Chapter 31

1. How would each of the following transactions affect UK *NCO* (net capital outflow)? Does the transaction affect direct investment or portfolio investment?

a. UK bank Barclays buys shares in South African bank Absa.

b. UK firm JCB buys steel from a Japanese manufacturer to use in the production of its diggers, excavators and trucks.

c. French car manufacturer Peugeot expands its plant in Coventry in England.

d. An American investment fund buys shares in UK aerospace and defence firm BAE Systems.

e. UK oil company BP builds a plant in Venezuela.

2. Suppose a resident of Portugal buys a set of golf clubs from a UK manufacturer using euros.

a. If the UK manufacturer holds on to the euros, does UK *NX* = *NCO* in this case? Explain.

b. Suppose the UK manufacturer uses the euros to help build a factory in Portugal. Does *NX* = *NCO* in this case? Explain. What kind of foreign investment is this?

c. Suppose the UK manufacturer uses the euros to buy shares in a Portuguese company. Does *NX* = *NCO* in this case? Explain. What kind of foreign investment is this?

d. Suppose the UK manufacturer uses the euros to buy leather made in Portugal. Does NX = NCO in this case? Explain.

3. Suppose the nominal exchange rate is 1,000 Chilean pesos per UK pound. Further, suppose the price of a bushel of UK wine is £5 per bottle and the price of a bottle of Chilean wine is 7,500 pesos.

a. What is the real exchange rate between Chile and the UK in terms of wine?

b. Does a pound have purchasing power parity in the UK and Chile? Explain.

c. Is there a profit opportunity that you could exploit with arbitrage? Where would you buy and where would you sell?

d. If the nominal exchange rate stayed the same, what should happen to the price of wine in the UK and Chile? Explain.

e. Suppose prices move as you have suggested in part (d). What has happened to the real exchange rate?

4. Suppose the price of a pair of Levi's jeans is €40 in Spain and 400 pesos in the Philippines.

a. What is the nominal peso/euro exchange rate if purchasing-power parity holds?

b. Suppose the central bank in the Philippines is politically pressured to double the country's money supply, which doubles the price level in the Philippines. If purchasing-power parity holds, what is the new peso/euro exchange rate? Did the peso appreciate or depreciate?

c. Suppose the ECB now doubles the Eurozone money supply, which doubles the price level in the Eurozone, including, of course, Spain. If purchasing power parity holds, what is the new value of the peso/euro exchange rate? Did the euro appreciate or depreciate?

d. Compare your answer to part (a) and part (c). What has happened to the exchange rate? Why?