4.6 International linkages

Name: _____ Class: _____ Date: _____ **Total: 14 marks**

KEY WORDS balance of payments • purchasing power parity

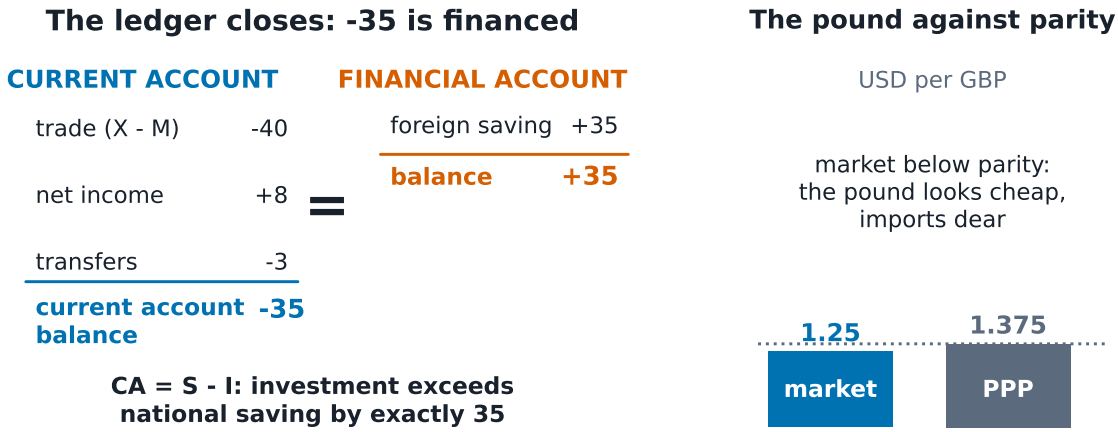
Objective

Assemble a current account and its financial mirror; interpret the saving-investment identity; price currencies with PPP and UIP, stating each model's limits.

1 Key knowledge and worked examples

■ The ledger, the anchor, the model

Current account = trade + net income + transfers; the financial account mirrors it; $CA = S - I$ is the content. **PPP** compares baskets; **UIP** equates expected currency returns – a model with famous short-run failures.



A current-account deficit is foreign saving financing domestic investment

■ Worked example. Aurora's ledger

$X - M = -40$, income $+8$, transfers -3 → CA **−35**, financial **+35** ✓. PPP: 1,100/800 = 1.375; market 1.25 → pound cheap ✓. UIP: 5% vs 4% → expected rate $1.25 \times 1.04/1.05 = 1.238$ ✓.

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2 Practice

A country has X 210, M 180, net investment income −12, net transfers +4.

2.1 Compute the current account balance and the financial account balance. [2]

2.2 What does your current-account answer say about saving and investment? And who is financing whom? [2]

2.3 The same basket costs 900 in pounds at home and 1,170 in dollars abroad. Compute the PPP rate. The market rate is 1.20: which currency looks cheap, and what force should that set off? [3]

2.4 Home interest 4%, abroad 6%, spot 1.20 home-currency per foreign. Compute the UIP expected rate (three decimals). Who is indifferent under the model? [3]

2.5 The country tightens monetary policy. In two lines, trace the exchange-rate channel to the current account. [2]

2.6 One line each: why is PPP a poor monthly forecast, and why do carry traders exist? [2]

Solutions

2.1

- CA $= (210 - 180) - 12 + 4 = +\mathbf{22}$.
- Financial account $= -\mathbf{22}$ – the country invests abroad.

2.2

- $CA = S - I = +22$: national saving exceeds investment by 22.
- The country is a net LENDER to the rest of the world.

2.3

- PPP $= 1{,}170/900 = \mathbf{1.30}$ dollars per home currency.
- Market $1.20 < 1.30$: the home currency looks CHEAP.
- The force: buy the cheap currency / its goods – exports and inflows should push the rate toward parity.

2.4

- Expected rate $= 1.20 \times 1.04/1.06 = \mathbf{1.177}$.
- The home currency is expected to APPRECIATE about 2%.
- A saver comparing deposits is indifferent under the model – the 2-point rate gap is exactly the expected gain.

2.5

- Tightening $\rightarrow$ capital inflow $\rightarrow$ home currency appreciates $\rightarrow$ exports dearer, imports cheaper $\rightarrow$ the current account narrows (moves toward deficit).
- The exchange rate is a transmission channel, not a scoreboard.

2.6

- PPP: baskets differ, transport and borders are real – it anchors decades, not months.
- Carry traders: UIP fails in the short run, so borrowing low and lending high can earn the gap without the offsetting depreciation – riskily.

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