

The Balance of Payments

3

Chapter Three

Chapter Objective:

This chapter serves to introduce you to the balance of payments. How it is constructed and how balance of payments data may be interpreted.

OUTLINE

- Balance of Payments Accounting
- Balance of Payments Accounts
 - The Current Account
 - The Capital Account
 - Official Reserves Account
 - Statistical Discrepancy
- The Balance of Payments Identity

BALANCE OF PAYMENTS ACCOUNTS

- The balance of payments accounts are those that record all transactions between the residents of a country and residents of all foreign nations.
- They are composed of the following:
 - The Current Account
 - The Capital Account
 - The Official Reserves Account
 - Statistical Discrepancy

BALANCE OF PAYMENTS (BOP)

BOP = cash flow of the country

Sources of the cash flow:

- 1) earned income from trade in goods and services
- 2) donated money
- 3) foreign loans and investment

1) + 2) → Current Account (cannot be taken back)

3) → Capital Account (can be taken back)

WHY WE NEED TO KNOW BOP

- It provides detailed information about demand and supply of the currency
- It signals economic (external) health
- It helps evaluate the performance of the country in international economic competition
- Sources of pressure on currency

THE CURRENT ACCOUNT (CA)

Mainly consists of 4 types of transactions:

1. Exports and imports of goods
 2. Exports and imports of services
 3. Interest payments received and paid out on international investments
 4. Unilateral transfers
- If the debits exceed the credits, then a country is running a *current account deficit*.
 - If the credits exceed the debits, then a country is running a *current account surplus*.

THE CAPITAL ACCOUNT (KA)

KA primarily tracks transactions involving buying and selling of financial and non-financial assets.

... can be divided into 3 categories:

1. Direct investment
 2. Portfolio investment
 3. Other investments (mostly loans, currencies)
- Purchase of residents assets by non-residents (i.e. **inflows**) are **credits**.
 - Purchases of non-residents assets by residents (i.e. **outflows**) are **debits**

NET CAPITAL FLOWS (RESIDENT & NR)

Millions of USD	2008 ^P	2008 ^P			2009 ^P			
		H1	Q3	Q4	Q1	Feb	Mar	Apr ^E
1. Non-bank private & public	4,736	4,516	-952	1,172	-654	-349	-142	-1,142
1.1. Resident flows	-4,010	-2,087	-2,901	978	-210	27	-222	-1,161
TDI	-2,714	-1,740	-103	-871	-565	-173	-253	-234
Thai portfolio inv.	-2,408	-1,171	-2,355	1,119	454	209	106	-543
Other loans	-8	72	-175	95	-375	-171	-58	-284
Trade credit (provided by Thai exporters)	578	415	-145	307	274	105	9	35
Other inv.	542	337	-124	328	3	57	-27	-135
1.2 Non-resident flows	8,746	6,603	1,949	194	-444	-375	80	19
FDI	9,811	5,063	2,525	2,224	2,158	681	868	580
Portfolio investment	-24	1,826	-887	-962	-692	-83	-262	-164
- Equity investment	-1,279	-125	-750	-404	-272	83	-70	-7
- Debt sec. investment	1,256	1,951	-137	-558	-420	-166	-192	-157
Other loans	-911	-1,687	146	630	-266	31	-427	-21
Trade credit (provided to Thai importers)	108	1,542	196	-1,630	-1,430	-946	-30	-328
Other inv.	-239	-141	-31	-67	-213	-59	-68	-47
2. Bank flows	8,052	5,520	2,065	467	-2,206	-241	-1,223	391
- o.w. portfolio liabilities	-3,270	-1,443	-921	-906	15	-45	-103	167
Total capital flows (1+2)	12,788	10,036	1,113	1,639	-2,860	-590	-1,365	-751

THE OFFICIAL RESERVES ACCOUNT (RA)

- Reports the net change in FX reserves.
- Increases in FX reserves held by a central bank count as debits to the RA

$$\Delta \text{FX reserves} = \text{BOP} + \Delta \text{Valuation}$$

STATISTICAL DISCREPANCY

- There's going to be some omissions and misrecorded transactions—so we use a “plug” figure to get things to balance.
 - Different methods of accounting
 - Imperfect records
 - Invisible services (eg. consulting, guide business)
 - Online transactions difficult to keep track
 - Illegal activities not detected

THE BALANCE OF PAYMENTS IDENTITY

Most important feature of the BOP is a double-entry system of accounts: a positive entry in BOP has a corresponding negative entry elsewhere in the BOP, and vice versa.

In general,

$$CA + KA + RA = 0$$

Under a pure flexible exchange rate regime,

$$CA + KA = 0$$

EXAMPLE: U.S. BALANCE OF PAYMENTS DATA

		Credits	Debits
Current Account			
1	Exports	\$1,516.2	
2	Imports		(\$2,109.1)
3	Unilateral Transfers	\$16.4	(\$89.4)
	Balance on Current Account		(\$665.9)
Capital Account			
4	Direct Investment	\$115.5	(\$248.5)
5	Portfolio Investment	\$794.4	(\$90.8)
6	Other Investments	\$524.3	(\$483.7)
	Balance on Capital Account	\$611.2	
7	Statistical Discrepancies	51.9	
	Overall Balance	\$2.8	
Official Reserve Account			\$2.8

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Including the statistical discrepancies, the balance of payments identity should hold:

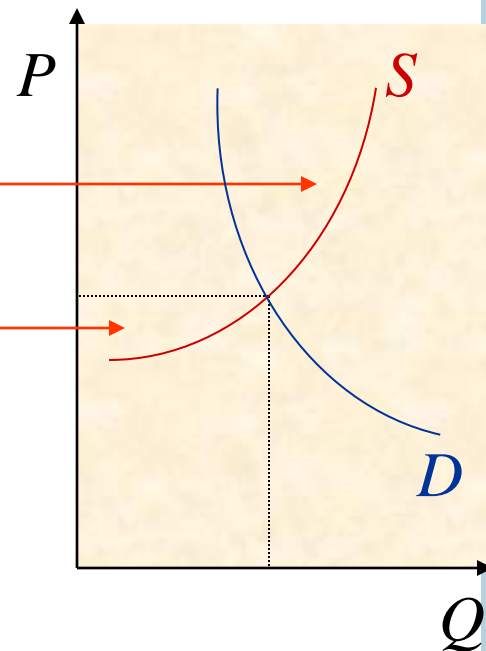
$$CA + KA = -RA$$

$$(\$665.9) + \$611.2 + \$51.9 = (\$2.8)$$

BOP AND EXCHANGE RATE

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Exchange rate \$

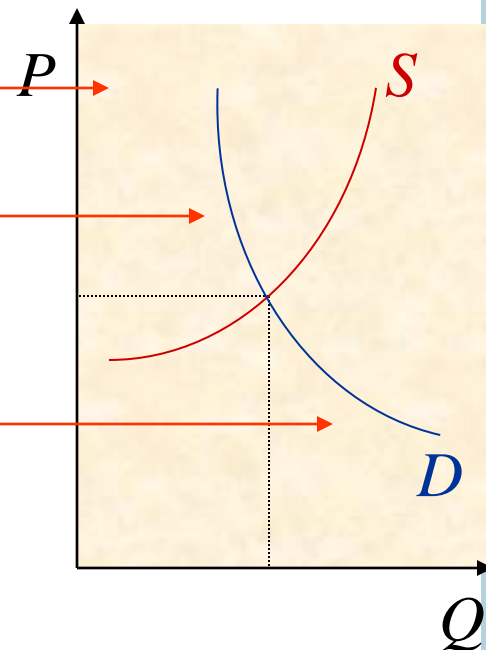


As U.S. citizens import, they supply dollars to the FOREX market.

BOP AND EXCHANGE RATE

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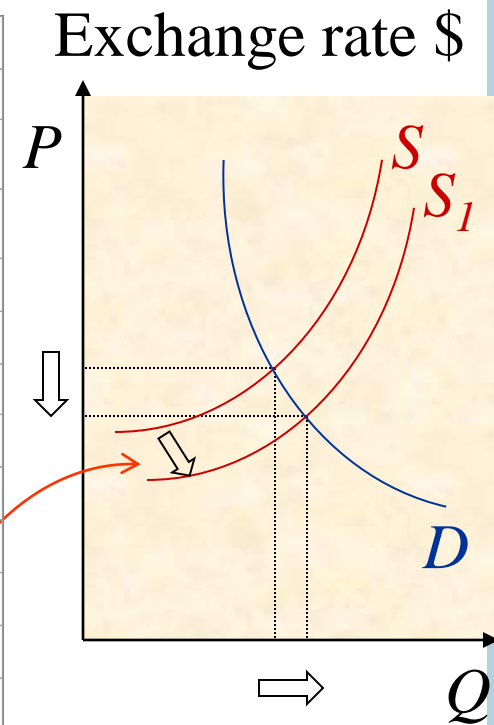
Exchange rate \$



As U.S. citizens export, others demand dollars at the FOREX market.

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As the U.S. government sells dollars, the supply of dollars increases.

BOP ADJUSTMENTS

Suppose **CA deficit** > **KA surplus** (at some point in time)

Under flexible regime:

→ **Currency depreciates**

→ CA improves (more exports, less imports)

→ KA improves (more inflows, less outflows)

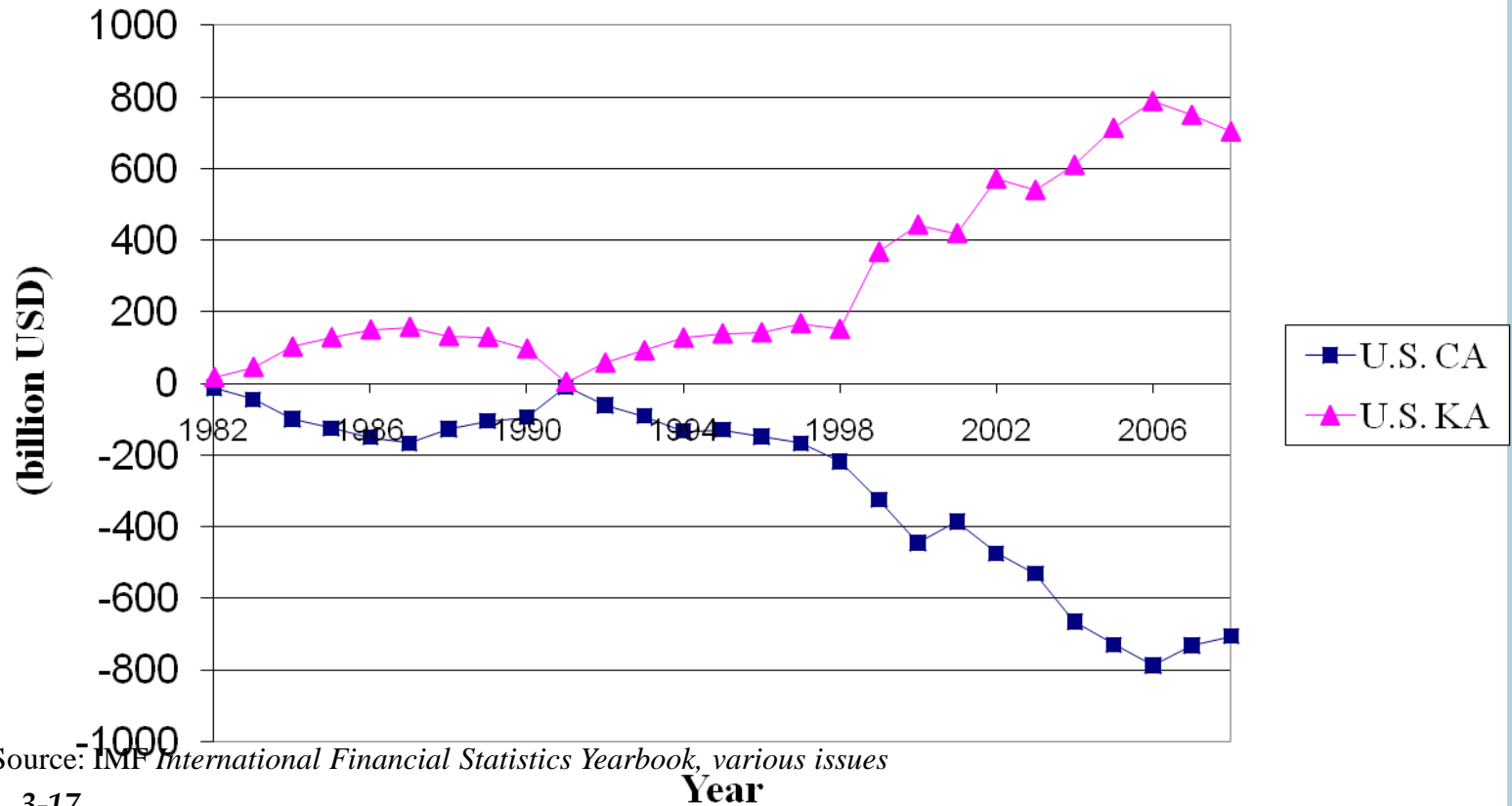
Under fixed regime:

→ **FX reserves decrease**

→ If not enough reserves, then BOP crisis

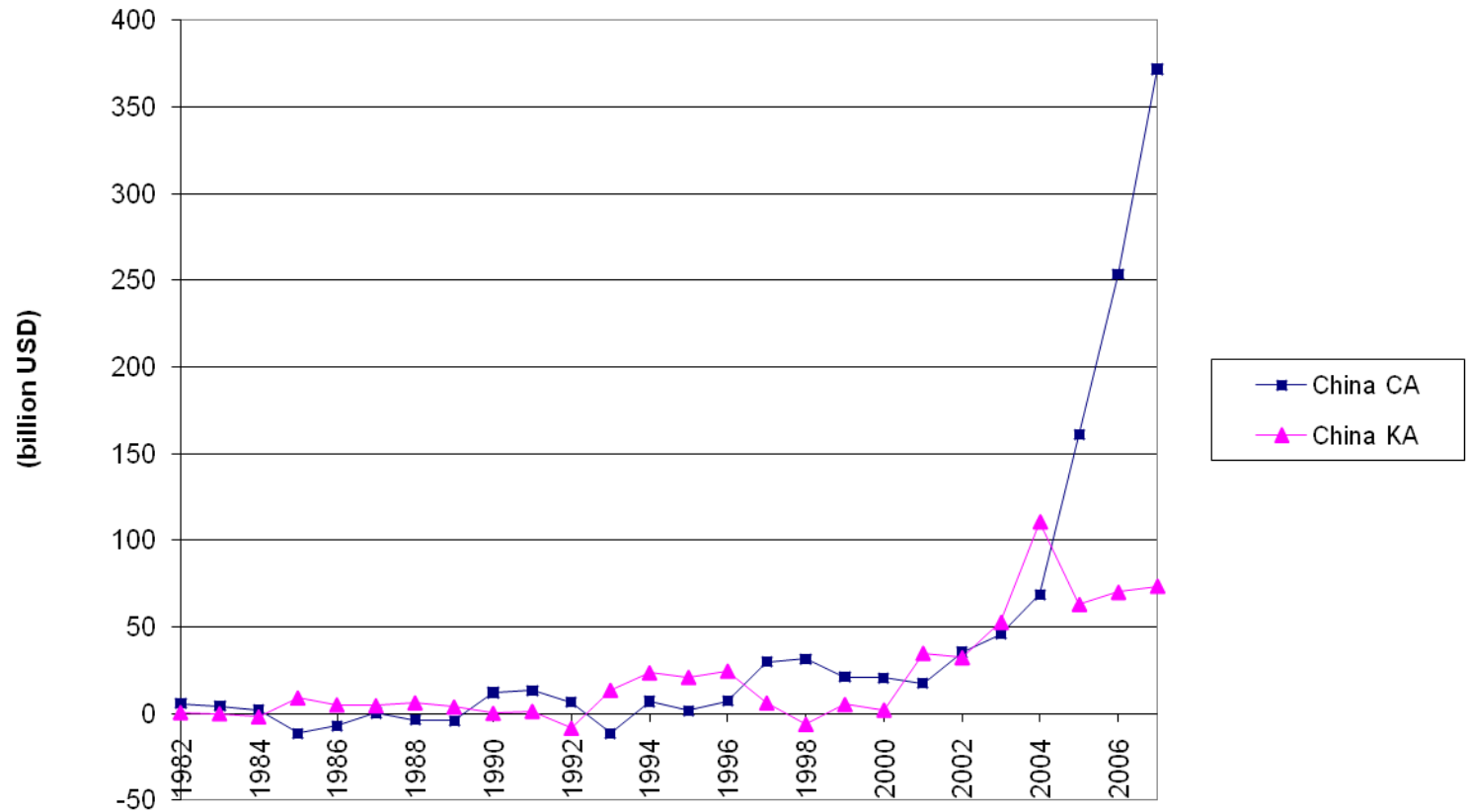
CA AND KA OF THE UNITED STATES

U.S. Balance of Payments Trend: 1982-2008



Source: IMF International Financial Statistics Yearbook, various issues

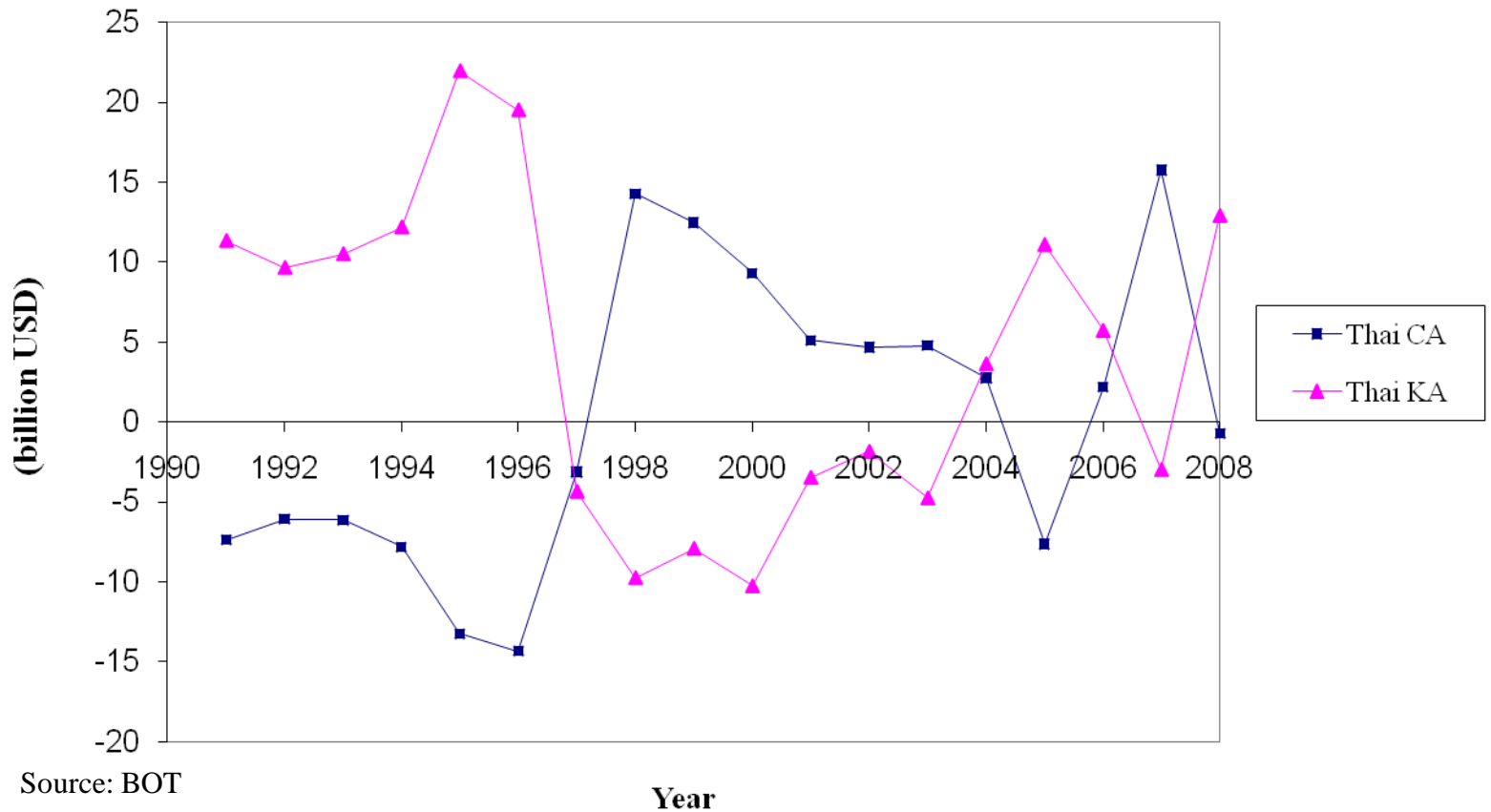
CA AND KA OF CHINA



Source: IMF *International Financial Statistics Yearbook*, various issues

CA AND KA OF THAILAND

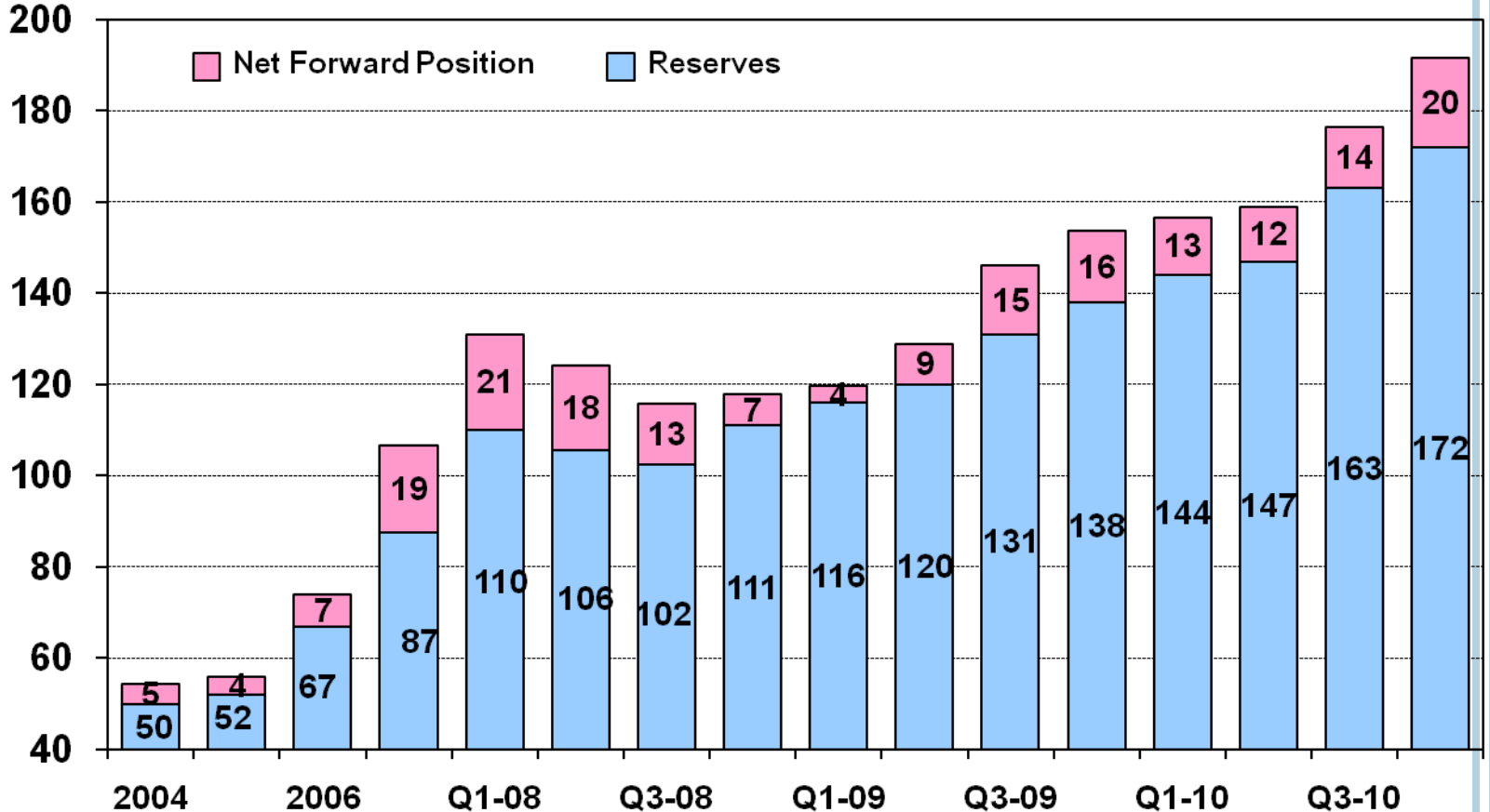
Thailand Balance of Payments Trend: 1991-2008



Source: BOT

THAILAND'S INTERNATIONAL RESERVES

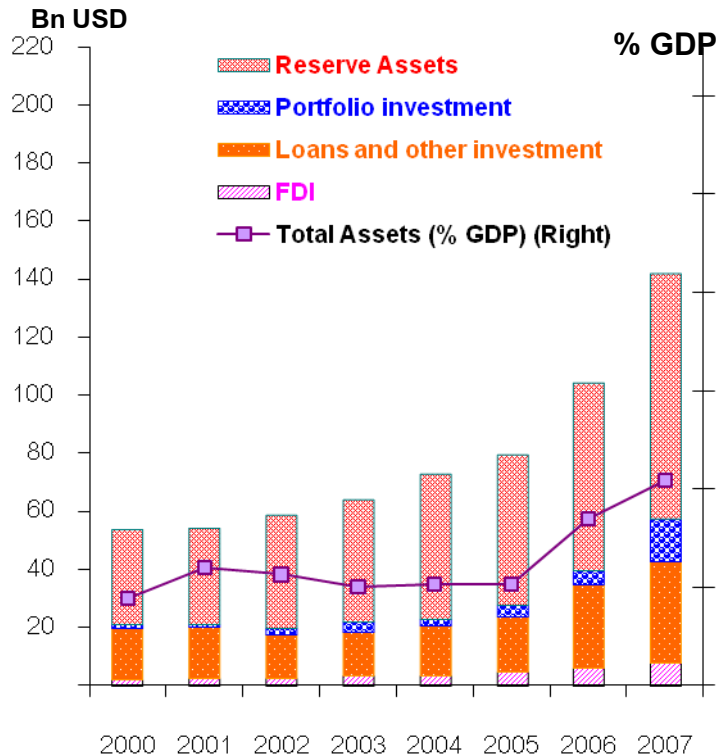
Billion USD



Source: BOT

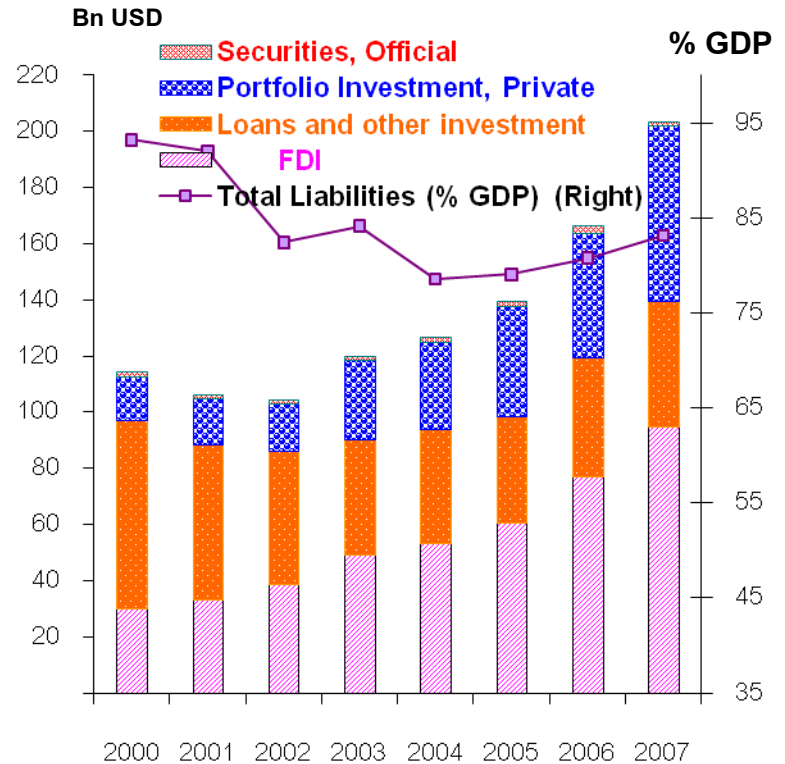
International Investment Position (IIP)

FOREIGN ASSETS



Resident investment

FOREIGN LIABILITIES



NR investment