

BSc Financial Economics
International Finance
Solution 1

Question 1

I. Record the following transactions in the Pongoland balance of payments using the double-entry bookkeeping system. Use the following accounts:

- Merchandise exports
- Merchandise imports
- Services
- Income
- Current transfers
- Pongoland claims on foreigners
- Foreign claims on Pongoland
- Direct investment
- Official Reserves

- A. Pongoland residents buy sweaters costing 4 million pongos from the UK. They pay with cheques drawn on a Pongoland bank. [Note: the currency of Pongoland is the pongo.]

Debit	Merchandise imports	4 million
Credit	Foreign claims on Pongoland	4 million

- B. Pongoland corporations sell cars costing 8 million pongos to residents in the US. They are paid with cheques drawn on US banks.

Debit	Pongoland claims on foreigners	8 million
Credit	Merchandise exports	8 million

- C. Pongoland residents earn 3 million pongos on their investments in Switzerland. They are paid with cheques drawn on Swiss banks.

Debit	Pongoland claims on foreigners	3 million
Credit	Investment	3 million

- D. Pongoland residents send a gift of 1 million pongos of food to a small island nation that was hit by a hurricane.

Debit	Current transfers	1 million
Credit	Merchandise exports	1 million

- E. A German company pays 5 million pongos for a company located in Pongoland. It pays with a cheque drawn on a Pongoland bank.

Debit	Foreign claims on Pongoland	5 million
Credit	Direct investment	5 million

II. Provide a balance of payments table for Pongoland

Current Account		7
Merchandise trade	5	
Merchandise Exports	9	
Merchandise Imports	-4	
Services	0	
Investment	3	
Current transfers	-1	
Capital Account		0
Financial Account		-7
Direct investment	5	
Pongoland claims on foreigners	-11	
Foreign claims on Pongoland	-1	
Official Reserves		0

Question 2

A UK distillery sells an American firm 200 cases of whiskey in exchange for a £25,000 cheque drawn on American bank. The distillery uses £15,000 of the money it receives to buy equipment from a French firm and the other £10,000 to retire bonds that it had issued years ago to a group of Italian investors. In both cases it makes payment with a cheque drawn on a US bank. Assume that the payment to the Italians does not include interest. Write all of the resulting balance of payments entries for the United States, the United Kingdom, France and Italy.

United States

Debit	Merchandise imports	£25,000
Credit	Foreign claims on the US	£25,000

United Kingdom

Debit	UK claims on foreigners	£25,000
Credit	Merchandise exports	£25,000

Debit	Merchandise imports	£15,000
Credit	UK claims on foreigners	£15,000

Debit	Foreign claims on the UK	£10,000
Credit	UK claims on foreigners	£10,000

France

Debit	French claims on foreigners	£15,000
Credit	Merchandise exports	£15,000

Italy

Debit Italian claims on foreigners £10,000

Credit Italian claims on foreigner £10,000

Question 3

During 2008, suppose that Ruritania had a current account surplus of \$100 million, a capital account deficit of \$2 million and a financial account deficit of \$120 million. Assume that there was no measurement error.

A. What was the balance of on the Ruritanian official reserves account in 2008?

Current Account + Capital Account + Financial Account + Reserves = 0.

Thus, 100 million – 2 million – 120 million + Reserves = 0.

Thus, Reserves = 22 million

B. What was the Ruritanian balance of payments in 2008?

Reserves *fell* by 22 million. Thus, there was a balance of payments deficit of 22 million.

C. What was the gap between Ruritanian savings and investment?

Savings – Investment = Current account = 100 million.