

Investment and Balance of Payments

Name of student

[Institutional affiliation]

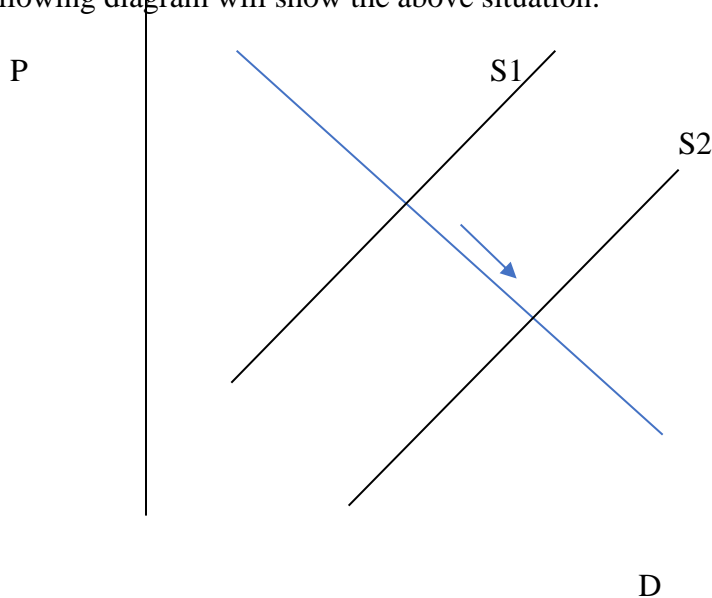
Author note

Investment and Balance of Payments

The current account in the balance of payments shows the equilibrium in goods and services plus the aggregate investment income from resources in other countries and the net difference of transfers. The negative difference in the current account means that the country is buying more than it is selling. Thus, there will be a net decrease in money within the national circular flow

. The locals pay for the imported goods in their own currency, which are then converted to the currency of the other country. An increase in the current account deficit will result in a higher supply of the local currency in the foreign exchange markets (Layton & Tucker, 2019). This situation will lead to a decrease in value because there is not an equal increase in the demand for the same currency. Alternatively, the exports of the country may also decrease and result in the rise of the trade deficit. This aspect may also result in a devaluation of the currency.

The following diagram will show the above situation:



Graph 1: Demand and Supply of currency (D, S)

In the above diagram, prices are shown on the Y-axis, and quantities are shown on the x-axis. The blue line shows the demand whereas the black lines show the supply. There is an increase in supply given a constant demand, which results in a decline in the price of the currency.

In the monetary approach to the exchange rate, there are two basic ingredients namely homogeneity of real exchange rates and a simple determination of the price level. The first factor means that inflation in any country will not affect the cost of foreign goods in terms of domestic goods. The price determination model states that there is a proportionality among the price level and money supply (Dunn & Mutti, 2004). The real exchange rate in this theory is presented by the following equation:

$$Q \stackrel{\text{def}}{=} \frac{SP^*}{P}$$

In the above equation, Q is considered the real exchange rate because it shows the rate at which domestic goods will be given up for foreign goods. This approach considers the real exchange rate as exogenous, which sets accurately with the classical model of price determination because it also considers real variables as exogenous. With the real exchange rate, the relationship between the nominal exchange rate and relative price level can be given by the following relationship:

$$S = Q \frac{P}{P^*}$$

In the above equation, S is the exchange rate, P is the local price index, P* is the price index in the foreign market and Q is the real exchange rate that is exogenous. The above equation requires that for any real exchange rate, the movement in the exchange rate will offset the movements in the price so that the exchange rate remains the same. Various presentations of

the monetary approach assume that the real exchange rate is constant or invariant. Thus, the exchange rate is assumed to be proportional to the price level. A change of 1.5 times in the inflation may result in a proportional change in the price level with zero inflation in the foreign market. In this case, 1.5 times change in the exchange rate will have no impact on the real exchange rate. The comparison of the relative price levels is undertaken through the classical model of price discrimination. The supply of money will determine the price level, which is also perfectly flexible. Under the basic classical model, the monetary policy does not influence economic activity. The real interest rate and income are set in the respective markets independent of the monetary policy. This independence makes it easier to model monetary concepts like the nominal interest rates.

The purchasing power parity theory was presented under the efficiency theory of exchange rates. This theory describes the determination of the exchange rate between two paper currencies that are not convertible. The theory states that the purchasing power of two currencies should be equated to get the exchange rate between two countries. The absolute version states that the exchange rate should show the relationship between the purchasing power of different units of a local currency (Krugman & Obstfeld, 2009). The exchange rate shows the ratio between the money required to buy a set of particular goods locally as compared to the purchasing power abroad. The absolute version of the theory has many pitfalls or shortcomings. The exchange rate determined under this method has no practical use because it measures the value of money in absolute terms. The diversities among the kinds and qualities of goods can create many problems in comparing the product prices in different countries.

The relative version of the theory tries to explain the changes in exchange rate by relating the change in the exchange rate to the purchasing power parities of the currencies. The inflation

or changes in prices of similar products in both countries will be an important factor in determining the exchange rate. Initially, the ratios are calculated between the current and past prices of goods for currencies A and B. Then, these two ratios are further divided by each other to get the exchange rate. The theory is criticized for assuming the direct functional relationship between the exchange rate and purchasing power. The theory also neglects the capital and financial accounts for the country.

The interest rate parity theory is considered the technical theory of exchange rate. The theory states that the difference between the interest rates in two countries will remain equal to the difference between interest rates under the forward and spot techniques. The theory connects the interest, foreign exchange rate, and spot rates. The theory is useful in assessing the relationship between the spot rate and the relevant future rate of the currency. It is assumed that there is no arbitrage within the interest rate differentials between the two currencies. The theory also states that the size of forwarding discount or premium will be equal to the difference between spot and foreign exchange rates.

Financial institutions, central, and commercial banks can be considered the biggest investors in the foreign exchange market. London is the major center for trading foreign currencies, followed by New York, Sydney, and Tokyo. U.S. Dollar and Euro are the top currencies in international trade.

Definitions

The spot exchange rate is the current or present exchange rate whereas the forward exchange rate can be executed at some future date.

The direct quote shows the cost of a standard unit of foreign currency in the units of local currency whereas the indirect quote will show the price of a standard unit of local currency in the units of other currency.

The swap is the amount of interest paid or earned when a trade is kept open overnight. A long swap is used to keep long positions for several nights, whereas a short swap is used to keep a short position overnight.

The J curve shows how a country's balance of trade suffers immediately after the currency devaluation and improves afterward. When a currency is depreciated, the imports for a country will get more expensive and the exports will get cheaper. This will worsen the trade deficit or decrease the trade surplus. The nation starts rising the level of exports because of a relatively cheaper price. Local consumers also tend to increase local products because they are relatively cheaper as compared to imported goods. With the passage of time, the trade balance for the nation and partners will improve to the original level. When there is an increase in the country's currency, a reverse J-curve can be observed. The exports will be more expensive for the other countries. The other countries will be able to fill the demand at a lower price. The stronger currency may have to surrender its export competitiveness. National consumers will also shift to imported goods because they will be cheaper.

The term "bid and ask" refers to the price quote showing the best price at which a currency can be bought or sold at a given time.

References

Dunn, R., & Mutti, J. (2004). *International Economics* (6 ed.). London: Routledge.

Layton, A., & Tucker, T. R. (2019). *Economics for today*. Melbourne: Cengage Learning.

R.Krugman, P., & Obstfeld, M. (2009). *International Economics* (8 ed.). New Delhi: Pearson.