International Trade and Capital Flows

Basic Terminology
Autarkic price – price in a closed economy

World price – price in an open economy

Excess domestic demand – leads to imports

Excess domestic supply – leads to exports

Benefits and Costs of International Trade
Benefits:
1) economies of scale
2) increased choice
3) increased resource allocation efficiency
4) increased welfare overall

Costs:
1) greater income inequality
2) loss of jobs
3) shut down of industries

Comparative Advantage – producing a good at a lower opportunity cost than your trading partner

Absolute Advantage – produce a good at a lower cost or using less resources than your trading partner

Ricardian Model
A country can gain from trade if it has a comparative advantage (lower opportunity cost)
Labour is the only factor of production considered in this model

Heckscher-Ohlin Model
Differences in factor endowments are the source of comparative advantage
A country has a relative comparative advantage in goods whose production is intensive in the factor with which it is relatively abundantly endowed
Labour and capital are considered in this model as relevant factors of production
Allows for possible income redistribution through trade

Trade Restrictions
1) Tariffs
2) Quotas
3) Voluntary Export Restraints (VER)
4) Export Subsidies
Balance of Payments

**Current Account**
1) Merchandise trade
2) Services
3) Interest and dividend income receipts
4) Transfer payments

**Capital Account**
1) Capital transfers
2) Sales and purchases of non-produced, non-financial assets

**Financial Account**
1) Financial assets abroad
2) Foreign owned financial assets within the reporting country

General Relationships;
If $X < M$ then the capital account will be in a deficit position
If $X > M$ then the capital account will be in a surplus position

\[
CA = X - M = Y - (C + I + G)
\]

\[
CA = S_{private} + S_{gov} - I
\]

**International Organizations**

**World Bank** – create economic infrastructure in developing economies

**International Monetary Fund (IMF)** – mission is to ensure stability of the international monetary system, exchange rates and overall systematic risk control

**World Trade Organization (WTO)** – mission is to foster free trade and to provide a framework of global trade rules
1. The law of comparative advantage explains why a nation will benefit from trade when:
   A it exports more than it imports.
   B it exports goods for which it is a high-cost producer, while importing those for which it is a low-cost producer.
   C it exports goods for which it is a low cost producer, while importing those for which it is a high-cost producer.
   D it imports more than it exports.

2. "Import quotas will create jobs, increasing the employment level of a nation." Economic analysis indicates that this statement is in the:
   A short run, true; long run, true
   B short run, false; long run, true
   C short run, false; long run, false
   D short run, true; long run, false

3. Under a system of fixed exchange-rates, a nation experiencing an excess of imports over exports can try to remedy this situation by:
   A adopting tariffs and quotas.
   B building up its reserves of foreign currencies and reserve balances with the International Monetary Fund.
   C applying expansionary macroeconomic policy that would drive prices up and interest rates down.
   D reducing its income from investments abroad.

4. The following table illustrates the domestic prices of items of similar quality shoes, watches and electric motors in the U.S. and Israel.

<table>
<thead>
<tr>
<th>Item</th>
<th>United States (dollars)</th>
<th>Israel (pounds)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Shoes</td>
<td>20</td>
<td>40</td>
</tr>
<tr>
<td>Watches</td>
<td>40</td>
<td>90</td>
</tr>
<tr>
<td>Electric Motors</td>
<td>80</td>
<td>300</td>
</tr>
</tbody>
</table>

Assuming that the exchange-rate for the Israeli pound is 2.50 per U.S. dollar and that transportation costs are zero, which goods will the U.S. tend to export to Israel?

   A   Shoes only
   B   Shoes and watches only
   C   Shoes, watches and electric motors
   D   Electric motors only
Solutions:
1. X
2. X
3. X
4. X

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Currency Exchange Rates

Exchange Rates: Basic Terminology
The exchange rate is the number of units of one currency (the price currency) that one unit of another currency (the base currency) will buy

\[
\text{Exchange Rate} = \frac{\text{Price Currency}}{\text{Base Currency}}
\]

Real Exchange Rates – reflect changes in purchasing power

\[
S_{\text{Real DC/FC}} = S_{\text{DC/FC}} \times \frac{P_{\text{FC/PL}}}{P_{\text{DC/PL}}}
\]

Spot vs. Forward Exchange Rates

\[
F_{\text{DC/FC}} = S_{\text{DC/FC}} \times \frac{(1+i_{\text{DC}})}{(1+i_{\text{FC}})} \leq \text{“Interest Rate Parity”}
\]

Direct Quote: DC/FC

Indirect Quote: FC/DC

Calculation Examples:
1) Percentage Change in a Currency
Suppose \(S_{0\text{DC/FC}} = 1.25\) and \(S_{1\text{DC/FC}} = 1.30\)

2) Currency Cross Rate
Suppose \(S_{\text{CAD/USD}} = 1.046\) and \(S_{\text{USD/EUR}} = 1.288\)
The CAD per EUR cross rate would be:
3) Forward Premium/discount

\[ F - S = (+) \text{ Premium} / (-) \text{ Discount} \leq \text{“scale by 10,000”} \]

\[ \frac{F - S}{S} = (+) \text{ Premium} / (-) \text{ Discount} \% \]

Suppose \( S_{\text{USD/EUR}} = 1.2875 \) and \( F_{\text{USD/EUR}} = 1.28485 \)
The forward points would be:

The forward premium as a percent would be:

4) Forward Exchange Rate

\[ F = S + (\text{Points}/10,000) \]

\[ F = S \times (1 + \text{Premium/Discount} \%) \]

5) Conversion of Forward “Points” to Percentage

\[ \% = (\text{Spot} + \text{Points}) / \text{Spot} \]

Suppose \( S_{\text{USD/EUR}} = 1.2875 \) and \( F_{\text{USD/EUR}} = 1.28485 \)
The forward points expressed as a percentage would be:

Exchange Rate Regimes
Fixed Regimes
Floating Regimes

\[ X - M = (S - I) + (G - T) \]

A trade surplus – the country saves more than its investment needs (\( S > I \))

A trade deficit – the country does not save enough to fund its investment spending (\( S < I \))

Elasticities Approach (Marshall-Learner Condition)

If: \( W_x \varepsilon_x + W_m (\varepsilon_m -1) > 0 \) then, a decrease in the DC will move the trade balance towards surplus

Trade deficit: \( W_m > W_x \)

Absorption approach

A decrease in the DC will cause an increase in GDP only if there is excess capacity (ie. Output gap)
1. Under a system of flexible rates of exchange, a deficit in a country's balance of payments will be corrected by:

A a depreciation in the nation's currency.
B a decline in the nation's domestic price level.
C an increase in the nation's inflation rate.
D an appreciation in the nation's currency.

2. Under a system of fixed exchange-rates, a nation can attempt to remedy its balance of payments deficits by:

A applying expansionary fiscal policy.
B reducing its income from investments abroad.
C applying restrictive monetary policy that would keep prices down and interest rates up.
D apply expansionary monetary policy that would drive prices up and interest rates down.

3. Under a system of flexible exchange-rates, an increase in the foreign demand for a nation's currency will cause the nation's:

A product prices to decline, in terms of foreign currencies.
B consumer prices to decline, in terms of foreign currencies.
C balance of payments deficits to increase.
D currency to appreciate in value.

4. The difference between the balance of merchandise trade and the balance of payments is that:

A the balance of merchandise trade includes the value of goods, services and unilateral transfers and the balance of payments includes both current account and capital account transactions.
B both are different terms used to describe the same transaction.
C the balance of merchandise trade includes the value of goods imported and exported and the balance of payments includes only capital account transactions.
D the balance of merchandise trade includes only the value of goods imported and exported and the balance of payments includes the value of all payments to and receipts from other nations.

5. Consider a U.S. investor who wishes to purchase U.K. securities. The current exchange rate is $1.80 per pound. Assume that the price level of a typical consumption basket in the U.K. is three times the price level of a typical consumption basket in the U.S.

Based on this information, the real exchange rate is closest to:

A $1.80 per pound
B $5.40 per pound
C $0.55 per pound
D $0.60 per pound

6. Its one year later and price levels in the U.S. have risen 5%, while price levels in the U.K. have risen 2%. The new exchange rate is $1.854 per pound. What is the new real exchange rate?

A $1.80 per pound
B $5.40 per pound
C $0.55 per pound
D $0.60 per pound
Based on your answers to the previous questions and the data above, one can conclude:

A. The U.S. investor did not experience a change in the real exchange rate
B. The pound appreciated relative to the U.S. dollar by 3%
C. Inflation in the U.K. is less than inflation in the U.S. by 3%
D. All of the above

(Use the following information to answer questions 8 and 9)

Assume that the eurozone risk-free interest rate on bonds with one year to maturity is 4.78% and the U.S. risk-free interest rate on one-year bonds is 3.15%. The current exchange rate is $0.90 per euro. Assume that the U.S. is the domestic country.

8. The one-year forward exchange rate is:

A. $0.914 per euro
B. $0.90 per euro
C. $0.886 per euro
D. $1.13 per euro

9. Based on the information above, the euro is:

A. trading at a forward premium of 0.56%
B. trading at a forward premium of 1.56%
C. trading at a forward discount of 1.56%
D. trading at a forward discount of 0.56%
Solutions:
5. X
6. X
7. X
8. X
9. X

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