Economics 161 — Fall 2013

Global Integration of Latin America

Review Sheet 2: International Capital Flows

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1 Savings, Investment, and the Current Account

If a country's current account is in deficit today (period 1), what does this mean for the relationship between the country's income, consumption, and investment (including both households and the government)? The world ends tomorrow (in period 2). Will the country be a net exporter or net importer of goods and services tomorrow (in period 2)? Will the country 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 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 investment are there beyond those of intertemporal trade? What are the risks associated with intertemporal trade?

3 Capital Market Integration

Consider the effects of capital market integration.

1. An economy has an endowment of income of Y_{today} and invests a positive amount of that income I1 for future consumption. Draw the economy's intertemporal 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 the economy has access to international capital markets at the world interest rate $(1+r^*)$. What will this do to the economy's consumption and investment decisions? Again, draw the economy's intertemporal 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 Offshoring, Intra-firm Trade 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.

Explain how offshoring of intermediate production stages with different relative skill requirements can simultaneously raise demand for relatively more skilled workers in the offshoring and the inshoring location.

6 Uncertainty, Asymmetric Information and Hidden Action

Explain why the three crucial institutional conditions—verifiability of states of nature, the enforceability of contractual stipulations and the prevention of hidden actions—are crucial for the idea that "the case for free international capital markets is the same as the case for free trade but for the subscripts". Explain why under these three institutional conditions the diversification of country risk under uncertainty provides another source of gains from intertemporal trade.

Explain how a lacking willingness to repay sovereign debt (lacking international enforceability of contractual stipulations) changes the standard case of intertemporal trade. Explain how a provoked inability to repay sovereign debt (under hidden action) changes the standard case of intertemporal trade, and relate the idea of minimum guaranteed consumption to bailouts.