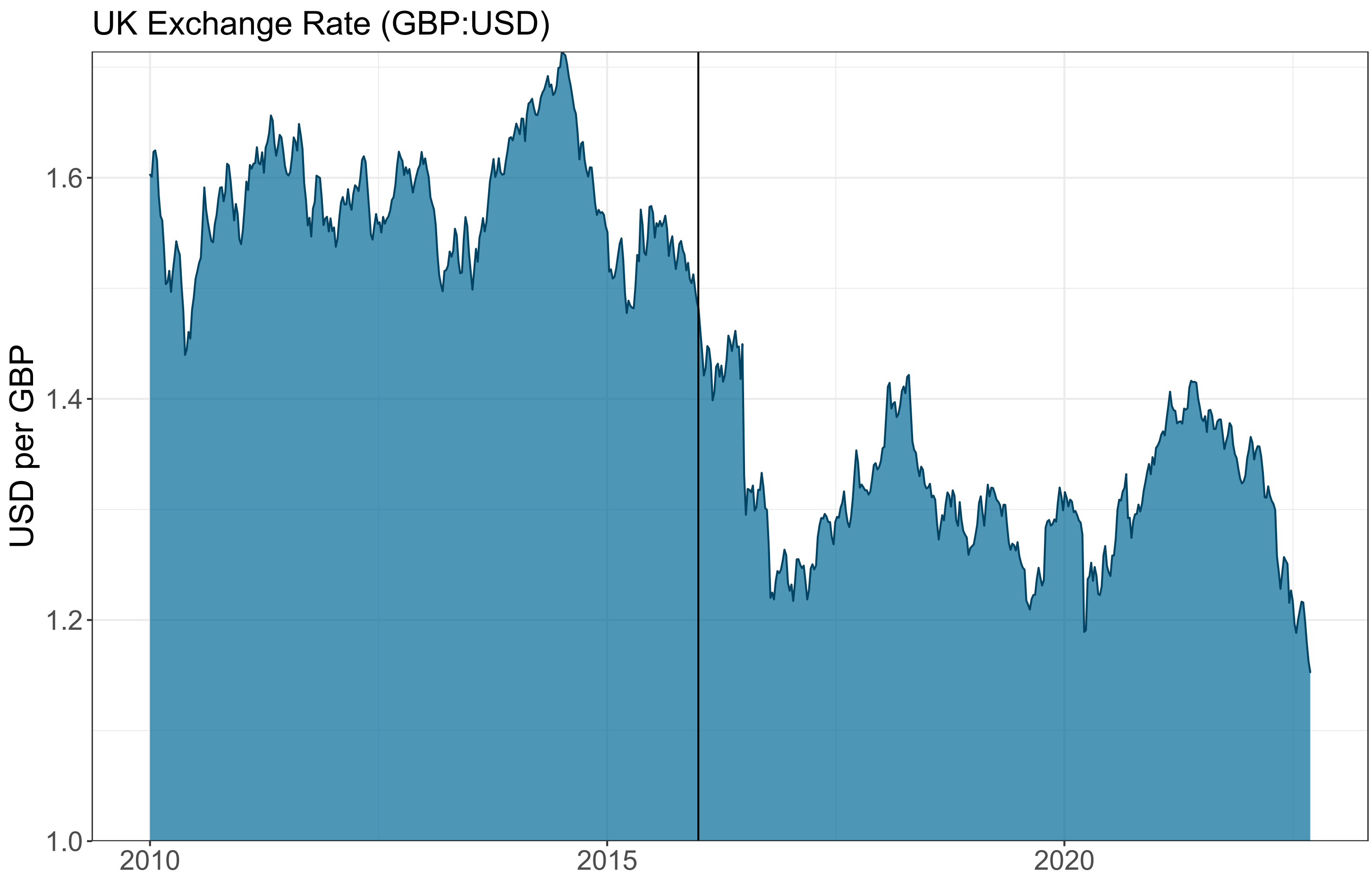
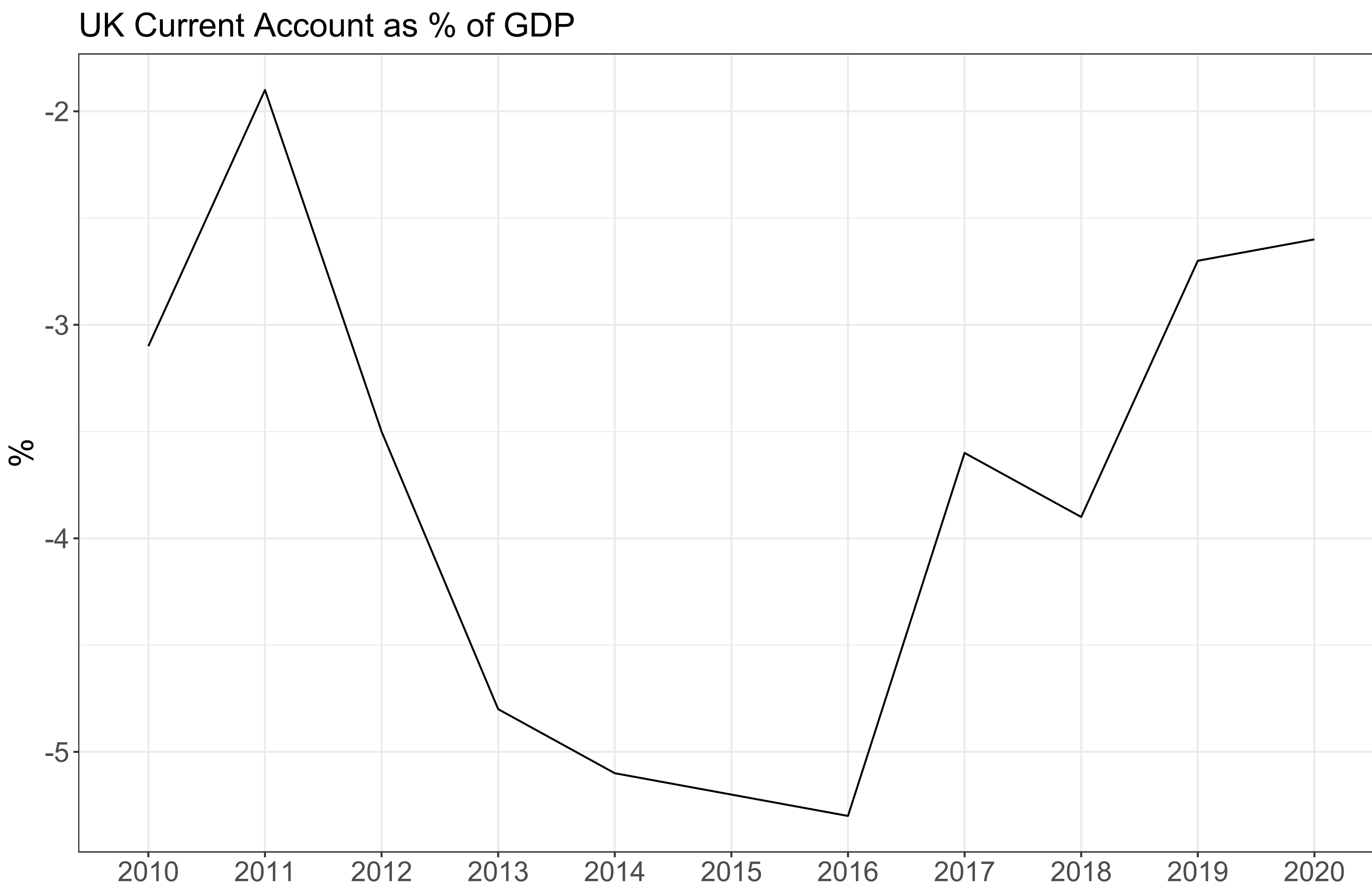


Current Account



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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)