1. (2 points) Is it possible for a country to have a current account surplus at the same time and has deficits in balance of payments? In this case, does this country experience capital inflows or outflows? Explain your answer using hypothetical figures.

**ANSWER** Yes. Balance of Payments (BOP) is the sum of current account (CA), capital account (KA) and financial account (FA).

\[
\text{BOP} = \text{CA} + \text{KA} + \text{FA}
\]

When current account is in surplus and the sum of capital account and financial account is in deficits, we can have deficits in balance of payments. In this case, this country experiences capital outflows. For example, \(\text{CA} = \$100\text{ billion}, \text{KA} = -\$10\text{ billion}, \text{FA} = -\$100\text{ billion}\), then \(\text{BOP} = -\$10\text{ billion}\).

2. (2 points) The nation of Pecunia had a current account deficit of \$1 billion and a nonreserve financial account surplus of \$500 millions in 2002. What was the balance of payments (BOP) of Pecunia in that year? What happened to the country’s net foreign assets?

**ANSWER** Its BOP = \(-\$1000 + \$500 = -\$500\) million. The country’s net foreign assets fall as much as its current account deficit, which is \$1 billion.

3. (2 points) Following Question 2, assume that foreign central banks neither buy nor sell Pecunian assets. How did the Pecunian central bank’s foreign reserves change in 2002? How would this official intervention show up in the balance of payments accounts of Pecunia?

**ANSWER** From Question 2, the private capital flows finance only half of the current account deficits. The central bank then has to finance half of the current account deficits by selling its foreign exchange reserves. The official intervention will appear as an official capital inflow in the ”reserve financial account.”
4. (2 points) How would your answer to Question 3 change if you learned that foreign central banks had purchased $600 million of Pecunian assets in 2002?

**ANSWER** In this case, the total capital inflows without the Pecunian central bank is $1.1 billion. Then, \[ \text{BOP} = -1000 + 500 + 600 = 100 \text{ million}. \] In this case, the capital inflows exceed the current account deficit by $100 million. This amount will increase the foreign exchange reserves of the Pecunian’s central bank.

5. (2 points) Why a government might be concerned about a large current account deficit or surplus? Why might a government be concerned about its official settlements balance?

**ANSWER** A large current account deficit or surplus is not sustainable in the long run. A deficit can be justified when it results from borrowing to improve productive capacity in order to increase national income. However, for any period of current account deficit there must be a corresponding period in which spending falls short of income, or current account surplus, in order to pay the debts back to foreign lenders. A current account surplus also means that the country is financing a debt for foreigners, so the analogy of debt repayment applies also to the foreign borrowers.

As we see in Questions 2 and 3, the official settlements balance reflects the official intervention carried by the central bank. When its size is too large, it implies that the central bank becomes very active. In particular, when it is a large negative number, it means the central bank faces a large loss of foreign exchange reserves. This can limit the ability of the central bank to intervene in the future.