* 1. The basic balance = the balance of payment on capital + the balance of payment on current account. The exchange rate moves so as to eliminate the total excess demand/supply of foreign currency, which keeps the overall balance at zero.
  2. Black markets for foreign exchange exist when the government of a country places legal restrictions on the dealings in its currency so as to fix its exchange rate. For example, when there is excess demand for dollars in the market, the spot exchange rate is expected to rise immediately to offset the excess demand. But when the exchange rate is fixed by government by some restrictions (e.g. private holding of dollars is forbidden), then people try to buy dollars from unofficial sources, thereby creating black markets, where the exchange rate can rise towards its equilibrium level.
  3. (a) California does not have its own currency, so there is no reason to worry about the effect of its deficit or surplus on its exchange rate. Insofar as its balance of payments represents its net accumulation of assets, it is normal to focus on the USA rather than a single state.

(b) Yes, the net current account balance represents the nation’s net accumulation of assets. A deficit means it is (net) borrowing from the rest of the world (running down its assets or running up its liabilities).

(c)(d) It is often argued that we should not be interested in the balance of payment of Eurozone member countries, only about the overall balance of the Eurozone as a whole – which is certainly the case if we are concerned only with the value of the Euro. But balance of payments deficits are settled in Euros within the Eurozone, so e.g. Greece’s deficit with Germany means Euros flow from Greece to Germany, reducing Greece’s money supply and raising Germany’s. Left to itself, this imbalance may rectify itself (see Chapter 5), but with some discomfort along the way (usually, temporary unemployment, perhaps some bankruptcies etc). Of course, if Germans make loans to Greece (which should be reflected in an offsetting surplus in Greece’s capital account), the rebalancing effect will be blocked – which is more or less what happened in the run-up to the sovereign debt crisis of 2010 onwards.

* 1. No. Because the Bank of England can print Pounds Sterling at zero cost in any time to satisfy an excess demand for pounds. While the US Federal Reserve needs to hold Pounds Sterling in case of an excess demand for pounds (excess supply of dollars) in US.
  2. When there are long periods of excess demand for petrol or Pounds, the problem is the same. To keep the price fixed, the UK Government has to keep on supplying petrol from stock or dollars from its reserves, so that in either case at some point its stock or its reserves are likely to be exhausted.

On the other hand, if it faces long periods of excess supply situation, the problem is slightly different, since preventing the price from falling requires it to keep supplying Pounds, so as to buy up the excess supply of petrol or dollars. The Bank of England (the UK monetary authority) can always print additional Pounds at zero cost to satisfy the excess demand for UK currency, but the drawback is that it thereby surrenders control of monetary policy, leaving the money supply subject to the vagaries of fluctuations in the demand for petrol or US dollars.

**1.6**

Buy $HK at Bank B at the exchange rate $US1.00 = $HK 0.1284 giving

$HK 7,778,162.

Then sell these $HK at Bank A at the exchange rate $US1.00 = $HK 0.1285 giving $US 1,000, 779

NET PROFIT $US 779

**1.7**

1. **(b)**

Under a floating exchange rate regime, a surplus/deficit on capital account is simply the counterpart of the current account deficit/surplus, so, if one is sustainable, so is the other. The question of how long an imbalance can be sustained is uncertain and much debated. You might think a country cannot go on borrowing from/lending to the rest of the world indefinitely. That would certainly make sense. In practice, however, it seems that countries like UK can run a current account deficit (and consequent capital account deficit), and Germany the opposite, for decade after decade. At some point, you would expect the lenders to get fed up of financing the lifestyle of the borrowers (which is what it ultimately amounts to), but not so far….watch this space!

Under a fixed exchange rate regime, the situation is simpler in this respect. The surplus/deficit on capital account *plus the reserve change* is the counterpart of the current account deficit/surplus, so a nonzero basic balance implies either a build-up or a run-down in the reserves. The latter is clearly unsustainable, since it must end when the reserves are exhausted, if not sooner (see Chapter 15). A build-up can in principle be sustained indefinitely, but again in practice you would expect the lenders to weary of the situation, especially if they start to suspect that the reserves they are accumulating may turn out to be a poor investment long term (see Case Study 5.1 for China)