



# Understanding Economics

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2nd edition

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## Chapter 15

# **The Foreign Sector**

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# Chapter Objectives

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In this chapter, you will:

- be introduced to the balance-of-payments accounts, which include the current account and the capital account
- learn about exchange rates and how they are determined
- examine exchange rate systems and their evolution

# The Balance of Payments Accounts

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- The balance of payments accounts provide a summary of all transactions between Canadian residents and foreigners that involve exchanging Canadian dollars for some other currency
  - receipts (shown by a + sign) represent monetary inflows to the Canadian economy
  - payments (shown by a - sign) represent monetary outflows from the Canadian economy

# The Current Account (a)

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- The current account (which summarizes all foreign transactions associated with current economic activity in Canada and involving Canadian dollars) includes four types of transactions
  - trade in merchandise
  - trade in services
  - flows of investment income
  - transfers

# The Current Account (b)

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- A current account surplus occurs when this account's receipts outweigh payments while a current account deficit occurs when payments outweigh receipts
  - the merchandise balance of trade equals merchandise export receipts minus merchandise import payments
  - the balance of trade represents export receipts minus import payments for both goods and services

# Canada's Current Account (2000)

Figure 15.1, Page 374

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	Receipts (+) (Canadian \$ inflows)		(Canadian \$ billions) Payments (-) (Canadian \$ outflows)		Balance (net) (Canadian \$ inflows – Outflows)
Merchandise trade	417.7	-	363.2	=	+54.5
Trade in services	56.2	-	62.8	=	-6.6
Balance of trade (net exports)				=	+47.9
Investment Income	37.8	-	68.0	=	-30.2
Transfers	5.7	-	4.5	=	+1.2
Current account surplus (+) or deficit (-)				=	+18.9

# The Capital Account (a)

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- The capital account (which summarizes all foreign transactions of financial assets involving Canadian dollars) includes three types of transactions
- portfolio investment does not give the buyer controlling interest
- direct investment is financial investment that gives the buyer controlling interest
- other capital flows are connected with day-to-day fluctuations in bank deposits

# The Capital Account (b)

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- A capital account surplus occurs when this account's receipts outweigh payments so that Canadians make less foreign investments than foreigners make in Canada
- A capital account deficit occurs when this account's payments outweigh receipts so that Canadians make more foreign investments than foreigners make in Canada

# Canada's Capital Account (2000)

Figure 15.2, Page 376

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	Receipts (+) (Canadian \$ inflows)	(Canadian \$ billions) Payments (-) (Canadian \$ outflows)		Balance (net) (Canadian \$ inflows – Outflows)
Portfolio investment	18.8	- 62.8	=	-44.0
Direct investment	93.2	- 61.7	=	+31.5
Other capital flows	5.0	- 3.6	=	-1.4
Capital account surplus (+) or deficit (-) (excl. official reserves)				<u>-11.1</u>

# Balance-of-Payments Surpluses and Deficits

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- A balance-of-payments surplus is a positive net balance showing that receipts outweigh payments on the current and capital accounts combined
- A balance-of-payments deficit is a negative balance showing that payments outweigh receipts on the current and capital accounts combined

# Canada's Balance of Payments (2000)

Figure 15.3, Page 378

(Canadian \$ billions)

	Balance (net)
1. Current account	+1.89
2. Capital account	-11.1
3. Statistical discrepancy	-2.3
Balance-of-payments surplus (+) or deficit (-)	+5.5
4. Changes in official reserves	-5.5

# Changes in Official Reserves (a)

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- The change in official reserves
  - shows the effect of the Bank of Canada's buying and selling of foreign currency on the flow of Canadian dollars
  - is equal in value (and opposite in sign) to the surplus or deficit noted in the balance of payments

# Changes in Official Reserves (b)

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- A negative change in official reserves indicates that the Bank of Canada sold Canadian dollars (creating an outflow) by buying foreign currency
- A positive change in official reserves indicates that the Bank of Canada bought Canadian dollars (creating an inflow) by selling foreign currency

# Exchange Rates

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- The exchange rate is the value of one nation's currency in terms of another currency
  - Two exchange rates can be used to compare any two currencies (e.g. the Canadian and U.S. dollars)
  - Canadian dollars to buy US\$1 = (1/U.S. dollars to buy CDN\$1)

# Exchange Rates and Prices

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- The impact of exchange rates on prices can be illustrated using Canadian and U.S. dollars
  - a product's U.S. dollar price = the Canadian dollar price x U.S. dollars to buy CDN\$1.00
  - a product's Canadian dollar price = the U.S. dollar price x Canadian dollars to buy US\$1.00

# The Demand for Canadian Dollars

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- The demand for Canadian dollars is the relationship between the price of a Canadian dollar and the quantity demanded in exchange for another currency (e.g. the U.S. dollar)
- the demand curve's negative slope is determined by foreign export buyers since the higher Canadian \$ means that Americans find Canadian products more expensive and so they buy fewer of them

# The Supply of Canadian Dollars

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- The supply of Canadian dollars is the relationship between the price of a Canadian dollar and the quantity supplied in exchange for another currency (e.g. the U.S. dollar)
- the supply curve's positive slope is determined by Canadian import buyers since a higher Canadian \$ means that Canadians find American products cheaper and so they buy more of them

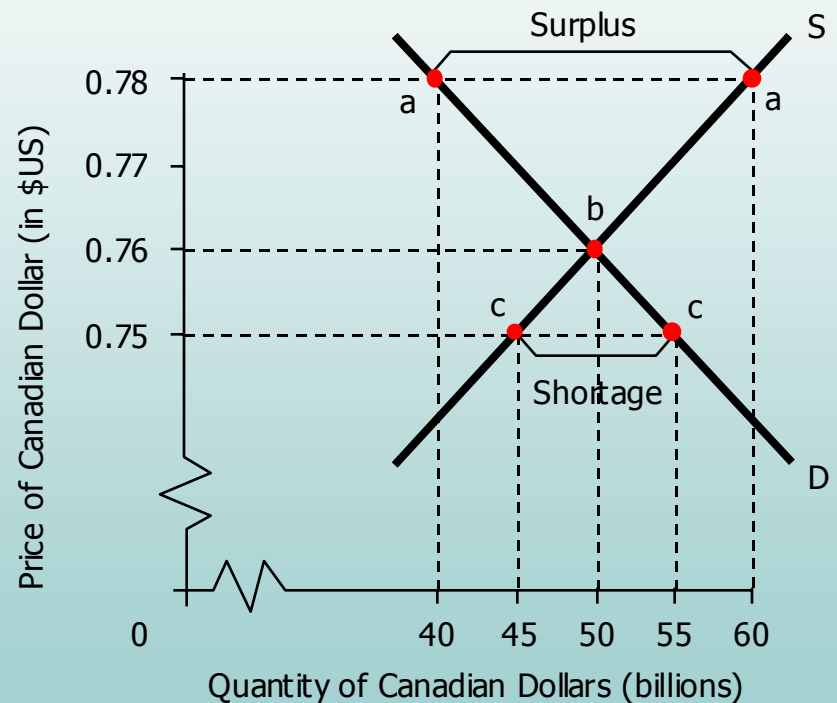
# A Foreign Exchange Market

Figure 15.4, Page 381

## Canadian Dollar Demand and Supply Schedules

Price of Cdn. Dollar (in \$US)	Quantity of Cdn. Dollars Supplied (\$ billions)	Quantity of Cdn. Dollars Demanded (\$ billions)	(surplus (+) or shortage (-))
US\$0.78	60	40	+20
US\$0.76	50	50	0
US\$0.75	45	55	-10

## Canadian Dollar Demand and Supply Curves



# Appreciation and Depreciation

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- When an exchange rate is allowed to vary foreign exchange markets will reach equilibrium where demand and supply are equal
- A currency appreciates when its price rises relative to the price of another currency
- A currency depreciates when its price falls relative to the price of another currency

# Changes in Exchange Rates (a)

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- Four factors change exchange rates
  - price differences
    - a rise in A's prices relative to B's decreases demand and increases supply of A's currency and lowers its price in terms of B's currency (and vice versa)
  - product demand
    - a rise in demand for A's products increases demand and decreases supply of A's currency and raises its price in terms of other currencies (and vice versa)

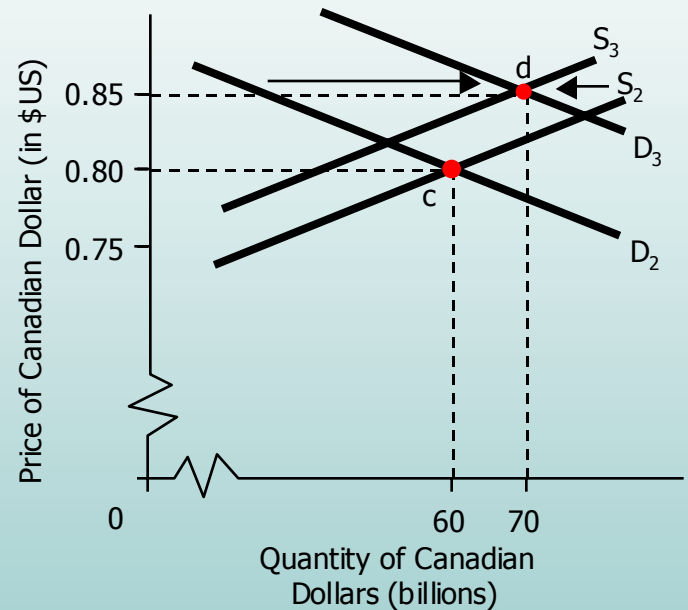
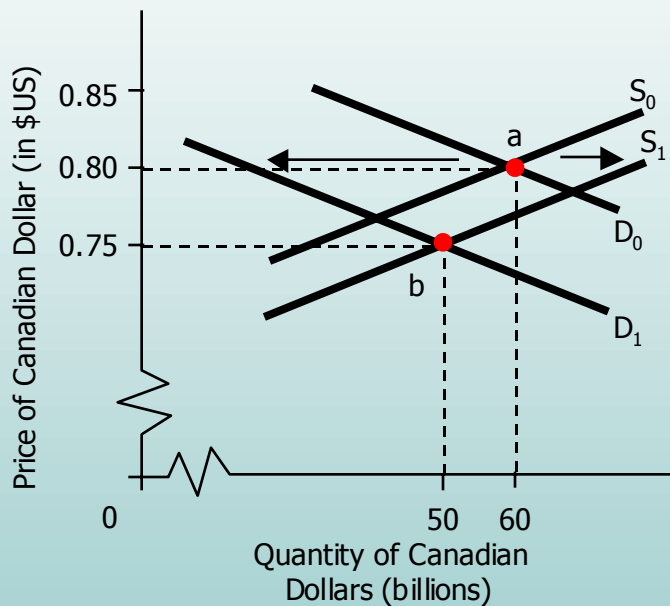
# Changes in Exchange Rates (b)

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- interest rates
  - a rise in A's interest rate relative to B's increases demand and decreases supply of A's currency, raising its price in terms of B's currency (and vice versa)
- speculation
  - signs that A's currency will increase relative to B's currency means an immediate increase in demand and decrease in supply of A's currency and raises its price in terms of B's currency (and vice versa)

# Exchange Rate Changes

Figure 15.5, Page 383



# Exchange Rate Systems (a)

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- Flexible exchange rates are allowed to move freely to their equilibrium levels
- Fixed exchange rates are set or “pegged” to a certain value by each country’s government
  - a target exchange rate below equilibrium creates an excess demand for the currency and a balance-of-payments surplus

# Exchange Rate Systems (b)

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- a target exchange rate above equilibrium creates an excess supply for the currency and a balance-of-payments deficit
- A low fixed exchange rate stimulates exports but brings the danger of inflation
- A high fixed exchange rate puts downward pressure on inflation as well as on real output and employment

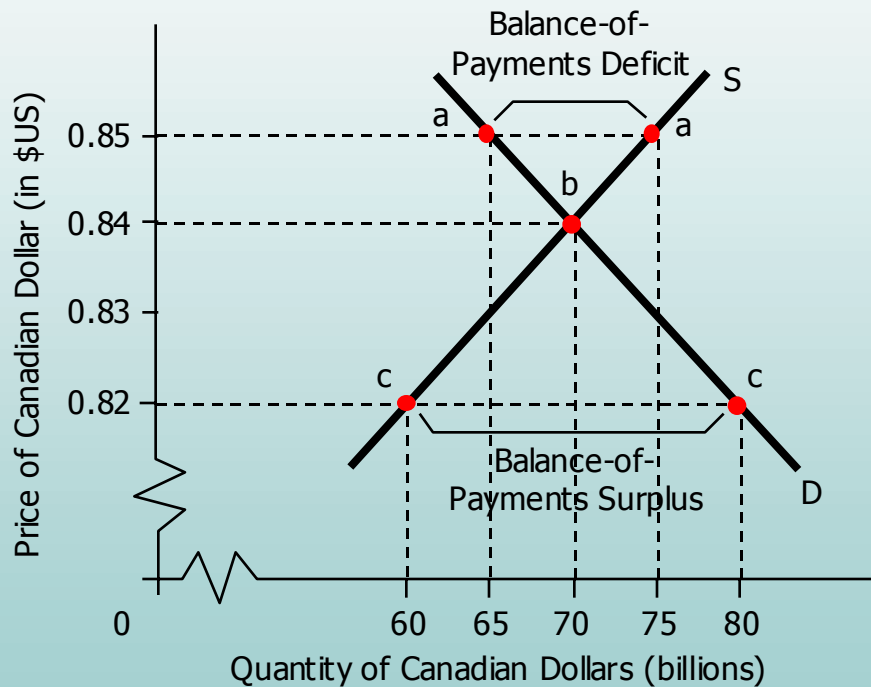
# Fixed Exchange Rates

Figure 15.6, Page 386

Canadian Dollar Demand and Supply Schedules

Price of Canadian Dollar (in \$US)	Quantity Supplied (\$ billions)	Quantity Demanded (\$ billions)	Balance-of-Payments (surplus (+) or shortage (-))
US\$0.85	65	75	-10
US\$0.84	70	70	0
US\$0.82	80	60	+20

Canadian Dollar Demand and Supply Curves



# The Evolution of Exchange Rate Systems (a)

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- There have been three major exchange rate systems used by industrialized countries during the past century
  - the gold standard (1879-1934) meant that each country set the value of its currency in terms of an amount of gold
  - the Bretton Woods System (1945-1971) was based on adjustable fixed exchange rates

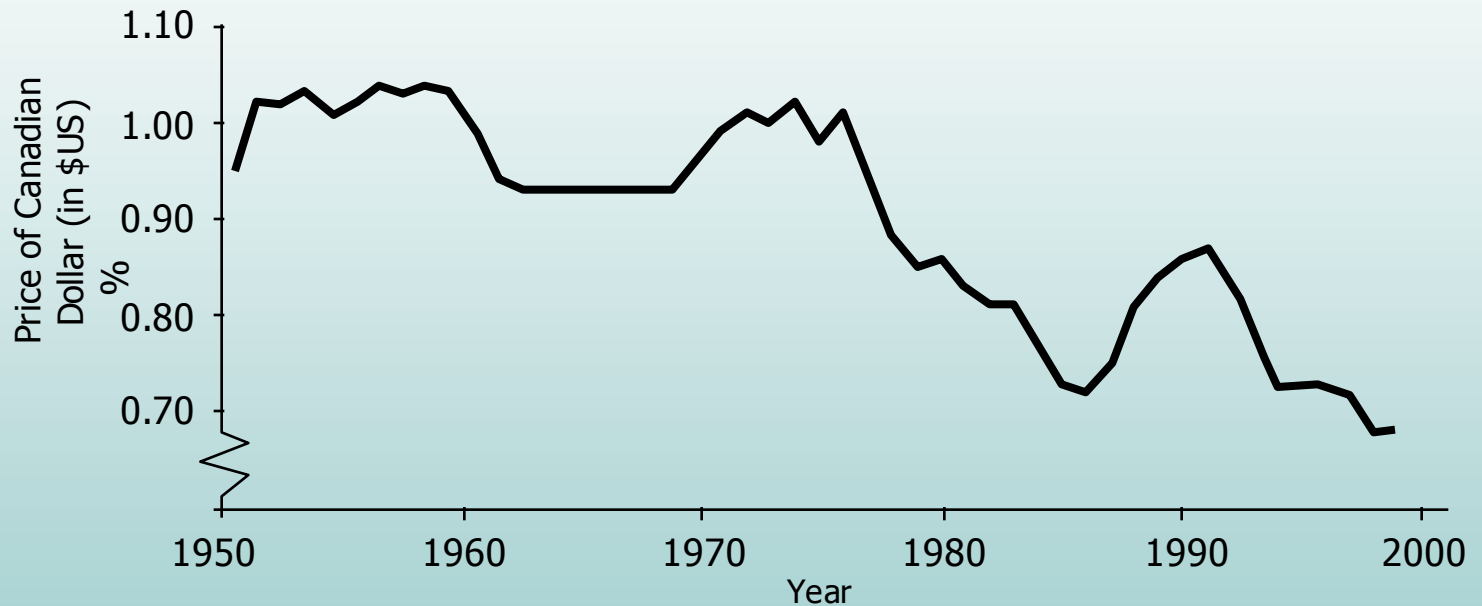
# The Evolution of Exchange Rate Systems (b)

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- the managed float (1971-the present) is a flexible exchange rate system that sometimes involves short-term government intervention

# Canadian Exchange Rates

Figure 15.7, Page 389



# Sharing Prosperity (a)

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- According to Canadian economist Judith Maxwell, globalization and new technologies have created two contradictory trends
  - more prosperity, when incomes are viewed in average terms
  - more polarization of incomes

# Sharing Prosperity (b)

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- Maxwell also suggests that globalization and new technologies create countervailing forces
  - global interdependence
  - a quest for community
- Governments must take on these challenges, says Maxwell, which means a bigger role for the public sector in future years

# Sharing Prosperity (c)

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- Governments can help by
  - balancing short term economic goals with long term social goals
  - investing in shared public spaces, citizen participation and programs that promote trust within communities
  - mobilizing society to deal with those left behind by current economic trends
  - designing laws and structures (domestic and international) based on shared standards and guidelines

# International Finance in Canada (a)

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- At one time, a capital account surplus and current account deficit were typical for Canada.
- This reflects the fact that Canadians' foreign liabilities exceed Canadians' foreign assets.

# Canada's Foreign Assets and Liabilities (1998) Figure A, Page 396

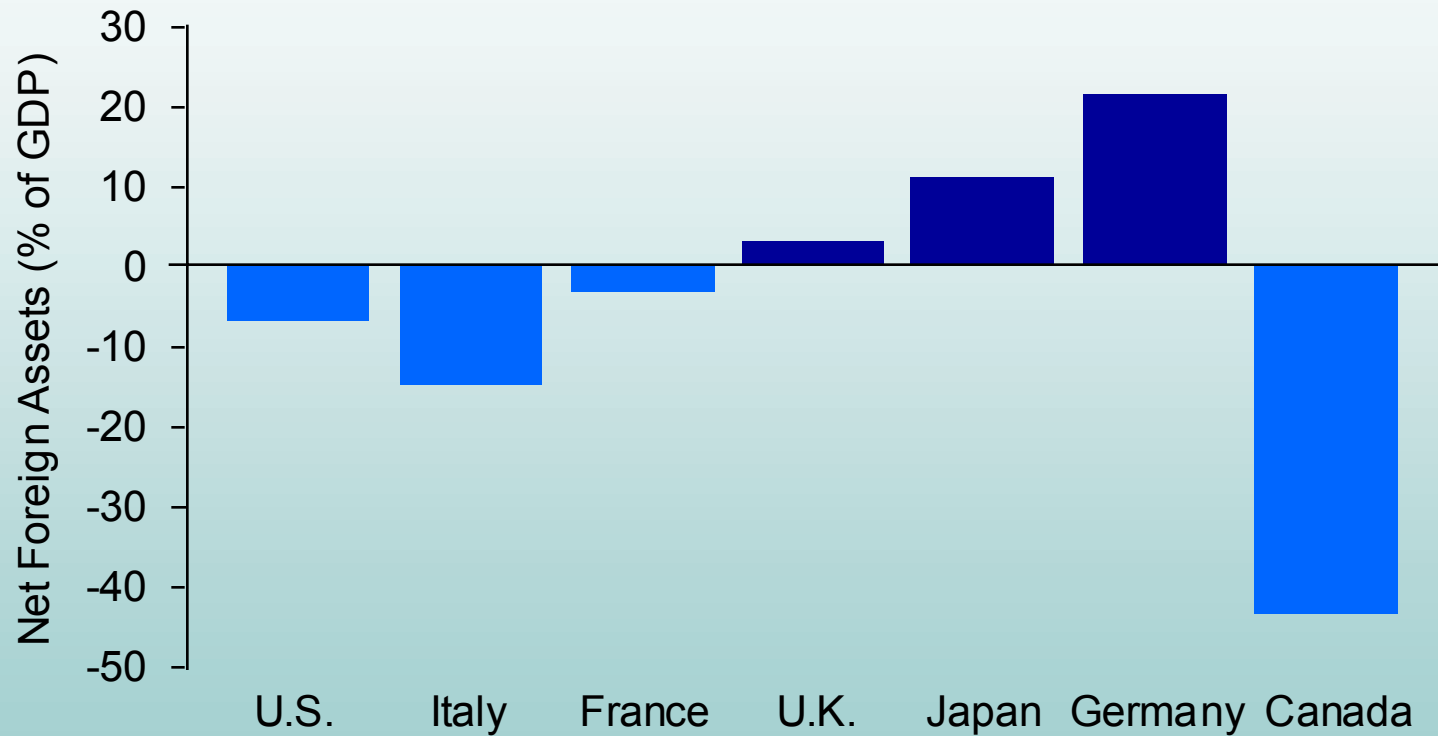
Foreign Assets			Foreign Liabilities		
	\$ Billions	% Foreign Assets		\$ Billions	% Foreign Assets
Stocks	349	53.9	Stocks	269	27.7
Bonds	35	5.4	Corporate Bonds	141	14.5
Government Reserves and loans	86	13.3	Federal Bonds	88	9.1
Other	177	27.4	Provincial Bonds	124	12.7
			Municipal and government enterprise bonds	57	5.9
			Other	292	30.1
<b>Total foreign Assets</b>	<b>647</b>	<b>100.0</b>	<b>Total foreign liabilities</b>	<b>971</b>	<b>100.0</b>

# International Finance in Canada (b)

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- Canada's net foreign assets are its foreign assets minus its foreign liabilities.
- For 1998, net foreign assets were -\$324 billion, which means that we are net foreign borrowers by this amount.
- Canada's net foreign borrowing as a percentage of GDP is high by international standards.

# Net Foreign Assets as a Percentage of GDP (1992) Figure B, Page 397



# Foreign Control of the Canadian Economy (a)

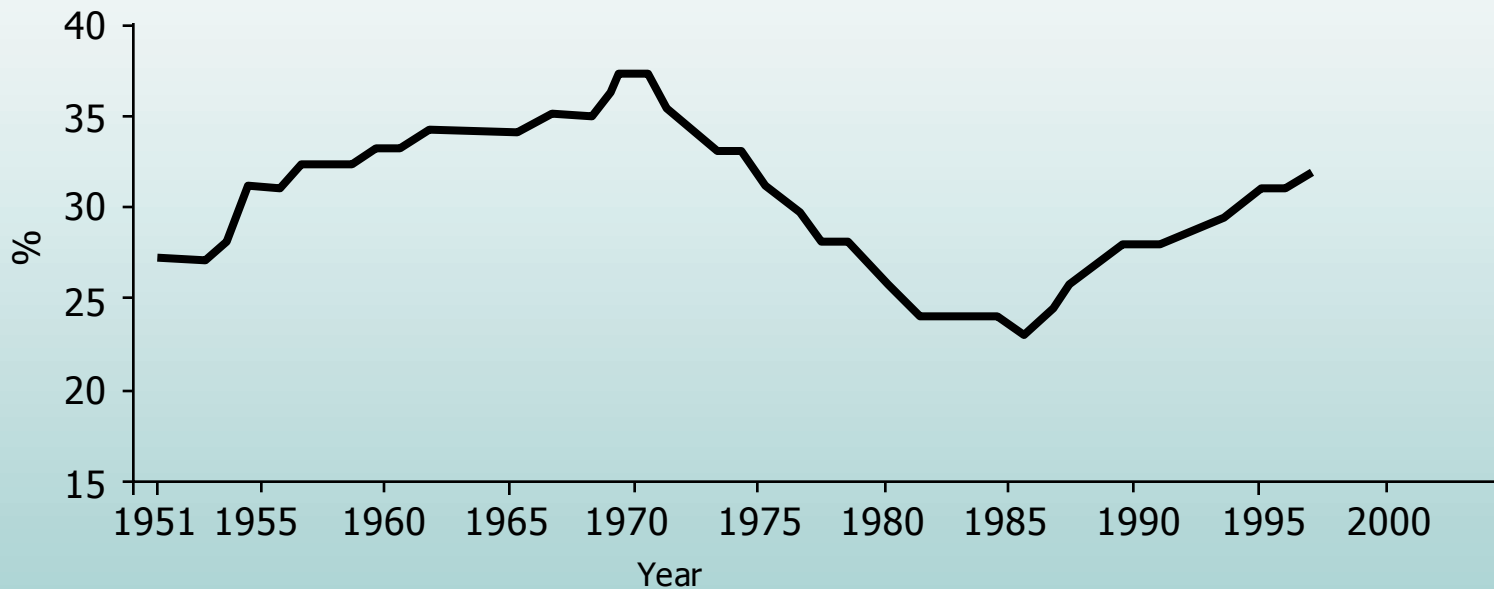
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- Much of the controversy over Canada's net foreign liabilities relates to foreign direct investment, which involves controlling interest in Canadian companies
- After falling the 1970s and early 1980s, the share of foreign control of capital employed in nonfinancial industries in Canada has been rising.

# Share of Foreign Control of Capital Employed in Nonfinancial Industries in Canada

Figure C, Page 398

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# Foreign Control of the Canadian Economy (b)

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- Foreign control in the Canadian economy is most prevalent in the chemical industry as well as machinery and equipment.
- Foreign control is least prevalent in construction and communications.

# Foreign Control in Nonfinancial Industries (1997)

Figure D, Page 398

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## Industry Assets that Are Foreign-Controlled (%)

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Chemicals, chemical products, and textiles	71.1
Machinery and equipment	43.7
Wood and paper	31.7
Energy	19.8
Metallic minerals and metal products	19.7
Services	16.1
Construction and related activities	13.4
Communications	10.2
Nonfinancial industries as a whole	26.7

# Foreign Control of the Canadian Economy (c)

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- The debate over foreign direct investment is closely tied to the role of transnational corporations, which play a major role in the Canadian economy.

# Largest Foreign-Owned Companies in Canada

Figure E, Page 399

Company	Revenue (\$ millions)	% Foreign- Owned	Parent
General Motors of Canada Ltd.	39 678	100	General Motors (U.S.)
Ford Motor Co. of Canada Ltd.	29 977	100	Ford Motors (U.S.)
Daimler Chrysler Canada Inc.	22 445	100	DaimlerChrysler (U.S.)
Imperial Oil Ltd.	9 071	82	Exxon-Mobil (U.S.)
Imperial Tobacco Canada Ltd.	9 066	100	British Imperial Tobacco (U.K.)
Sears Canada	6 131	55	Sears, Roebuck (U.S.)
Honda Canada Inc.	5 961	100	Honda (Japan)
Shell Canada Inc.	5 286	80	Shell (Netherlands)
Canada Safeway Ltd.	4 942	100	Safeway (U.S.)
Canadian Ultramar Co.	4 392	100	Ultramar Diamond Shamrock (U.S.)

# Foreign Control of the Canadian Economy (d)

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- There are two main benefits of foreign ownership
  - it increases the overall stock of capital assets, raising productivity and living standards
  - to the extent that transnational corporations concentrate production in those countries where it can be carried out most efficiently, they help cut production costs and prices

# Foreign Control of the Canadian Economy (e)

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- There are three main drawbacks of foreign ownership
  - it increases Canada's overall foreign liabilities
  - it reduces Canadian economic sovereignty
  - it tends to reduce research and development expenditures in Canada, since these expenditures are often concentrated in the head-offices of transnational corporations



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## Chapter 15 **The End**

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