

Exercise Sheet 1: Balance of Payments.

Short Solutions.

- 1.1) Services: Credit 10m Sfr. Capital in Bank Accounts: Debit 10m Sfr.
- 1.2) Capital in Bank Accounts: Credit 10m Sfr. Portfolio Investments: Debit 10m Sfr.
- 1.3) No change on the balance of payments. (But Swiss NIIP decreases)
- 1.4) Goods: Credit 100m Sfr. Bank Loans: Debit 100m Sfr.
- 1.5) Goods: Credit 20'000 Sfr. Unilateral Transfers: Debit 20'000 Sfr.
- 1.6) Services: Credit 10'000 Sfr. Compensation of Employees: Debit 10'000 Sfr.
- 1.7) Portfolio Investment: Credit 100m Sfr. Direct Investment: Debit 100m Sfr.
- 1.8) Investment Income: Credit 1m Sfr. Unilateral Transfers: Debit 1m Sfr.
- 1.9) Capital in Bank Accounts: Credit 120'000 Sfr. Official Reserves: Debit 120'000 Sfr.
- 1.10) Portfolio Investment: Credit 100'000 Sfr. Investment Income: Debit 100'000 Sfr.

Exercise 2

2.1) Since Swiss assets held by foreign residents increase by 100m Sfr, we have a positive entry (i.e. an entry on the credit side) on the financial account. However there is no corresponding negative entry on the balance of payments. If everything was legal, we would see a negative entry of 100m Sfr in the trade balance (goods) since Switzerland imported the drugs from abroad.

2.2) Swiss assets held by foreign residents decrease by 20'000 Sfr. Therefore we have a negative entry on the financial account of 20'000. However it is almost certain that the corresponding positive entry on the trade balance (services) will be smaller than 20'000 Sfr. For example, if the British lady dines at a restaurant and pays in cash, this transaction is unlikely to appear in the statistics of the national bank (the restaurant does not record the place of residence of their customers).

Exercise 3

3.1) Using again the stylized balance of payments, we can see that several categories in the current account could account for the difference: Labor income, unilateral transfers or investment income. Investment income could account for the difference if the residents of the Phillipines get large investment income from assets they hold abroad. For a poor country such as the Phillipines this is rather unlikely. Labor income could account for the difference if many people who live in the Phillipines work abroad (i.e. they commute daily to a different country for work). For an island state, this seems impossible. Services could account for the difference if the Phillipines have a large financial sector or a large tourist sector. This does not seem to be true. Unilateral transfers are most likely to explain the difference. Many people from the Phillipines emigrate to work abroad. If they regularly send money to their families at home, this creates a positive entry under unilateral transfers that could explain the difference between the trade balance and the current account.

3.2) Remember that a positive current account always means that there is a negative financial account (ignoring statistical errors and the capital account). This means that the residents of the Phillipines buy more foreign assets than foreign residents buy assets in the Phillipines. One could speculate that the reason for this might be that the Phillipines are not considered to be a good place to invest. Of course that is only one of several possible interpretations of the positive current account.

Exercise 4

4.1) It is possible with a positive entry on official reserves. A positive entry on official reserves means that official bodies (such as the central bank) are selling their reserves, such as foreign currency, gold, etc. By selling those assets the country can finance a negative current account without inflows of foreign capital. However this works only for a certain time. At some point the official reserves will be exhausted.

4.2) Labor income will be an important entry in the balance of payments of Switzerland because many people who work in Switzerland live abroad. Switzerland thus has a large negative entry under labor income. For the USA this entry is negligible. Almost all people who work in the USA also live there.

Exercise 5

5.1) The NIIP decreases. (The value of foreign assets owned by Swiss residents, expressed in Swiss Francs, decreases. The value, expressed in Swiss Franc, of Swiss assets owned by foreign residents did not change).

5.2) The NIIP decreases

5.3) The NIIP increases