

PART I: Replies to memo questions, 09/16/03

Dear Students,

The answer to my question, what is balance of trade & why is it so widely reported in the financial press is: balance of trade is the export & import of merchandise (goods) only. It is so important and receives such media coverage because it represents the main component of the current account.

Following are the answers to your questions.

Given the US balance of payments deficit, why is the US dollar still so strong? Would the dollar still have declined if the administration didn't give tax cuts that augmented the budget deficit?

Great question. The deficit of the BOP would predict that the US \$ will experience depreciation, as we have seen recently. How did the budget deficit reflect on the dollar? In general, deficit on the government budget will contribute to increase in the government debt. That usually increases the risk of government default, as we have seen in the cases of Argentina, Russia, & Turkey. The case of US however is different from the cases of these countries. The reason is, unlike most other countries, the US government can simply print more money, or offer more T-bills at higher interest rates, and thus stimulate investors to buy US \$ - denominated financial assets. Thus, unlike other countries, the US can afford to finance its government spending directly from foreign investors.

In a nutshell, the US is unlikely to default because of the increased government debt. But, the expectations of higher interest rates to finance government budget deficits, will make investors expect that the US \$ will depreciate. This prediction is based on the assumption that the international Fisher effect (we will explore it in next class) works. In essence, the international Fisher effect states that the spot exchange rate will change in equal amount but opposite direction to the difference in interest rates b/n two countries, in order to compensate investors for investing in low-interest currency. So, if the US interest rates are to increase, it must be the case that the US\$ has to depreciate to currencies w/ lower interest rates.

Wouldn't the home country object the fact that foreign companies invest in US and leave profits/ proceeds for further investments in the US? The home country is bleeding money to the US & its foreign resources are shrinking.

Yes, they will, so they will try to attract investment (or beef up the return on investment opportunities in their country). There is a worldwide competition for long-term capitals ☺. The channel through which this happens is the capital budgeting of multinational companies. Why should Duracell invest in Belgium versus investing in US? If the expected rate of return in US is higher, clearly the investment will go there.

Now, on average, the US has over-performed in terms of economic growth any other country in the past century. No wonder many foreign companies reinvested in the US.

Has foreign exchange declined in importance since the advent of the Euro? Has the foreign exchange industry consolidated?

The forex exchange industry in Europe seems to have consolidated after the Euro launch in 1999. The advent of the Euro though did not make the forex trading less important, from international investor's perspective. However, it definitely lowered the risk premium & volatility in the forex market within Europe.

Why do countries restrict foreign ownership? Is it the fear of capital flight?

Yes, usually fear of financial crises, & political instability motivate governments to impose restrictions on ownership (e.g restrictions on ownership of domestic banks, as in Latin American countries, like Mexico). Furthermore, oftentimes governments impose restrictions beyond any reasonable cost-benefit analysis due to personal goals (usually in less democratic regimes): the government officials & red tape can benefit privately from the right to allow/ disallow foreign investment. How can that happen? Usually through the channel of increased corruption. However, it has been an empirical phenomenon, that when a country opens up its equity markets for foreign investment, it actually lowers the volatility of its growth (in other words, it reduces the possibility of bad recessions).

How are the unregulated capital flows beneficial to companies? (transfer by bearer, laundering, etc)

They aren't beneficial. In fact, they harm company (shareholder) value especially if the company is a publicly traded one. These types of transfers are looked unfavorably in the Anglo-American model of corporate governance, where dispersed ownership is prevalent.

However, using tax heavens as ways to shelter investment from tax claims, could add value to corporate wealth enough to offset the cost of lowered transparency (due to high complexity of the transaction), especially for companies w/ concentrated ownership (i.e. one major stockholder).

I'm still not clear on the reasons why there's an increasingly large deficit on US goods.

You see, there is an increasing tendency for the US to import cheap goods & services, while exporting high value added products, such as software (Windows, Oracle database software), jets (Boeing, Lockheed Martin aeronautical componets), education (US universities' diplomas, cutting edge expertise in sciences) & good will (good corporate governance practices) abroad. Clearly this is an arbitrage opportunity on a grand scale.

What is the point of producing low-value-added products that could be obtained from Asian, Latin American, or European producers at a low cost? That's why we see growing deficits on the US current account.

Why is it that when BOP has surplus, the demand for the currency is higher than the supply? Why when there is deficit in BOP, the supply of the currency is above its demand? How does BOP affect exchange rates – why do current account deficit leads to depreciation?

When BOP has surplus that implies that the demand for that country's exports is higher than the demand for its imports. To pay exporters you need local currency (usually). Thus this will raise the demand for local currency.

The opposite happens when the BOP has a deficit. Try constructing the argument yourself! ☺

Which cases are we supposed to study for the group projects?

You have to make your own choice. There are two options. You can pick a case study from the textbook. In that case, you have to develop it further, & send me your presentation before the class you will make it. You can also choose a topic, e.g. from a reputable business journal or newspaper, such as the Wall Street Journal, The Financial Times, The Economist, and Business Week. In this case the rules are as for the textbook case study, but you need to ascertain that the topic is related to the course contents.

Would an American working as a manager in an American company but based in Russia (resident of Russia) have his income counted as a net transfer in the US BOP too? What about US\$ that she brings w/ her but does not spend (e.g. puts in a Russian savings account)?

The income paid from a US source to the American manager who resides in Russia as a salary (managerial compensation) would be counted as a current income and will be noted as a debit to the income sub-account of the current account of the US BOP. Vice versa, it will be represented as a credit to the income sub-account of the current account of the Russian BOP.

The savings she bring w/ her from US to Russia represent an example of "other investment assets" and will be noted as a debit to the "other investment assets" sub-account in the financial account of the US BOP. Vice versa, the transaction will be represented as a credit to the "other investment assets" sub-account in the financial account of the Russian BOP.

What is debt overhang in terms of BOP? Why hasn't the US dollar depreciated even though it has been carrying a BOP current account deficit for many years?

I used “debt overhang” as to refer to the piling up of BOP deficits, which eventually will transfer into “debt” to foreign nations. As for the second question, the US\$ has been fluctuating throughout the years, to accommodate the BOP changes. However, in the past years substantial amount of investment has been vested in US interests. This, of course, shows as deficits on the BOP accounts.

Is there a commonly accepted convention on which stock exchange using which currency?

No. Integration of financial markets worldwide necessitates that Frankfurt, Tokyo, & New York Stock Exchanges all operate in multiple currencies.

Why are current & financial accounts mirror images?

Because usually, over longer periods of time, the balance of payments has to clear (balance out) any deficits or surpluses. Thus, on average there shall be no deficit and no surplus (well, oversimplification, true for averages over a very long period of time, but bear with me). Thus, if the sum of financial account and current account has to be approximately zero, they are like twin (in terms of their size) accounts, that have, however, opposite signs.

I don't understand why PPP holds better for countries w/ high inflation & underdeveloped capital markets. Does PPP hold better in underdeveloped markets because people who live there are less affluent and therefore unable to afford most goods and thus unable to change demand?

The PPP holds better for countries w/ underdeveloped capital markets because they rely more on trading goods & services (as compared to financial instruments) with other countries and thus their exchange rates would be more likely set by/ reflect the price differentials with their trading partner countries, as the absolute purchasing power parity theory predicts.

For countries w/ high inflation, or hyperinflation, the PPP will also hold relatively better. Why? If prices change a lot, as is the case in hyperinflationary economies (think about inflation of 70 % per year, for example), then importers & exporters will watch more closely the price differentials and try to arbitrage them away more often. Why? Because the profit could be higher (as compared w/ countries w/ price differentials of, say 3 %).

You mentioned asset-pricing bubbles in China due to the nation's high amount of forex reserves. Could you explain what you mean and how the two are related?

In order to take all the forex (usually US \$) proceeds from exporters & individuals in China, the government has to offer them Chinese yuan (at the fixed rate of 8.28 Yuan per 1 US\$). More forex revenues thus imply that the government has to dish out more yuans to domestic investors & businesses. What to do with this money? You can not spend yuans in India, or in US. So you spend them on stuff in China. For example, you can buy

Chinese stocks. When this liquidity gets very high, the effect is that the prices of assets, like real estate, stocks, etc, become very (unreasonably) high. Cases like that we call asset-pricing bubbles.

Why is it that the PPP is not an accurate predictor?

Because of the presence of transaction costs. For example, the presence of transportation costs make the parity of purchasing power weaken. Why? It is difficult to arbitrage away any price differentials, if you have to pay freight cost. Also, some goods can not be transported easily – e.g. beauty saloon services (well, you can transport the hairdresser but again, that is very costly). Finally, the goods are not viewed same across borders – for example a car ownership is very highly valued in China, where it is considered a sign of prosperity. Much less so in the US, where it is a daily necessity. Can you then compare these prices and use them in determining exchange rates?

Can we do more exercises on BOP?

Sure, we will have four exercises in class on Tuesday, 9/16.

The growth of a country is usually supported by its government. However, this brings about deficits on the budget. Why budget deficit is not a priority goal as compared to the growth of the economy, in the US?

Because, if you have growth, you would be able to tax it. The higher the growth, the higher the tax base, and thus the higher the revenue. So, it is better to use these funds to stimulate growth in the first place, so that at the end you can harvest (from government's point of view) higher tax revenue to offset the increased government purchases.

Is there a force to counteract the running trend of exporting services abroad? Example – customer service representatives in Bangalor for US companies.

Yes, if all companies start doing so, they will bid up the prices of the customer service representatives abroad. That will put a hurdle on that trend.

Is it beneficial to have a low deficit on the balance of payments? Is it possible to have large deficit on the BOP?

Low deficit is always better than too low or too high deficit. Why? Because it implies lower risk of default on government obligations. Sure it is possible to have large BOP deficits/ surpluses. For example, the US is a net importer (large BOP deficits), while many East Asian countries are net exporters (large BOP surpluses).

What is a liquidity trap?

This is a term used by central bankers, to tell others that their monetary policy actions are “trapped” in the following sense. When you lower interest rates up to 0% (as in Japan),

you cannot use monetary policy as a policy tool anymore. Why? Because, you cannot make people invest/ borrow more anymore (in general lowering the interest rate has the effect of stimulating investment & consumption borrowing). However, once you reach the level of 0% interest you can not go any further down. Besides, people will not hold any more money in the bank (why would they, it earns nothing). So, even though you make them keep more cash (liquidity), you cannot achieve the goal of inducing people to spend/ borrow more.