

Economics 548 International Economic Relations
Summer 2007
Homework 3

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Due date: Wed., July 18, 2007

General instructions: For the short essays (questions 3-5), a paragraph or two per question will suffice.

1. For this question, reference the BEA publication of the Balance of Payments (U.S. International Transactions) at this address:
<http://bea.gov/newsreleases/international/transactions/2007/pdf/trans107.pdf>
It is on pages 7 and 8 of the document (Table 1). In what category in the balance of payments would each of these transactions be counted? (Give the line number or title for each, referring to the document.)
 - (a) A U.S. bank makes a loan to a Canadian auto parts manufacturer, creating a \$1 million deposit for the firm in the U.S. bank.
 - (b) A U.S. steel manufacturer sells \$1 million worth of steel to the Canadian auto parts manufacturer which pays for the steel using their deposit in the U.S. bank.
 - (c) A U.S. citizen deposits \$100,000 in a Swiss bank.
 - (d) The Chinese government buys \$1 million in U.S. government bonds.
 - (e) A British citizen buys a ticket for a flight on United Airlines.
 - (f) A Canadian citizen who plays professional hockey in the U.S. receives his salary from the team.
 - (g) An American firm builds a factory in Brazil. (Foreign direct investment)
 - (h) The Mexican central bank sells off \$1 million of its dollar reserves, all of which is purchased by an American investment bank.

2. Consider the model in the paper: “The U.S. Trade Deficit and the New Economy” which can be found here:
<http://research.stlouisfed.org/publications/review/99/09/9909mp.pdf>
Show graphically that an economy with greater access to foreign capital will experience less of a drop in investment (i.e. less crowding out) when there is an increase in the government budget deficit than an economy with less access to foreign capital.

3. How does a currency board differ from a fixed exchange rate that is managed by a central bank? (See chapter 26) Why might that difference matter?
4. What is dollarization, and why have some countries considered it?
5. In class we considered the case of a country maintaining a fixed exchange rate by issuing domestic currency to prevent it from appreciating. Draw a supply and demand diagram for the opposite case in which a country attempts to defend a fixed exchange rate from a speculative attack. In this case, a country will need to buy back its currency to keep its value up. Explain the difficulty of doing this, and give an example from recent history based on the readings.