The Balance of Payments

Multiple Choice Questions

Use the information in the table to answer the following question(s).

**Table 1**

<table>
<thead>
<tr>
<th>Description</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Exports of goods and services</td>
<td>1000</td>
</tr>
<tr>
<td>Imports of goods and services</td>
<td>800</td>
</tr>
<tr>
<td>Net change in assets owned abroad</td>
<td>500</td>
</tr>
<tr>
<td>Net change in foreign owned assets at home</td>
<td>400</td>
</tr>
<tr>
<td>Unilateral transfers received</td>
<td>100</td>
</tr>
<tr>
<td>Unilateral transfers paid</td>
<td>200</td>
</tr>
<tr>
<td>Investment income paid to foreigners</td>
<td>300</td>
</tr>
<tr>
<td>Investment income received from foreigners</td>
<td>400</td>
</tr>
</tbody>
</table>

1) Based on Table 1, the balance on the current account is
   A) +100.
   B) +200.
   C) 0.
   D) -100.
   E) -200.

2) Based on Table 1, the balance on the capital account is
   A) +100.
   B) +200.
   C) 0.
   D) -100.
   E) -200.

3) Based on Table 1, the statistical discrepancy is
   A) +100.
   B) +200.
   C) 0.
   D) -100.
   E) -200.
4) Based on Table 1, if the information in the table is typical of current and capital account values over a long period, then it would be reasonable to infer that
   A) the net international investment position is negative.
   B) the net international investment position is positive.
   C) national savings are less than domestic investment.
   D) government accounts are in deficit.
   E) the current account balance is greater than domestic investment.

5) If the residents of a country receive income from their foreign investments, it is counted as a
   A) credit in the current account.
   B) debit in the current account.
   C) credit in the capital account.
   D) debit in the capital account.
   E) debit in either the capital or current account, depending on the type of investment income.

6) Which of the following is NOT part of the current account?
   A) Dividends received on a foreign investment
   B) Purchase of a plane ticket on a foreign airline
   C) Shipment of food aid to a poor country
   D) Purchase of a foreign bond
   E) All of the above.

7) If a country runs a current account surplus and national private savings equals domestic investment, then the combined governmental accounts
   A) must be balanced.
   B) must be positive.
   C) must be negative.
   D) could be either negative or positive, depending on the capital account.
   E) could be either negative or positive, depending on the net international investment position.

8) If all government budgets are balanced, and $S$ is greater than $I$, then
   A) the net international investment position must be positive.
   B) the capital account must be positive.
   C) the capital account must be negative.
   D) the net international investment position must be negative.
   E) Both A and B.
People sometimes worry that a country’s trade with other countries will lead to large trade deficits and the outflow of massive amounts of that country’s capital. This worry is unfounded because countries cannot
A) increase savings at the same time that a trade deficit grows.
B) spend more than they earn.
C) invest more than they save.
D) have both current account and capital account deficits at the same time.
E) increase their trade with other countries without increasing their savings.

Use the following table to answer the next question(s). All values are net.

<table>
<thead>
<tr>
<th>Purchase of official reserve assets in Austria by foreigners</th>
<th>100</th>
</tr>
</thead>
<tbody>
<tr>
<td>Purchase of nonreserve assets in Austria by foreigners</td>
<td>500</td>
</tr>
<tr>
<td>Purchase of official reserve assets by the Austrian government</td>
<td>50</td>
</tr>
<tr>
<td>Purchase of nonreserve foreign assets by the Austrian government</td>
<td>25</td>
</tr>
<tr>
<td>Purchase of private foreign assets by Austrians</td>
<td>400</td>
</tr>
</tbody>
</table>

10) Based on Table 2, the capital account balance is equal to
A) +25.
B) -25.
C) -125.
D) +125.
E) -225.

11) Based on Table 2, if values in the table are amended to reflect a net increase in Austrian foreign direct investment of 100, then the new balance for the capital account balance becomes
A) -75.
B) -25.
C) +25.
D) +75.
E) +225.

12) Capital controls are most often aimed at slowing or eliminating movements of
A) reserve assets.
B) foreign direct investment.
C) foreign portfolio investment.
D) nonreserve government assets.
E) None of the above.
13) The most important determinant of private investment in an economy is
A) the inflow of foreign investment.
B) the size of the capital account surplus.
C) the size of the current account deficit.
D) the outflow of private investment.
E) the amount of domestic savings.

14) A current account deficit implies that
A) the capital account is negative.
B) the capital account is in surplus.
C) exports of goods and services exceed imports of goods and services.
D) unilateral transfers are positive.
E) None of the above.

15) Which of the following is NOT true about this national income equation: \( S + (T - G) = I + CA \)?
A) For the current account, CA, to improve, we may have to invest less than otherwise would be the case.
B) For the current account, CA, to improve, we may have to save more to maintain the same amount of investment that includes foreign saving.
C) For the current account, CA, to improve, the government may have to run budget surplus.
D) A reduction in the trade deficit with one country will simply show up as an increase in a trade deficit with another country.
E) None of the above.

16) Which of the following is NOT true about the national income identity given by the equation: \( S + (T - G) = I + CA \)?
A) If CA is positive, national saving finances the purchase of our goods by foreign users.
B) If CA is negative, our investment exceeds our national savings.
C) A negative CA may imply that foreigners have confidence in a country’s economy.
D) If CA is negative and large, a country risks foreigners owning a large piece of its assets.
E) None of the above.

Which of the following is FALSE?

17) A) Current account deficits must be financed through inflows of capital.
B) Loans from abroad add to a country’s stock of external debt and generate debt service.
C) Borrowed funds are always used in a manner that contributes to the expansion of the country’s productive capability.
D) Debt service can become an unsustainable burden that holds back development.
E) All countries have external debt.
18) Looking at the financial account data, it is possible to determine the total amount of official reserves available to a nation.

19) Direct foreign investment items have more liquidity than foreign portfolio investment items.

**Essay Type Questions**

20) Briefly describe the factors that can contribute to a country’s Current Account deficit

21) What does a current account deficit do that is positive for a nation?

22) Explain the relation of the current account and the capital (= financial) account.

23) What is the relation between the capital account and the international investment position of a country?

24) Why are statistical discrepancies in the balance of payments so large?

25) “A devaluation will lead to a deterioration of the current account.” Discuss this statement with reference to the elasticity approach to devaluation.

26) “A devaluation will lead to a J-curve effect on the balance of payments.” Discuss.

27) “Devaluation is a sign of economic failure and will do little to help improve the balance of payments or economic performance.” Discuss.

28) “A current account deficit is not necessarily a bad thing.” Discuss this statement.

29) You work in the economics office of a major bank. The bank is considering substantial participation in a major syndicated bank loan to the government of a less developed country called ZIGZAG. A senior bank executive has asked you to write an economic report on ZIGZAG. All he/she currently knows is that last year the country had a current account deficit of $3 billion. What type of data and analysis would you include in your report and why?

30) Derive the Marshall-Lerner condition under the assumptions that we initially have balanced trade and that the supplies of domestic exports and foreign imports are perfectly elastic.

31) Interpret the Marshall-Lerner condition and explain the two effects that determine the current account position after a change in the exchange rate.