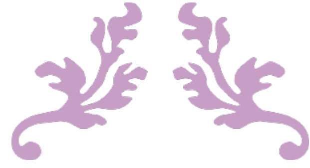
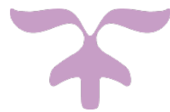


BFC 3240

International Finance



2015 SEMESTER 1

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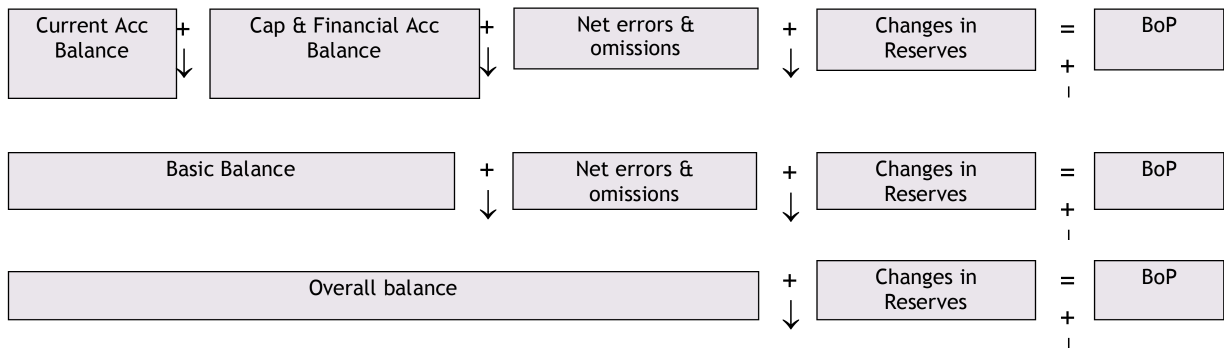
Week 3

Lecture Notes

Balance of Payments

A record of all transactions between the residents of a country and the rest of the world during a given period (AU: monthly)

Components



1. **Current Account / Exchange of Real Assets**
   1) Net export of goods: Export – Import
   2) Net export of services
   3) Net transfers: Gifts, superannuation, pension
   4) Net income: Gov rev- gov spending

   AU have trade deficit as it imports more than it exports

2. **Capital & Financial Account / Exchange of Financial Assets**
   1) Net direct investment: Purchases of real assets *(tangible assets house, property)* abroad – overseas buying assets in AU (FDI)
   2) Net portfolio investment: Purchases of assets *(bond, shares, hedge funds)* abroad – overseas buying assets in AU (FPI)

   Threshold for an investment to be considered as an FDI is ownership more than 10%. If less than 10%, it is then considered as a portfolio investment rather than FDI/NDI.

3. **Net errors and omissions** Data are compiled by ABS. Trading for illegal items (drugs) would not be counted officially.
4. **Change in reserves** In general, in a floating exchange rate system, CB doesn't hold much foreign currency reserves. In hard peg system, they hold a lot to buy/sell their currency.

Effects of Economy Activities on Current Account

Import→ Buy U$, sell A$, A$↓ → C.A. Deficit
Export→ A$↑→ C.A. Surplus

Import > Export You pay your supplier with their currency →Demand for foreign currency↑ →Supply of home currency↑→Excess supply of home currency↑→Downward pressure on home currency↓

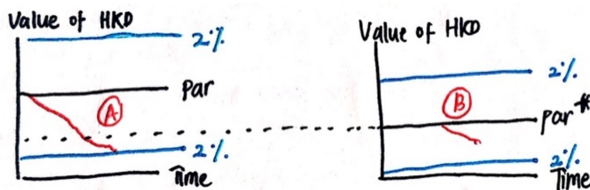
Capital outflows → Invest in U$, buy U$, sell A$, A$↓ → C.A. Deficit
Capital inflows A$↑→C.A. Surplus

Responding Current Account Deficit and Its Impact

This occurs when FA is not sufficient to cover negative CA deficit. A CA deficit might be caused by Inflation in Country A is higher than Country B, creating their P of goods higher than those of country B. Exports↓.

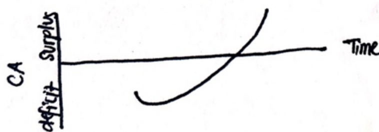
1. **Hard peg**
- Adjustment is borne by the real economy
- As import> export, currency ↓
- What they can do is ↓ import
- They can sell foreign reserves to buy their own currency
- ↑ Tax

2. **Soft peg**
- Adjustment is borne by the real economy
- Currency ↓, so CB need to ↑ the demand of their currency by selling foreign currency/depleting foreign reserves.
- What they can do is ↓ import (contractionary policies to restore equilibrium)
- They can also slow the economy down
- Fiscal policy: ↑ tax
- There's an option to devalue

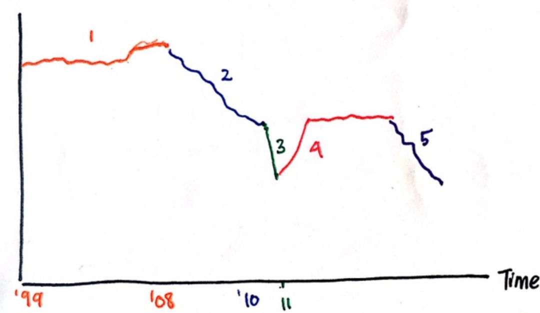


Graph A: Value of HKD has reached its minimum band value, they can devalue their currency, thus decreasing the par, along with its 2% band.
Graph B: After devaluation, the current currency is no longer as close as it was before to the band

3. **Floating**
- Self-correcting/ medium to LT Equilibrating Mechanism "J-curve" effect
- Currency ↓ P of goods ↓ Export ↑ Import↓
- Current account ↑ Back to equilibrium "Goods market arbitrage"



Example of Financial+ Cap Acc Surplus: Switzerland



1. Stable
2. Franc started to appreciate
3. Franc greatly appreciate 25% against Euro from Oct 2010 to Aug 2010. Why? Because of EZ crisis. People would want to collect their money out from Euro. Switzerland is considered as safe haven. People invest in Switzerland. There is huge capital coming from EZ. Is it necessarily good? No. Switzerland's Franc is↑ while the country relied heavily on its exports. A lot of companies went bankrupt as exports become uncompetitive.
4. Franc starts to depreciates. Cap it at 1.20 (peg to Euro). How? Print money, Money supply↑ (selling Franc), buy Euro using that printed Franc.

Tutorial

The Rules of the game: Under the gold standard, all national governments promised to follow the "rules of game". What did this mean?

CB obliged to convert currency to gold as reserve asset.
"Price specie flow mechanism"
Import> Export
Gold outflow↑ Gold reserves↓
Deflation (value↑ Price↓)→ Gov should↑ interest rate

How does the European Central Bank operate and what is its relationship with the central banks of the various jurisdictions of the Eurozone?

ECB is represented by each "region" CB.

Why do you think Saudi Arabia, Qatar, Venezuela peg to the dollar?

- Oil prices can't be controlled but exchange rate volatility can be eliminated by doing this.
- Exchange rate volatility is affected by: prices & forex rate.
- If they don't peg, they lose the forecasting ability of future revenue.
- Moreover, US is one of their biggest trading partner

Which countries use other countries' currencies (dollarization) and what currency do they use? Why do you think these countries have dollarized?

- Zimbabwe: IT can't print the USD, so the inflation is controlled. They were suffering from hyperinflation
- Montenegro: They have intentions to join the Euro. They're small and not able to enforce the monetary policy because of insufficient resources.
- Panama: small country doesn't have the resources to construct a monetary policy, etc. As USD is the most-used currency in the world, they adopt dollar.
- Pacific Islands: same reason↑, use AUD.

Which countries have currency boards? What currency are they linked to? Why do you think these countries have currency boards?

- A form of hard-peg. They use their own currency, but it is fully backed by USD.
- This promote exchange rate stability
- Ex: HKD→ USD.
- No CB
- Int rates are pegged to US
- Any circulation of money are fully backed by equivalent amount of USD.
- MU is when a same currency is used for several areas/countries.