

## Review Sheet 2: International Capital Flows

May 11, 2004

Instructor: Marc-Andreas Muendler  
E-mail: muendler@ucsd.edu

### 1 Savings, Investment, and the Current Account

If Chile's current account is in deficit today (period 1), what does this mean for the relationship between Chile's income, consumption, and investment (including both households and the government)? The world ends tomorrow (in period 2). Will Chile be a net exporter or net importer of goods and services tomorrow (in period 2)? Will Chile be a net exporter or net importer of capital tomorrow (in period 2)?

### 2 Intertemporal Trade

Present a brief explanation for why the theory of international capital investment can be recast as a theory of international trade. What are key differences between trade in commodities and the exchange of capital? What gains from international capital investment are there beyond those of intertemporal trade? What are the risks to intertemporal trade?

### 3 Capital Market Integration

Consider the effects of capital market integration.

1. Colombia has an endowment of income of  $Y_{\text{today}}$  and invests a positive amount of that income  $I_1$  for future consumption. Draw Colombia's production possibility frontier and demonstrate today's consumption, today's investment, tomorrow's consumption, and tomorrow's income in a closed economy.
2. Now assume Colombia has access to international capital markets at the world interest rate  $(1+r^*)$ . What will this do to Colombia's consumption and investment decisions? Again, draw Colombia's production possibility frontier and demonstrate today's consumption, today's investment, tomorrow's consumption, and tomorrow's income in an open economy.

## **4 Foreign Direct Investment as a Source of Financing**

Foreign direct investment (FDI) is an important source of current account financing in Latin America. What are specific characteristics of FDI that set it apart from other forms of capital? What are advantages and disadvantages of this kind of investment over other types of capital flows? Why? Under what conditions can a country be both a net exporter of goods and services, and simultaneously attract foreign direct investment? Can a country be both a net exporter of goods and services and a net importer of capital?

## **5 Foreign Direct Investment and the Boundary of the Firm**

Discuss three reasons why a firm wishing to enter a new market abroad would want to own multinational assets rather than engage in a contractual relationship.