Motivation: International Economics

- The study of micro and macro issues in interdependent countries
Motivation: International Economics

- The study of micro and macro issues in interdependent countries
  - Dependence through trade and capital flows

International Finance is mostly interested in the second whereas International Trade focuses on the first. This class will study important large-scale economic problems, focusing on capital flows but they need to be understood in conjunction with trade flows. How these flows affect economic activity and the economic fate of countries.

We pay some more focus on recent global events: macroeconomic imbalances, debt crises, macroeconomic comovement, currency crises etc.
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The Links: Trade in 2009

Width of lines shows total value of cross-border investments between regions. Figures in bubbles show size of total domestic financial assets, $ billion, 2008 2008 exchange rate.

- World GDP, 2008 = $61 trillion
- Blue lines represent an increase between 2007-2008
- Orange lines represent a decrease between 2007-2008

1 Includes total value of cross-border investments in equity and debt securities, lending and deposits, and foreign direct investment.

SOURCE: McKinsey Global Institute Cross-Border Investments database
This Class

- Balance of Payments Accounting
- Current Account and National Accounting
- Global Imbalances
Balance of Payments Accounting

- **Balance of Payment**: records a country’s international transactions
  - **Current Account**: records trade transactions and income from abroad
    - 
  - **Financial Account** (sometimes called Capital Account): records net change in ownership of assets
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- Export-Imports + International income receipts - payments to foreigners (e.g., Japanese TV imported, an American CEO makes a trip to Germany to advise a company)
- Sales of assets to foreigners - purchases of assets located abroad e.g., purchasing a residence abroad: negative entry (since they need to transfer money to the foreigners)/ purchases of domestic stocks by foreigners: positive entry)
Balance of Payments Accounting

- **Balance of Payment**: records a country’s international transactions
  - **Current Account**: records trade transactions and income from abroad
    - Exports - Imports + International income receipts - Payments to foreigners
      e.g. Japanese TV imported: negative entry/ An American CEO makes income from a trip to Germany to advise a company: positive entry.
  - **Financial Account** (sometimes called Capital Account): records net change in ownership of assets
    - Change in foreign ownership of domestic assets - Change in domestic ownership of foreign assets
      e.g. purchasing a residence abroad: negative entry (since they need to transfer money to the foreigners)/ purchases of domestic stocks by foreigners: positive entry.
Balance of Payments... Balances

- **Balance of Payment** = Current Account + Financial Account = 0
  - Fundamental balance of payments identity
    - Every movement of goods is offset by a balancing movement of capital (financial asset)
    - E.g. a U.S. retailer imports $1 of Japanese TVs, US current account goes down by $1, there is a corresponding movement of money to the Japanese producer and the US financial account increases by $1

- Now let’s study the Current Account and the Financial Account in more detail
Current Account

- Current Account = Trade Balance + Net income from abroad = Trade Balance + Income Balance + Net Unilateral Transfers
Current Account

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**Trade Balance**
- **Merchandise:** Exports - Imports of goods
- **Services:** Exports - Imports of services

**Income Balance**
- **Net investment income:** Net income receipts from assets
- **Net international compensation to employees:** Net compensation of employees

**Net Unilateral Transfers**
- Gifts or grants received from foreign countries minus gifts or grants to foreign countries
Current Account: Examples (from the perspective of the US)

- **Trade Balance**
  - Merchandise: Imports of Nokia phones from Finland (-)/ Export of ipods to France (+)
  - Services: Drinks in Paris Bar (-)/ German tourist watching Broadway (+)

- **Income Balance**
  - Fage yogurts US subsidiary makes profits and rebates them to Greece (-)
    Dividends for US Bondholders of German stocks (+)

- **Net Unilateral Transfers**
  - Charity gift to Haiti (-) Greek sends money to relatives in the US (+)
Current Account

**Current Account**

**Figure:** US Current Account, 2012. Source: Bureau of Economic Analysis

<table>
<thead>
<tr>
<th>Item</th>
<th>Billions of dollars</th>
<th>Percentage of GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current Account</td>
<td>-475.0</td>
<td>-3.0</td>
</tr>
<tr>
<td>Trade Balance</td>
<td>-539.5</td>
<td>-3.4</td>
</tr>
<tr>
<td>Merchandise Trade Balance</td>
<td>-735.3</td>
<td>-4.7</td>
</tr>
<tr>
<td>Services Balance</td>
<td>195.8</td>
<td>1.2</td>
</tr>
<tr>
<td>Income Balance</td>
<td>198.6</td>
<td>1.3</td>
</tr>
<tr>
<td>Net Investment Income</td>
<td>206.2</td>
<td>1.3</td>
</tr>
<tr>
<td>Net International Compensation to Employees</td>
<td>-7.6</td>
<td>-0.0</td>
</tr>
<tr>
<td>Net Unilateral Transfers</td>
<td>-134.1</td>
<td>-0.9</td>
</tr>
<tr>
<td>Private Remittances</td>
<td>-77.6</td>
<td>-0.5</td>
</tr>
<tr>
<td>U.S. Government Transfers</td>
<td>-56.5</td>
<td>-0.4</td>
</tr>
</tbody>
</table>
Trade Balance and the Current Account

- In most countries, trade balance is the main driver of the current account
  - Except in cases where debt forgiveness and direct transfers are large amounts

Figure: Trade Balance and Current Account as a Fraction of GDP. Source, IMF

<table>
<thead>
<tr>
<th>Country</th>
<th>TB/GDP</th>
<th>CA/GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Argentina</td>
<td>6.8</td>
<td>3.1</td>
</tr>
<tr>
<td>China</td>
<td>5.5</td>
<td>7.1</td>
</tr>
<tr>
<td>Ireland</td>
<td>11.8</td>
<td>-2.0</td>
</tr>
<tr>
<td>Mexico</td>
<td>-1.7</td>
<td>-0.6</td>
</tr>
<tr>
<td>Philippines</td>
<td>-8.9</td>
<td>2.3</td>
</tr>
<tr>
<td>United States</td>
<td>-5.7</td>
<td>-6.2</td>
</tr>
</tbody>
</table>
Current Account and National Accounting
National Accounting

- GDP = Gross National Expenditure + Trade Balance
National Accounting

- GDP = Gross National Expenditure + Trade Balance
- GNI (Gross National Income) = GDP + Income Balance
National Accounting

- GDP = Gross National Expenditure + Trade Balance
- GNI (Gross National Income) = GDP + Income Balance
- GNDI (Gross National Disposable Income) = GNI + Net Unil. Transfers
National Accounting and the Current Account

- GDP = Gross National Expenditure + Trade Balance = (Consumption + Investment + Government Spending) + Trade Balance
- GNI (Gross National Income) = GDP + Income Balance
- GNDI (Gross National Disposable Income) = GNI + Net Unil. Transfers

GNDI = Consumption + Investment + Government Spending + Current Account Balance = C + I + G + CA

- National Saving = S ≡ GNDI - C - G = I + CA
- Thus S = I + CA so that if CA > 0 (CA Surplus) ⇔ S > I
Current Account, Savings and Investment

- **CA Surplus**: the country saves more than it’s investment needs
- **CA Deficit**: the country saves less than it’s investment needs
  - Wealth decreases
  - Analogy to household
Current Account, Savings and Investment

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  - Wealth decreases
  - Analogy to household

- Non-zero CA implies changes in the Net International Investment Position (NIIP) of a Country
  - NIIP = foreign assets owned by US residents - US assets owned by foreigners
  - CA is a flow, NIIP is a stock. Thus, CA = ΔNIIP
  - In a sense, NIIP is the accumulation of the financial account positions over time, but not exactly because of the changes in the prices of the assets over time.
Global Imbalances
Global Imbalances over time

- Refers to the phenomenon of persistent current account surpluses or deficits for some countries, that leads eventually to the accumulation of assets or financial liabilities from those countries
  - How does this come about?
Global Imbalances over time

Figure: Current Account Imbalances. Source Feenstra and Taylor, 2010 (F&T)
Global Imbalances over time

Figure: Current Account, Saving and Investment as a Fraction of GDP. Source: F&T.
CA and NIIP for the US

- A dramatic change in the US NIIP.
  - Surprisingly, it could be much more than that if the value of US owned domestic assets did not appreciate so much!

Figure: The U.S. NIIP and the Hypothetical NIIP with No Valuation Changes Since 1976. Source: BEA and S-U
What are the implications of the rise of the Chinese economy for the US CA?

A large part of US Trade deficit is accounted by Chinese imports

- In 2008 US trade balance with China was -$268 Billion! (census.gov)
  - (more than 1/3 of the total US deficit)
- In 1985 the same statistic was a mere -$6 Million!

In this sense, a main driver of the CA imbalance of the US is the rise of the Chinese economy
CA and NIIP for the US

• A dramatic change in the NIIP of the US
  • In the past, many cases of large CA deficits proved not sustainable
    • In fact, Asian countries in 90s and Latin American countries in 80s experience large reversals in the international capital flows
  • Vivid debate of whether the US CA deficit is sustainable