Lecture : Balance of Payments

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Definition

Balance of payments (BOP) accounts refer to the system of accounts kept by each country that tracks payments to and receipts from nonresidents by residents of the country.

BOP represent flows (quantities measured per unit of time, e.g. month, quarter, annual). (Stocks refer to quantities measured at fixed points in time).

Residents are economic agents who normally reside in a country (even if they are temporarily abroad such as tourists, diplomats, migrant workers or students).

Consider these two examples
- US affiliates in Thailand
- Myanmar workers in Thailand

BOP accounts obey the basic rule of double-entry bookkeeping (debit and credit)

BOP is important in the macroeconomic policy making. It is interconnected with exchange rate regime and international foreign reserves

Imbalances in BOP (either deficit or surplus) is one of key economic signals taken into consideration by business decision.

Transactions in BOP

1. Exports and imports of goods
2. Exports and imports of services: Services that are traded between domestic and foreign residents include tourism, transportation (both passenger and freight), royalties and licenses, and insurance and financial services.
3. Receipts and payments of investment income (interest and profits): Investments income is the compensation that owner of capital receives for the use by someone else of the services of that capital. Income receipts and income payments

4. Unilateral transfers (Gift/Aid/ Donation)
5. Capital and financial accounts-sales and purchases of physical assets and financial claims by domestic residents to foreign residents.

   Domestic and foreign residents are classified into private agents, central bank (Monetary authority) and governments. (Elaborate more)

6. Statistical Discrepancy-errors and omissions: Data in the accounts are collected from different sources, measurement errors (including unrecorded transactions) and timing problems.

Further Discussion on Capital and Financial Account

- Capital and financial account consist of capital account and the financial account.
- Capital account is a relatively minor item, recording unrequited transfers of existing assets (rather than of currently produced goods and services) as well as transactions involving the purchase or sale of non-produced, nonfinancial assets such as patents, frachises, or leases that are not accounted themselves elsewhere.
- Majority of transactions are recorded in financial account. In many circumstance, capital and financial account is referred to capital account for brevity. It actually reflects transactions in financial account.

- Sales of financial claims (*Assets*) to foreign residents by domestic residents are called capital inflows. (+ sign).
- Purchases of financial assets (*Liability*) by domestic residents from foreign residents are called capital outflows (- sign).

Four types of financial transactions;

1. Foreign Direct Investment (FDI): when purchases of equity by foreigners transfer direct control over an enterprise to the buyers of that equity. Conventionally, purchases of equity associated with ownership of at least 10 % of the market capitalization are treated as FDI.

2. Portfolio Flows: purchase or sale without entailing control of domestic firms (debt and equity).

3. Financial Derivatives- financial instruments that are linked to other specific financial instruments, indictors or commodity and which specific financial risks can, in their own right, be traded in financial markets, e.g. currency options.

4. Other investments- public sectors and unclassified items.

Sub-accounts

1. Balance on merchandise trade (Trade Balance)
2. Balance on goods and services (1+ Service Balance)
3. Balance on goods, services, and net investment income (NINV)(2+net investment income)
4. Current Account- (3+unrequited transfers).
5. Capital and Financial Account
6. Overall Balance = 4+5+Error and omissions
7. Official Reserve Settlements Balance (Reserves and related items) = - Overall Balance

Official Reserve Settlements (ORS) Balance (Δ Foreign Exchange Reserves)

- ORS = Net change in official reserve assets (net increase in financial claims on domestic residents held by foreign central banks minus the net increase in claims on foreign residents held by the domestic central bank).
- Negative (positive) sign means an increase (decrease) in the domestic's central bank foreign assets.

- Generally, central banks hold foreign exchange reserves in order to have the option to engage in foreign exchange market intervention (to buy or sell their own currencies in the foreign exchange market). Why?
- Foreign exchange reserves are usually maintained in the form of vehicle currencies and gold, such as US dollar. (*Note: traders in the FX market tend to quote prices in terms of a small number of currencies known as international moneys or vehicle currencies).* In 2004, 89 per cent of all foreign exchange transactions around the world involved US dollars (Bank of International Settlements-*BIS*, 2005).

Is it possible for a given country always having zero BOP?

- It depends on the country's exchange rate regime.
- In theory, BOP under free floating exchange rate regime (where exchange rate is purely determined by demand and supply) is also zero.
- Under the fixed exchange rate regime (regardless the extent to which exchange rate is fixed), BOP can be positive or negative.

- BOP surpluses (deficits) mean the domestic's central bank must acquire (sell) net claims on the rest of the world and thus accumulate (lose) net foreign exchange reserves.
- What would happen when Country A with a fixed exchange rate regime experiences successive BOP deficit?
- Are you still interested to hold local currency of Country A?

Does BOP composition matter?

- Are two countries having same amount of BOP different in the view of economic analyst?

Country	CA	CAP	BOP
A	+20	-10	10
B	-30	+40	10

- What is the major difference between current account and capital account?

What does it mean when a country experiences current account deficit?

- Current account indicates to a certain extent ability to earn net foreign exchange and accumulate wealth (Competitiveness).
- Foreign exchange earning through current account is not obligation hence stability.
- According to National Income Account (NIA), current account is saving-investment gap.

Current Account and Saving Investment Gap

What is the meaning of saving-investment gap at the firm level?

- Firms might see some market potentials and need to invest beyond their own saving.
- If the project is well developed, firms would borrow today and pay back their loan later (tomorrow).
- Can it be generalized to the country level?

Is it good for a country to experience capital inflows?

- FDI is more preferable than other forms of capital flows (OFCF), after the Asian financial crisis in the late 1990s.
- FDI not only brings in financial resources but also advance technology. (FDI becomes main research topic in economic development).
- OFCF (Hot Money!) was highlighted as the cause of the Asian financial crisis so that control measures toward OFCF become more popular.

- Experience of Chile, Malaysia, and China supports the role of capital control on macroeconomic stability. Nowadays, the control is imposed in several countries either implicitly or explicitly.
- IMF argues for the further disaggregation of OFCF, based on cross-country experiences. There are potential gains from portfolio inflows in economic development.

  See details in Kose, M.A., E. Prasad, K. Rogoff, and S. Wei (2006), 'Financial Globalization: A Reappraisal', IMF Working Paper, WP 06/189.

- The recent debate focuses on how to regulate the use of capital controls ;

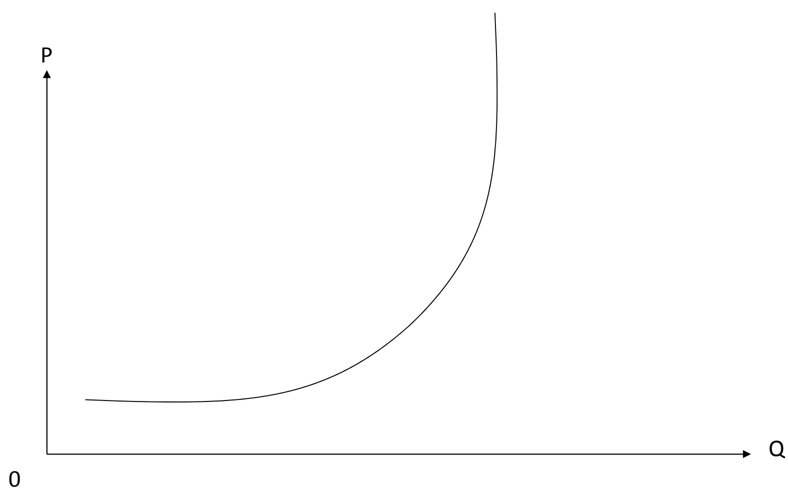
  IMF (The Free Capital Flow Enthusiasm)-- last resources

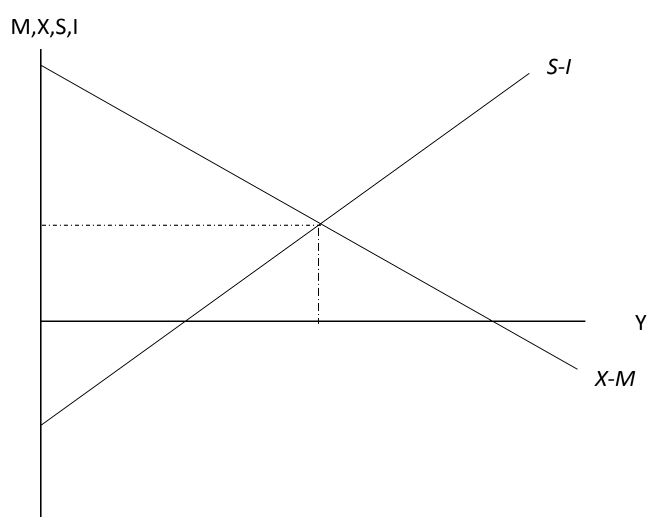
  ADB and G20– set conditions to justify the use (e.g. countries experiencing successive current account surplus are not eligible to use capital controls).

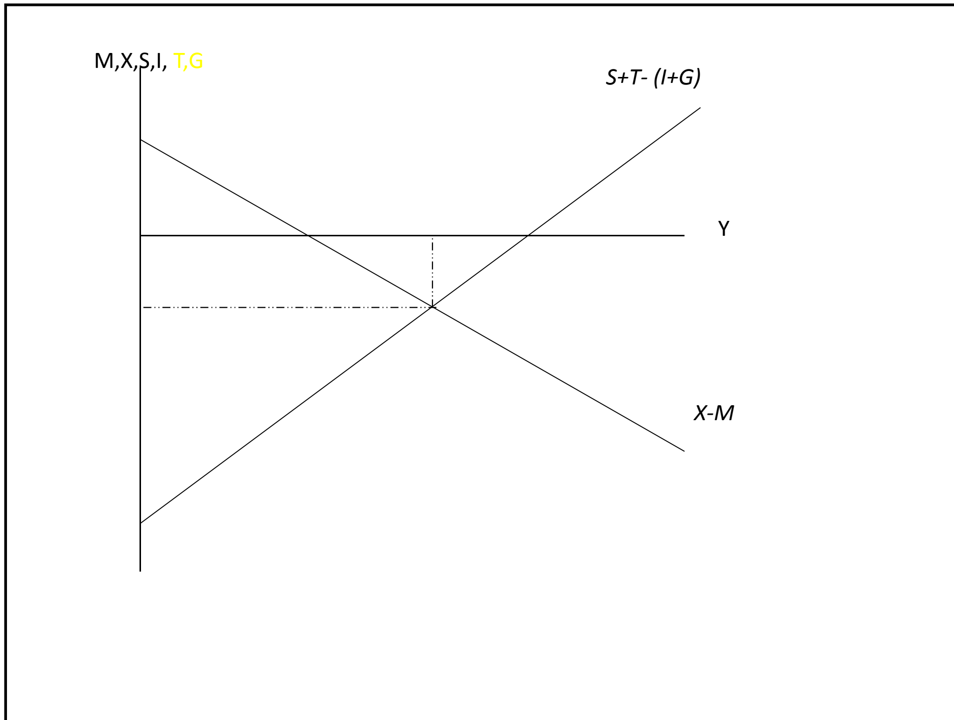
A Simple Model
Foreign Trade and National Income

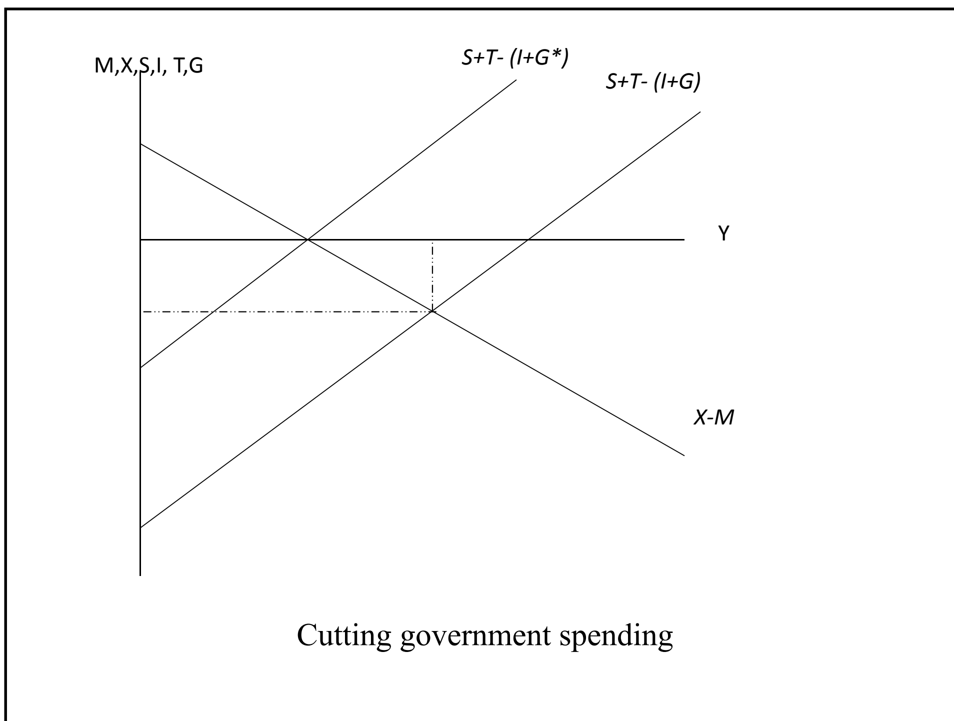
- Assume that the economy is under the Keynesian world where it is experiencing excess capacity.
- What is the implication of presence of excess capacity?

Aggregate Supply and Keynesian World









Cutting government spending

Use the diagram to examine the impact on the current account balance of the following circumstances

- Government cut tax as well as promote spending.
- Government impose compulsory saving on individuals.
- After flooding, damaged machines from the flooding are replaced.

? Can we infer the impact on the current account on changes in exchange rate?