

ECON 4420/5420

Quiz #8 (Answers)

Last Name: _____, First Name: _____

(1) [15 points] Answer the following questions using the U.S. Balance of Payments for 2005

(a) [3 points] What was the balance on current account (billions of dollars)?

The table shows a 2005 current account balance of $\$1750 - \$2455 - \$86 = -\791 billion, a deficit

(b) [3 points] What happened to net foreign assets (NFA) holdings (billions of dollars)?

The net foreign assets decreased by \$791 billion in 2005 because $CA_t = \Delta NFA_t$

(c) [3 points] What was official (international) settlement balance or the balance of payments (billions of dollars)?

The net increase in foreign official reserve claims on the U.S. less the net increase in U.S. official reserve is the “balance of official reserve transactions,” which stood at $\$199.5 + \$14.1 = \$213.6$ billion in 2005. The bookkeeping offset to the balance of official reserve transactions is called the official settlement balance or the balance of payments, which was $-\$213.6$ billion

(d) [3 points] What happened to foreign assets held by the Federal Reserve (billions of dollars)?

U.S. official reserve assets – international reserves held by the Federal Reserve – fell by \$14.1 billion. Recall that a positive sign here means a fall in U.S.-owned assets held abroad, that is, an export of assets to foreigners

(e) [3 points] If foreign assets held by the U.S. are denominated in foreign currencies and the U.S. liabilities (debt) are denominated in dollars, how would a depreciation of the U.S. dollar influence the value of net foreign wealth?

A depreciation of the U.S. dollar makes foreign assets held by the U.S. more valuable, but does not change the dollar value of dollar denominated debt. Note that systematic government attempts to reduce foreign investors’ wealth through exchange rate changes would sharply reduce foreigners’ demand for domestic-currency assets, decreasing or eliminating any wealth benefit from depreciating the home currency

- (2) [5 points] Use a figure to study the following question: Imagine that the economy is at a point on the $DD - AA$ schedule that is above both AA and DD , where both the output and asset markets are out of equilibrium. Explain what will happen next?

Since the asset market adjusts very quickly, the exchange rate drops immediately to a point on the AA schedule. There will be excess demand for the domestic currency because the high expected future appreciation rate of the domestic currency implies that the expected domestic currency return on foreign deposits is below that on domestic deposits. This excess demand leads to an immediate fall in the exchange rate