

International Trade

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Balance of Payments

- BoP accounting follows the principles of double-entry bookkeeping: every transaction is entered twice, once as a credit, once as a debit
- A US consumer buys a Volkswagen car for \$15,000 and pays for this with a dollar cheque. This transaction of \$15,000 *is entered as a debit item in the current account* of the US BoP
- The German supplier deposits the dollar cheque in its account and receives (say) 15,000 euros for the same
- The \$ assets of the European Central Bank increase by \$15,000 *and this item is entered as a credit item in the capital account* (under US Reserve Assets) of the US BoP

The Current Account

	Credits	Debits
Exports	579.6	
Imports		607.7
<i>Balance of Trade</i>		28.1
Investment income	133.3	108.9
Total	712.9	716.6
<i>Balance on current account</i>		3.7

US Balance of payments, 1992, \$ billion

The Capital Account

	Credits	Debits
US Assets held abroad		68.0
Foreign Assets held in the US	48.6	
<i>Balance on Capital Account</i>		<i>19.4</i>

Foreign assets purchased by US residents are entered as debit items
US assets purchased by foreigners are entered as credit items

The Consolidated Account

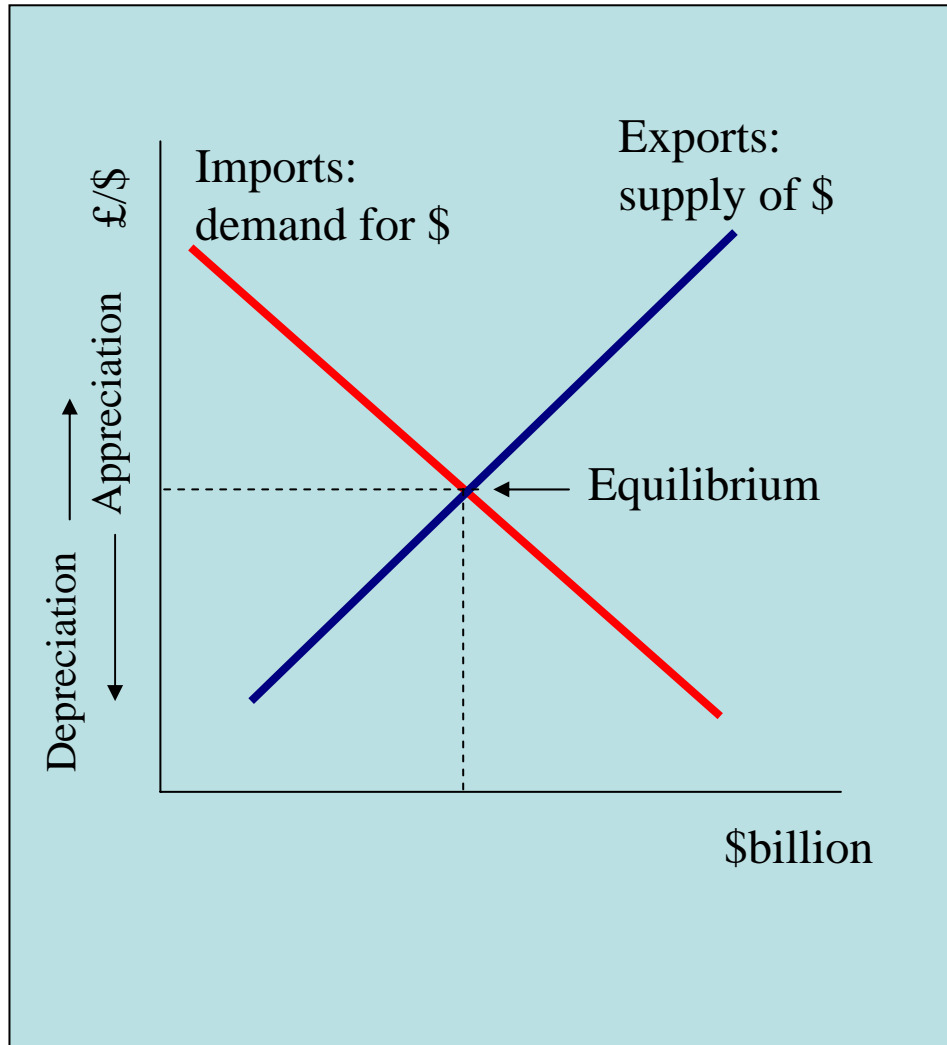
	Credits	Debits
Balance on Current Account		3.7
Balance on Capital Account		19.4
<i>Consolidated Balance</i>		<i>23.1</i>
<i>US Reserve Assets</i>	<i>23.1</i>	

US Reserve Assets fall by \$23.1 billion to finance its BoP deficit: this is entered as a credit item because it represents a sale of US assets
The BoP deficit comprises a \$3.7 billion deficit on the current account and a \$19.4 billion deficit on the capital account

Exchange Rates

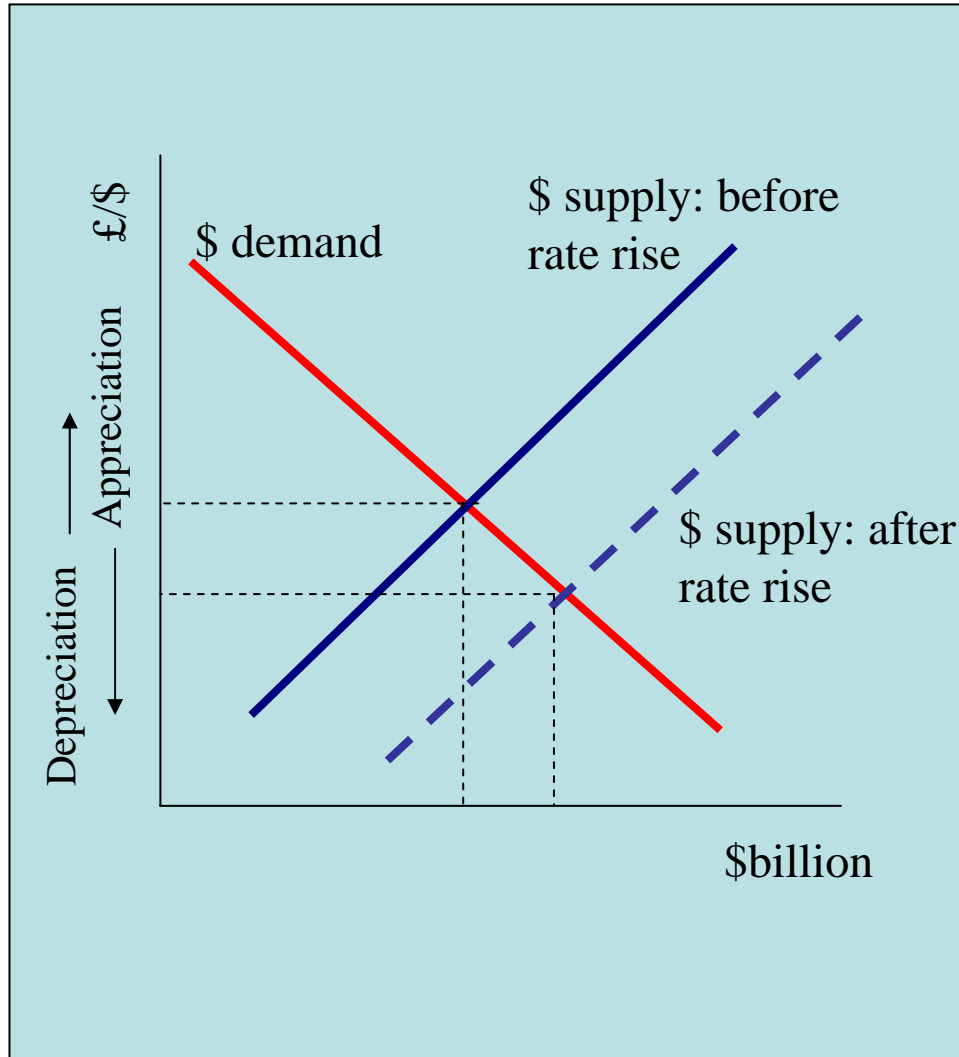
- An **exchange rate** represents the price of a foreign currency in terms of the domestic currency (for example: £0.50/\$ or Rs.40/\$)
- An exchange rate **appreciates** if a country's currency gains in value in terms of other currencies (£0.75/\$ to £0.50/\$)
- It **depreciates** if a country's currency loses in value in terms of other currencies (£0.50/\$ to £0.75/\$).

Equilibrium in the Foreign Exchange Market



- An excess of imports (demand for \$) over exports (supply of \$) exerts a pressure to depreciate
- An excess of exports (supply of \$) over imports (demand for \$) exerts a pressure to appreciate
- Equilibrium occurs when exports = imports or demand for \$ = supply of \$

Interest Rates and the Equilibrium Exchange Rate

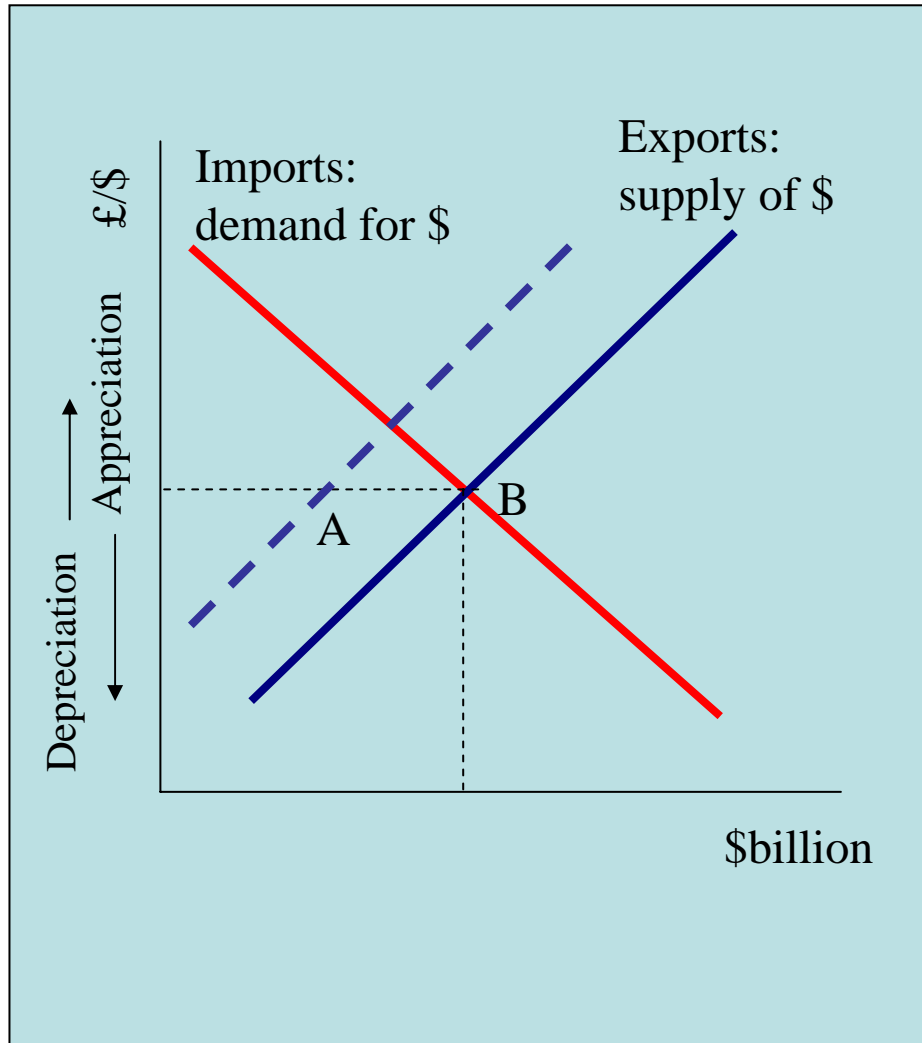


- After a rise in UK interest rate, UK assets become relatively more attractive
- Investment flows into the UK, increasing sales of UK assets to foreigners
- The \$ supply curve shifts to the right
- £ appreciates and the exchange rate falls to a new equilibrium

Forward Exchange Rates

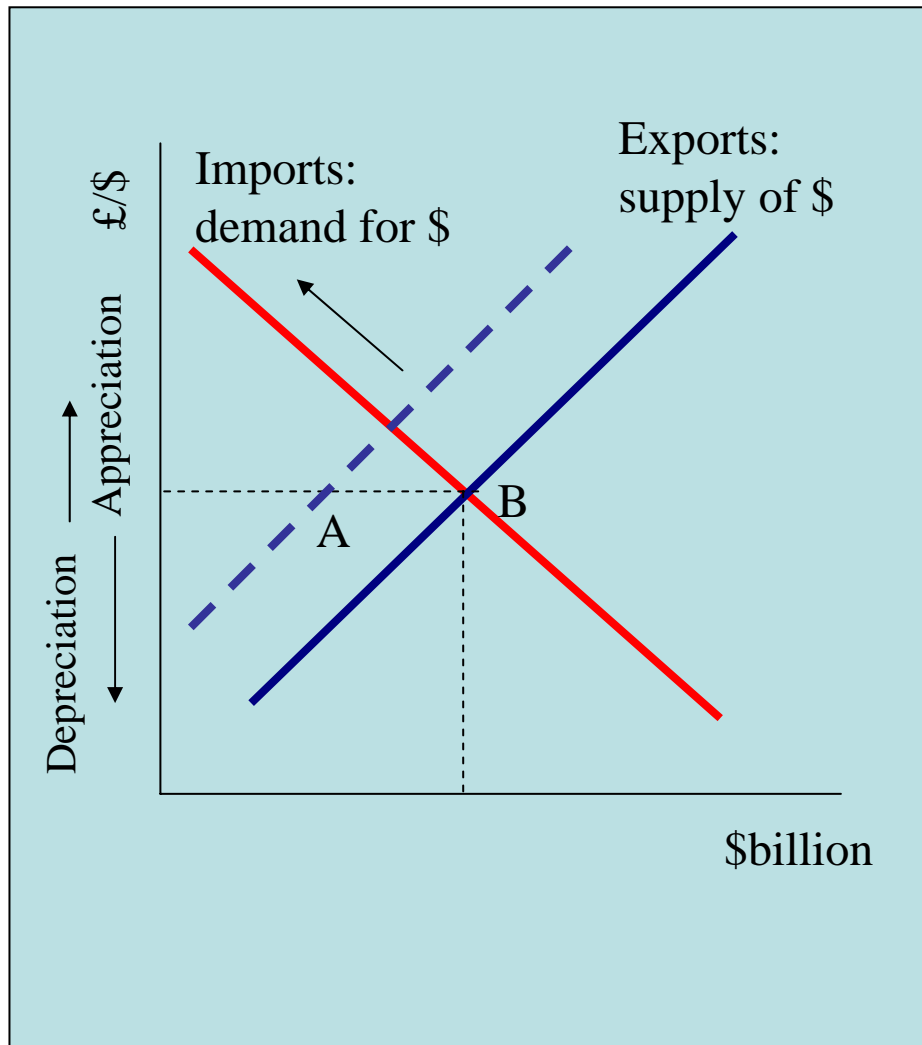
- A UK importer sells US computers for £1,000 per computer and pays his US supplier \$1,500 per computer
- So his profit depends upon the exchange rate: at £0.67/\$ he just breaks even; at £0.50/\$ he makes a profit of £250 per computer and at exchange rates above \$0.67/£ he makes a loss.
- Suppose the current exchange rate is £0.63/\$ at which he would make a profit of £55 per computer.
- *In order to ensure these profits* (which will only be realised in 30 days time when the computers arrive and are sold), the UK importer enters into a 30-day forward exchange deal by which his bank agrees to sell him \$ in 30 days time at £0.63/\$.

Putting Pressure on a Currency



- Economic events cause exports to fall: the export curve shifts to the left
- There is pressure on the currency to depreciate
- A government can resist this pressure by meeting excess demand for \$ (AB) from its reserves
- Failing that, it can raise interest rates and shift the supply curve to the right
- These measures will work only if the market perceives the economic difficulties to be temporary

Flight Out of A Currency



- If the market believes that the currency is *fundamentally* over-valued it will expect that it will depreciate
- In that case, speculators will buy \$ at the current low price (£0.50/\$) in order to make a profit at a higher price (£0.75/\$)
- Demand for \$ will rise until the current £/\$ rate becomes indefensible and the currency depreciates

The Asian Financial Crisis: I

- ❖ Between 1987-1997, the tiger economies of SE Asia: Thailand, Malaysia, Singapore, Indonesia, Hong Kong and Korea registered growth rates of 6%-9% per annum.
- ❖ A number of elements were common to all these countries – most importantly, export-led growth: between 1990-96, Malaysia's exports grew by 18% pa; Thailand's by 16%; Singapore's by 15%; Hong Kong by 14%. South Korea and Indonesia by 12%.

Asian Financial Crisis: II

- ❖ This 'Asian miracle' came to an end in June 1997 and the crisis lasted till January 1998.
- ❖ Main problem was an 'investment boom' in all these countries: investment in property (Thailand, Hong Kong, Malaysia) and in industrial assets (South Korea).
- ❖ In addition, in many cases, the governments in these countries had embarked on massive projects

Asian Financial Crisis: III

- ❖ This boom was based on heavy bank borrowing *and this was in US dollars*: currencies in these countries were pegged to the \$ and the interest rate on \$ loans were lower than on local currency loans
- ❖ But as the quantity of investment went up, *excess capacity* emerged: in South Korea, there was excess capacity in semi-conductors (DRAM chips); in Thailand, by 1997, there were 365,000 unoccupied apartment units with another 100,000 to be completed
- ❖ Also investments were sucking in imports: in the middle-1990s, all these countries were running a deficit on Balance of payments.

Asian Financial Crisis: IV

- On 5th February 1997, a Thai property developer failed to make a \$3.1 million interest payment on a \$80 billion eurobond loan
- After that, one by one, property companies began to default
- Then Finance One, Thailand's leading financial institution defaulted on its \$ loans

Asian Financial Crisis: V

- ❖ As a consequence of default, markets doubted the fundamentals of the Thai economy and, in particular, the sustainability of \$1=Bt25 pegged exchange rate of 13 years
- ❖ ‘Short selling’ was the rage. Borrow Bt100 from bank to buy \$4; when the rate falls to \$1=Bt50, sell \$2 to repay bank, leaving 100% profit
- ❖ The baht collapsed to \$1=Bt55 by January 1998: Thailand’s debt doubled and, in July 28th 1997, Thailand called in the IMF
- ❖ After that wave after wave of speculation hit the other countries: Malaysian ringgit; Indonesian rupiah; Korean won; Singapore \$ were all devalued against the US \$

The European Exchange Rate Mechanism

- The ERM gave European currencies a central exchange rate against the Ecu. That, in turn, gave them central cross-rates against one another
- The ERM gave national currencies an upper and lower limit on either side of this central rate within which they could fluctuate
- In 1992 the ERM was wrenched apart when a number of currencies could no longer keep within these limits
- On what became known as Black Wednesday, the British pound was forced to leave the system on 15 September

The Euro

- Pegged exchange rate regimes (like the ERM in Europe) are extremely dangerous because they leave economies open to speculative attack
- The single currency was adopted in recognition of these dangers: currency speculators cannot rip apart the euro
- But the euro involves imposing “one size fits all” policies on countries with different economic needs

National Income in an Open Economy

The basic National Income relation in an open economy is:

$$Y=C+I+G+X-M$$

- Y is national output (GDP)
- C is consumers' expenditure
- I is investment expenditure (private and government)
- G is government expenditure (on consumables)
- X is exports
- M is imports

The LHS tells us how much is produced; the RHS tells us where it goes

National Savings and Investment

- National saving = $Y - (C+G) = S$
- National investment = I
- Current account balance = $X - M$
- $S - I = X - M$
- ❖ If investment exceeds saving, a country will be a net borrower from abroad: \$3.7 billion in example
- ❖ If saving exceeds investment, a country will be a net lender to abroad