

Chapter 9: International Economics

- **Introduction to international trade**
- **Balance of Payments**
- **Market for foreign exchange**

9.1 Introduction to international trade

9.1.1 Reasons for trade

(1) The production cost of the same commodity in each country is not equal

(2) Comparative advantages

9.1 Introduction to international trade

9.1.2 Gains from trade

- (1) Welfare gains
- (2) Economies of scale
- (3) Technology transfer

9.1 Introduction to international trade

9.1.3 Trade barriers

- (1) Tariff barrier
- (2) Non-tariff barrier

9.1.4 Trade agreement

- (1) Bilateral agreement
- (2) Multilateral agreement

9.2 Balance of payments (BOP)

Balance of Payments:

- The record of a country **transactions** in goods, services, and assets with the rest of the world
- The record of a country's sources (supply) and uses (demand) of foreign exchange

9.2 Balance of payments (BOP)

9.2.1 Composition of BOP account

- 1. Current Account**
- 2. Capital and Financial Account**
- 3. Errors and Omissions**
- 4. International Reserve Account**

1. Current Account

Composition of current account

1.1 Trade in good account: record of foreign exchange receive and payment from the country's export and import of good

--- Trade in good account balance ----

1.2 Trade in service account: record of foreign exchange receive and payment from the country's export and import of services (such as, transportation, travel, government service and other services)

--- Trade in service account balance ----

1. Current Account

1.3 Income Account: record of foreign exchange income receipts and income payments from compensation of employees and investment income (such as dividends, interest, rent, and profits)

--- Income account balance ---

1.4 Transfer Account: record of transfer receive and payment from private and government sectors (such as, parents transfer money to children staying abroad, donation from Thai government to other countries, and donation of other countries to Thailand)

--- Transfer account balance ---

1. Current Account

1.1 Trade in good account ↔ **Trade in good account balance**

1.2 Trade in service account ↔ **Trade in service account balance**

1.3 Income Account ↔ **Income account balance**

1.4 Transfer Account ↔ **Transfer account balance**

--- Current Account ----

Example of Balance of Payment (units: million US dollars)

| | 2007 p | 2008 p | 2009 p |
|--------------------------------------|-------------------|-------------------|-------------------|
| Current account | 15,681.73 | 1,633.00 | 20,290.90 |
| a. Goods and services | 18,703.21 | 4,934.85 | 24,916.72 |
| 1. Goods | 12,782.03 | 108.09 | 19,416.41 |
| Exports (f.o.b.) | 151,258.35 | 175,233.06 | 150,883.04 |
| Imports (c.i.f.) | -138,476.31 | -175,124.97 | -131,466.62 |
| Of which: Non-monetary gold | -1,635.98 | -6,068.98 | -3,785.31 |
| 2. Services | 5,921.17 | 4,826.76 | 5,500.31 |
| Services receipts | 30,361.92 | 33,399.57 | 30,200.07 |
| Services payments | -24,440.74 | -28,572.81 | -24,699.75 |
| b. Income | -6,960.39 | -8,072.30 | -9,116.48 |
| Income receipts | 7,331.98 | 7,130.71 | 5,030.48 |
| Income payments 4/ | -14,292.38 | -15,203.02 | -14,146.96 |
| c. Current transfers | 3,938.91 | 4,770.45 | 4,490.66 |
| Capital and financial account | -2,623.78 | 14,603.70 | -1,199.44 |
| a. Capital account 6/ | 0.00 | 0.00 | 0.00 |
| b. Financial account | -2,623.78 | 14,603.70 | -1,199.44 |
| 1. Direct investment 3/ | 8,465.85 | 6,002.05 | 2,118.39 |
| (1) Abroad | -2,864.34 | -2,568.41 | -3,835.90 |
| (2) In reporting economy | 11,330.19 | 8,570.46 | 5,954.32 |
| 2. Portfolio investment | -6,726.91 | -2,080.36 | -9,211.68 |
| 3. Other investment | -4,362.72 | 10,682.01 | 5,893.84 |
| Errors and omissions | 4,044.25 | 8,456.58 | 5,035.12 |
| Overall balance | 17,102.20 | 24,693.30 | 24,126.60 |
| Reserve assets | -17,102.20 | -24,693.30 | -24,126.60 |

2. Capital and Financial Account

2.1 Capital Account

- Cancellation of debt by creditors
- Money transfer by refugees, assets/liabilities that are not for production or investment

--- Capital account balance ---

2. Capital and Financial Account

2.2 Financial Account

- Direct Investment: such as building a factory
- Portfolio Investment
- Other Investment: such as trade credit, international loans and deposits

--- Financial account balance---

2. Capital and Financial Account

2.1 Capital account \longleftrightarrow Capital account balance

2.2 Financial account \longleftrightarrow Financial account balance

--- Capital and financial account ---

Example of Balance of Payment (units: million US dollars)

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3. Errors and Omission

From data correction errors, incomplete data collection due to several obstacles and problems such as tariff avoiding trade, trade in drug, money laundry, statistics of foreigner spending in Thailand etc.

4. International Reserve Account

- Shows changes of the country international reserve during one period resulting from the adjustment of difference between total receipt and payment of foreign exchange for current account and capital and financial account.
- International reserve consist of

Note: SDRs are potential claims on the freely usable currencies of IMF members.

SDRs are used as a unit of account by the IMF and several other international organizations.

Balance of payments (BOP)

Composition of BOP account

- 1. Current Account**
- 2. Capital and Financial Account**
- 3. Errors and Omissions**
- 4. International Reserve Account**

Balance of Payments

Current account + capital and financial account + errors and omissions > 0

→ _____ BOP → International reserve _____

Current account + capital and financial account + errors and omissions < 0

→ _____ BOP → International reserve _____

Example of Balance of Payment (units: million US dollars)

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9.3 Relationship between differences in saving and investment and current A/C



9.4 Foreign Exchange Rate

9.4.1 Meaning and importance of foreign exchange rate

Meaning: *Foreign exchange rate is the price of foreign currency compared to domestic currency*

For example, amount of Baht per one dollar = 30 Baht per 1 US\$

9.4 Meaning and importance of foreign exchange Rate

Why exchange rate is important?

(1) Exchange rate is essential for payment of goods and services between trading partners in different countries

(2) Changes in exchange rate affect the country export and import, international investment

Then, can affect current A/C balance and capital and financial A/C balance, production, employment, and national income

9.4.2 Demand for Foreign Exchange

- Demand for foreign exchange is a **derived demand** to buy foreign goods and services, to invest abroad, to donate money to other country etc.
- Factors affecting demand for foreign exchange: exchange rate and other factors affecting _____
in current A/C and capital and financial A/C

9.4.2 (a) Move along demand for foreign exchange curve

Exchange rate Δ



Demand for \$ Δ

Move along

Ex.

Exchange rate \uparrow

eg. Baht/\$ \uparrow

from 32 Baht / 1 \$
to 35 Baht / 1 \$



Baht _____

\$ _____



G&S import price



Import from US _____

(affect _____
side of BOP)

Demand for \$ _____



9.4.2 (b) Shift of demand for foreign exchange curve

Other factors rather than exchange rate that affect payment of foreign exchange (debit side) of BOP

affect



Demand for \$

Demand for \$ curve shifts

9.4.2 (b) Shift of demand for foreign exchange curve

Ex

Tendency of Thai people using US products ↑



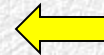
Import of US product _____



Demand for \$ _____



Demand for \$ shift to the _____



At the same level of ER D. for \$ _____

9.4.3 Supply of Foreign Exchange

- Supply of foreign exchange is a **derived supply** from selling goods and services abroad, from foreign countries invest in Thailand, from foreign countries donation to Thailand etc.
- Factors affecting supply for foreign exchange: exchange rate and other factors affecting _____ of current A/C and capital and financial A/C

9.4.3 (a) Move along supply for foreign exchange curve

Exchange rate Δ



Supply for \$ Δ

Move along

Ex.

Exchange rate \uparrow

eg. Baht/\$ \uparrow

from 32 Baht / 1 \$
to 35 Baht / 1 \$



Baht _____

\$ _____



G&S export price



Export to US _____

(affect _____
side of BOP)

Supply for \$ _____



9.4.3 (b) Shift of supply for foreign exchange curve

Other factors rather than exchange rate that affect receiving of foreign exchange (credit side) of BOP

affect



Supply for \$

Supply for \$ curve shifts

9.4.3 (b) Shift of supply for foreign exchange curve

Ex

Tendency of US
people using Thai
products ↑



Thai export to
US ↑



Supply for \$ _____



Supply for \$ shift
to the **right**



At the same level of
ER S. for \$ _____

9.4.4 Exchange rate system

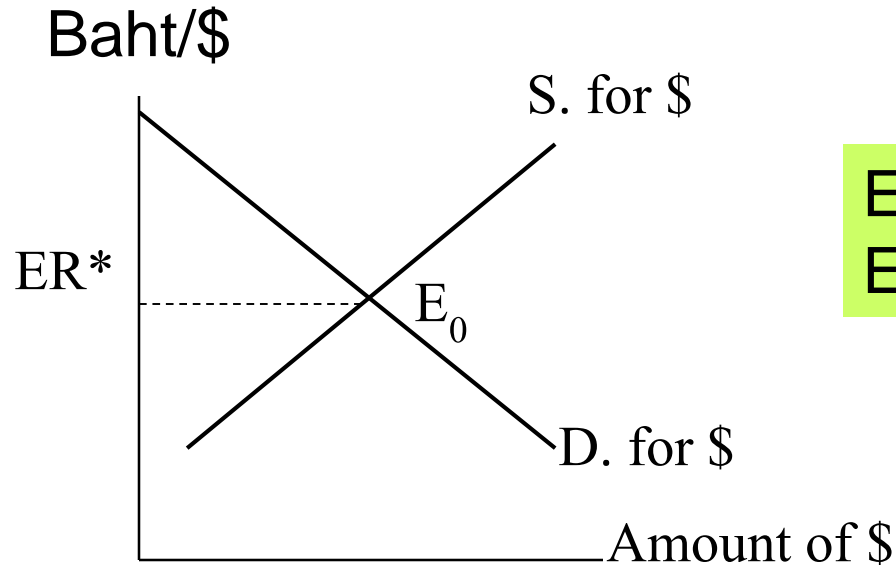
1. **Fixed (Pegged) Exchange rate System:** Exchange rates are determined by central bank (fix at a particular value)
2. **Adjustable Peg System:** Central bank fixes specific values for exchange rate, but explicitly recognizes that circumstances may arise in which it will change that value
3. **Managed Floating Exchange Rate:** The central bank seeks to have some stabilizing influence on the exchange rate, but does not try to fix it at some publicly announced value.
4. **Floating (market-determined) Exchange Rate System:** Exchange rates are determined by the unregulated forces of supply and demand.

9.4.4 Exchange rate system

| YEAR | | |
|----------------|---|------------------|
| 1963 | Original float | |
| 20 OCT 1973 | Fixed or Pegged exchange rate system (with \$US) | 20.80 Baht/ 1 \$ |
| 1978 | Basket of currency | Effective rate |
| 1984-1990 | Revise basket twice | Effective rate |
| 1984-1997 | Exchange Rate Equalization Fund (EEF) defend Baht value against \$US | |
| 2 July 1997 | Managed float exchange rate regime | |

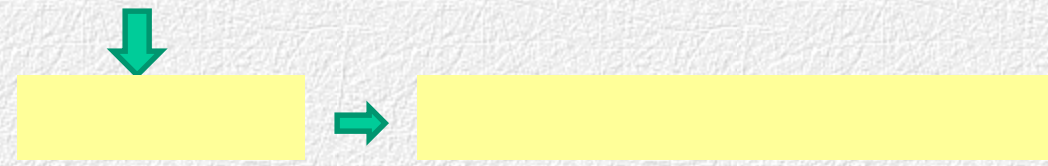
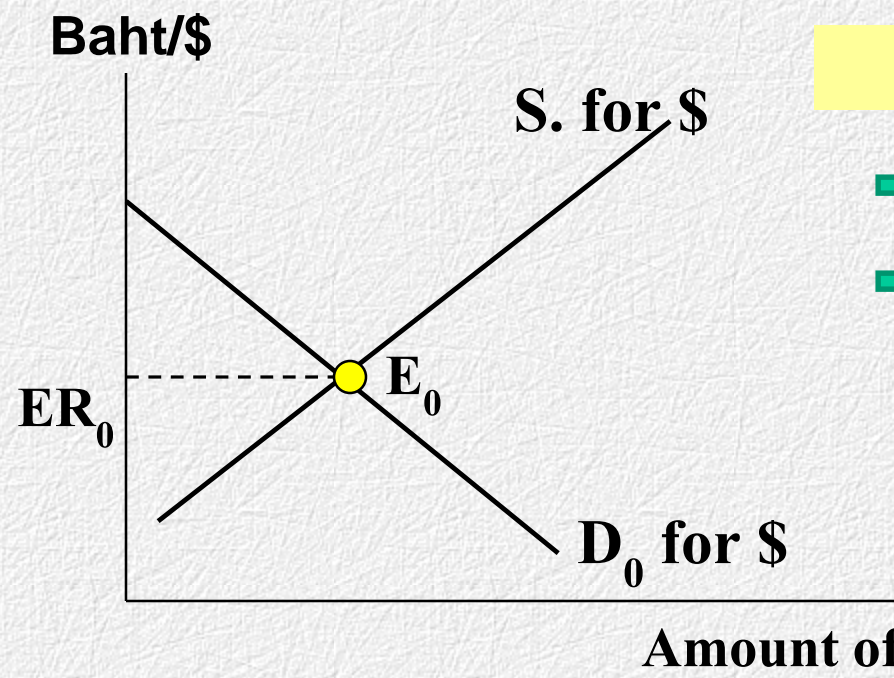
9.4.4 (a) Floating exchange rate system

is the exchange rates that are determined by market



ER^* is the Equilibrium Exchange Rate

If Thailand imports more US products



→ Equ^m changes from E₀ to E₁

→

Adjustment process from E₀ to E₁

At ER₀ →

Amount of \$ → Exchange rate has to

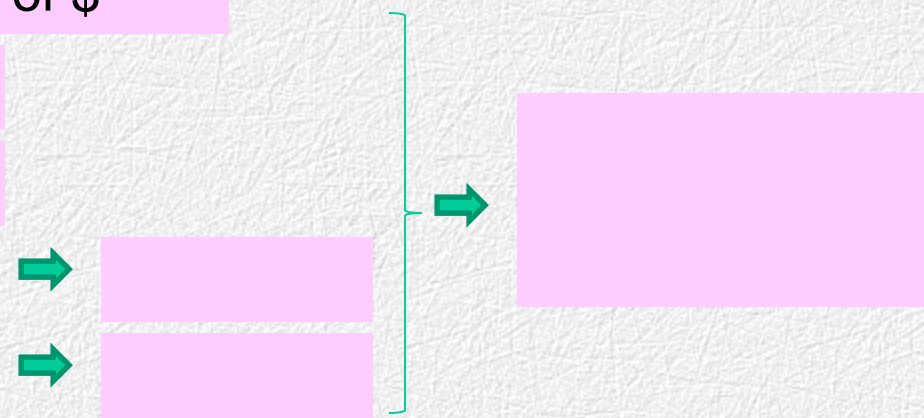
When ER → Value of Baht Value of \$

→ Import tends to →

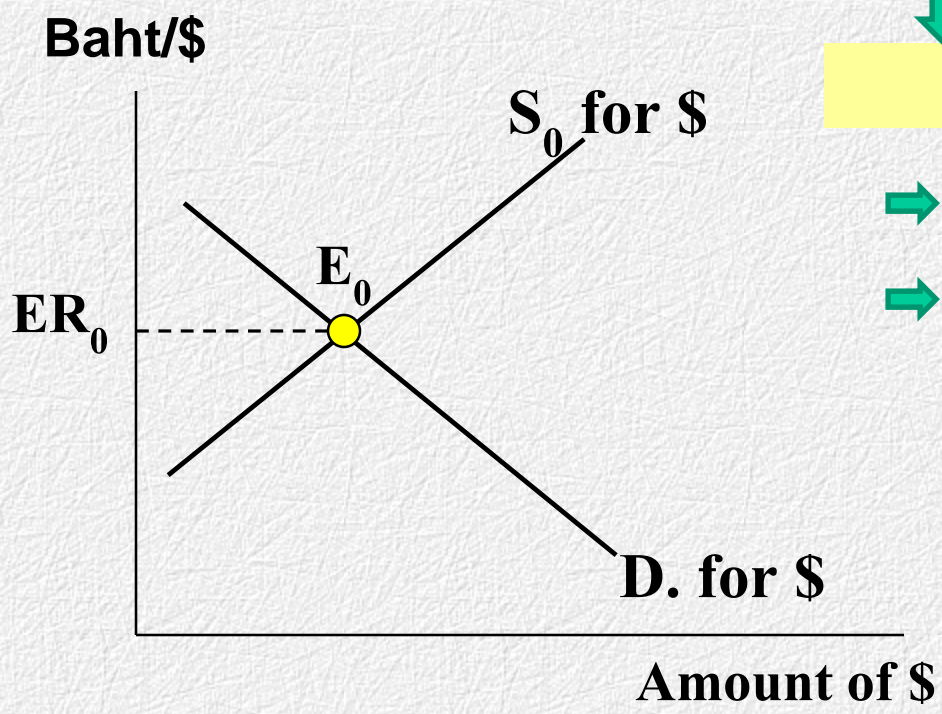
→ Export tends to →

→ Thai investors investment abroad →

→ Foreign investment in Thailand →



If foreigners invest more in Thai stock market



↓

→

→ Equ^m changes from E₀ to E₁

→

Adjustment process from E₀ to E₁

At ER₀ →

→

When ER → Value of Baht Value of \$

→ Import tends to →

→ Export tends to →

→ Thai investors investment abroad →

→ Foreign investment in Thailand →

} →

Example of the effects of other situations on Exchange Rate

1. Domestic price of export goods (such as rice)

Price of rice in Thailand in Baht ↑



Price of rice export



Effects on **S. of foreign currency** depends on **Price elasticity of foreign demand on Thai rice**

If foreign demand is **very elastic** to export price of Thai rice



The total amount of foreign spend on Thai rice ()



If foreign demand is **inelastic** to export price of Thai rice



The total amount of foreign sped on Thai rice ()



Example of the effects of other situations on Exchange Rate

2. Foreign price of import goods (such as machine)

Price of machine
in USA in \$



Price of
machine
import



Effects on **D. for foreign currency** depends on **Price elasticity of Thai demand on US machines**

If Thai demand is
very elastic to
import price of US
machine



The total amount
of Thailand spend on
US machine
()



If Thai demand is
inelastic to import
price of US
machine



The total amount
of Thailand spend on
US machine
()



Example of the effects of other situations on Exchange Rate

3. Changes in overall price level --please read Page 875 in Lipsey (2007)

- Case of equal inflation in both countries
- Case of inflation in only one country
- Case of inflation at unequal rates

Example of the effects of other situations on Exchange Rate

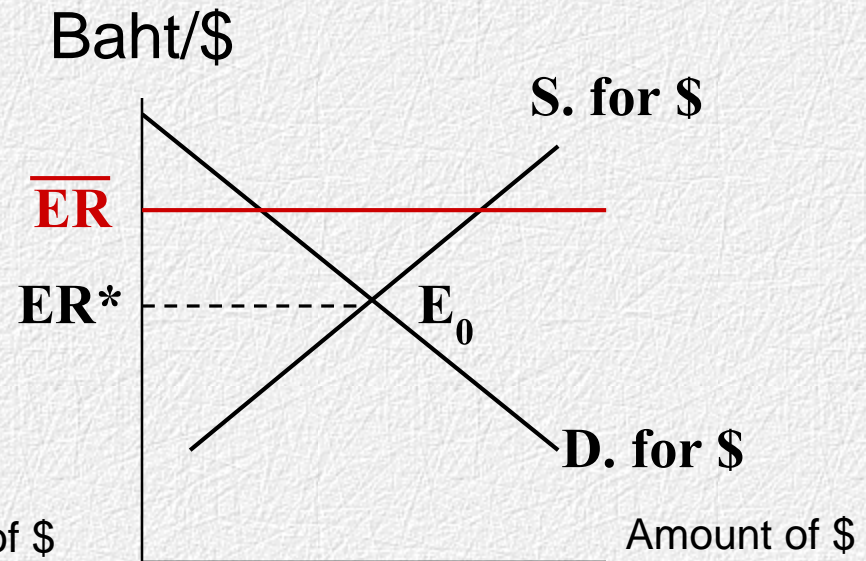
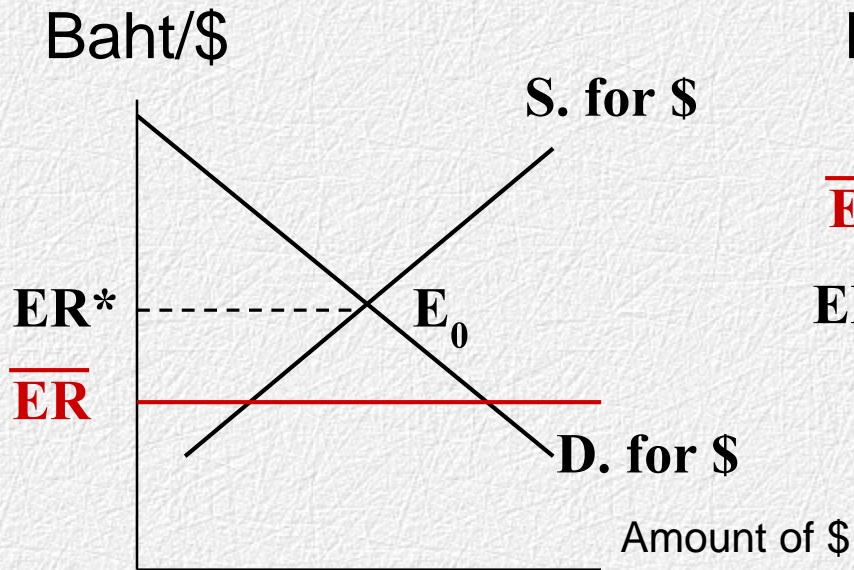
4. Interest rate

If interest rate in Thailand increase so that it is more than interest rates in other ASEAN countries

→ Financial capital flow to Thailand → →

→ Demand for foreign capital → →

9.4.4 (b) Fixed exchange rate system



$\overline{ER} < ER^* \Rightarrow$ Excess D. for \$
(At $ER = \overline{ER}$)

$\overline{ER} > ER^* \Rightarrow$ Excess S. for \$
(At $ER = \overline{ER}$)

Tools to control exchange rate

1. *International Reserve*

Excess D. for \$ → _____

Excess S. for \$ → _____

2. *Trade policy*

Excess D. for \$ →

Try to control _____
promote _____

Excess S. for \$ →

Try to control _____
promote _____

Tools to control exchange rate

3. Control foreign exchange

Excess D. for \$



Control import and promote export using financial instruments

Excess S. for \$



Control export and promote import using financial instruments