Balance of Payments

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Balance of Payments

- **Balance of Payments (BOP)**—is an accounting record of a country's trade in goods, services, and financial assets with the rest of the world during a particular time period (year or quarter). It is a statistical statement that summarizes transactions between <u>residents</u> and <u>nonresidents</u> during a period of time.
- BOP is <u>**a flow statement**</u>, not a stock statement.
- An international transaction involves two parties, and each transaction enters the accounts twice (a general principle of modern bookkeeping):
  - once as a credit (+)
  - and once as a debit (–).

Features of the BOP

- BOP follows the accounting procedure of double-entry bookkeeping (debits & credits), hence BOP will always balance
  - A credit entry records an item or transaction that brings foreign exchange into the country.
  - A debit entry represents a loss of foreign exchange.

Residents…(according to IMF)

- Residence is a particularly important attribute of an institutional unit in the balance of payments because the identification of transactions between residents and nonresidents underpins the system.
- The concept is not based on nationality or legal criteria. The concept of residence is based on a transactor's center of economic interest. Moreover, country boundaries recognized for political purposes may not always be appropriate for economic purposes.
- Therefore, it is necessary to recognize the economic territory of a country as the relevant geographical area to which the concept of residence is applied.
- An institutional unit is a resident unit when it has a center of economic interest in the economic territory of a country.

Debit and credit transactions

- Simple rules:
  - If Home buys anything (goods or assets): debit (-)
  - If Home sells anything to Foreign (goods or assets) : credit (+)
- Or equivalently:
  - Credit transactions (+) give rise to a demand for our currency
  - Debit transactions (-) give rise to a supply of our currency
- Or equivalently:
  - Capital inflow & borrowing from abroad is a (+) (in financial account) - either an increase in foreign holdings of domestic assets (such as when a foreigner purchases a domestic stock); or a reduction in the nation's assets abroad, such as when a Home's citizen sells a foreign asset;

Balance of Payments Accounts

- The balance of payments accounts are separated into 3 broad accounts:
  - **current account**: accounts for flows of goods and services (imports and exports).
  - **financial account**: accounts for flows of financial assets (financial capital).
  - **capital account**: flows of special categories of assets (capital): typically nonmarket, non-produced, or intangible assets like debt forgiveness, copyrights and trademarks.

➢ Once again: **BOP always balances!**

Example of Balance of Payments Accounting (US perspective)

- Merchandise: imports of Nokia phones from Finland (-) exports of Macs to France (+)
- Services: American tourist drinks in Paris Bar (-) German tourist watching Broadway (+)

Imports of Nokia phones from Finland (*current account, U.S. good import*)	−\$10 000
Nokia deposits the US dollars on a bank account (*financial account, U.S. asset sale*)	+\$10 000

Example of Balance of Payments Accounting (cont.)

- US citizen buys food & drinks in France and pays by credit card / or with euros - in cash.
- In the US BOP:

Meal purchase (*current account, U.S. service import*)	−$30
Sale of credit card claim (*financial account, U.S. asset sale*) or a decrease in foreign assets (euros)	+$30

Example of Balance of Payments Accounting (cont.)

- US citizen buys a share of BP (a foreign company).
- BP deposits the money in a bank.

Stock purchase (*financial account, U.S. asset purchase*)	–$90
Bank deposit (*financial account, U.S. asset sale*)	+$90

How Do the Balance of Payments Accounts Balance?

- Due to the double entry of each transaction, the balance of payments accounts will balance by the following equation:

current account +

financial account +

capital account = 0

BOP: Current account

Current account covers all the current transactions, between Home and ROW, i.e. transactions that create <u>no future claim</u>

- **Current account**:
  1. <u>imports and exports</u> of merchandise (goods)
  2. <u>imports and exports</u> of services (legal services, shipping services, tourist meals, etc.)
  3. income receipts (interest and dividend payments, earnings of firms and workers operating in foreign countries)
  4. *net unilateral transfers:* gifts, aid, donations across countries

The current account

- The **current account balance** (CA) has several meanings.
  - ***First,*** it is approximately equal to the difference (X - M) between the value of the country's exports of goods and services and the value of its imports of goods and services.
  - ***Second,*** it is the difference between domestic production of goods and services and national expenditures on goods and services (Y - E).
  - ***Third***, it is difference between national saving and domestic real investment ($S - I_d$).

Drawing a Line in the BOP

- Current account balance indicates the scale of excess demand within the domestic economy
- If we draw a line at the current account balance, then:
  - Items "above the line" refer to the current account trade in goods, services, income, and unilateral transfers.
  - Items "below the line" are the capital and financial account transactions (purchases and sales of financial assets).
  - Since the BOP always balances, then a current account deficit (above the line) implies that the country is running a net surplus below the line, so that the country is a net borrower from the rest of the world

Balance of Payments Accounts

- **Capital account**: records special transfers of assets like donations and funds included in non-returnable grants, specially assigned to fixed assets financing (usually a minor account, although in the case of PL -quite substantial as it includes the value of funds received from EU institutions, countries and international organizations, as well as funds transferred by the Polish government in favour of these institutions.)

- Acquisition and disposal of nonproduced, nonfinancial assets comprises purchase and sale of patents, copyrights, licenses and trademarks,

BOP: Financial account

- **Financial account**: the difference between sales of domestic assets to foreigners and purchases of foreign assets by domestic citizens.
- **Financial inflow (+)**
  - Foreigners loan to domestic citizens by buying domestic assets.
  - Domestic assets sold to foreigners are a credit (asset sale; demand for our currency)
- **Financial outflow (-)**
  - Domestic citizens loan to foreigners by buying foreign assets.
  - Foreign assets purchased by domestic citizens are a debit
- We can interpret the financial account surplus as borrowing (increase in net indebtedness or a reduction in assets) to finance current account deficit and vice versa

BOP: Financial account

- **Financial account** has at least 3 subcategories:
  1. Official (international) reserve assets/ Official international reserves transactions
  2. All other assets: portfolio & direct investment
  3. Statistical discrepancy

BOP: Financial account

- **Statistical discrepancy**
  - Data from a transaction may come from different sources that differ in coverage, accuracy, and timing.
  - The balance of payments accounts therefore seldom balance in practice.
  - The statistical discrepancy is the account added to or subtracted from the financial account to make it balance with the current account and capital account.

BOP: Financial account

- **Official (international) reserve assets**: foreign assets held by central banks to cushion against financial instability.
  - Assets include foreign government bonds, foreign currency, gold, and accounts at the International Monetary Fund.
  - **Official reserve assets purchased by the domestic central bank are a debit items (–)** (CB buys assets & supplies our currency)
  - Official reserve assets sold to foreigners are a credit (+) (CB sells assets & collects our currency in return)

BOP: Financial account

- The value of the official reserve assets mirrors the so called the **official settlements balance** (or even the“balance of payments”)
- The official settlements balance also equals the (negative of the) official reserves balance (OR).
- The **official settlements balance** is the sum of the current account, the capital account, the nonreserve portion of the financial account, and the statistical discrepancy.
- While there is no perfect indicator of overall balance, we often examine the country's official settlements balance, which is the sum of the current account balance and the private financial (&capital) account balance (including the statistical discrepancy).

BOP: Financial account

- Most of the official reserves flows indicate official intervention by the monetary authorities in the foreign exchange market.
- A „negative BOP” and a positive official reserve assets account may indicate that a country
    - is depleting its official international reserve assets, or
    - may be incurring large debts to foreign central banks so that the domestic central bank can spend a lot to protect against financial instability.

BOP: Financial account

- Financial account contains also information on net foreign investment: direct and portfolio
- „Portfolio investment includes equity securities and debt securities in the form of bonds and notes, money market instruments and financial derivatives”
- Direct investment occurs when foreign company extends its scale of operations at Home, by buying a Home company, expanding an existing subsidiary or by greenfield investment

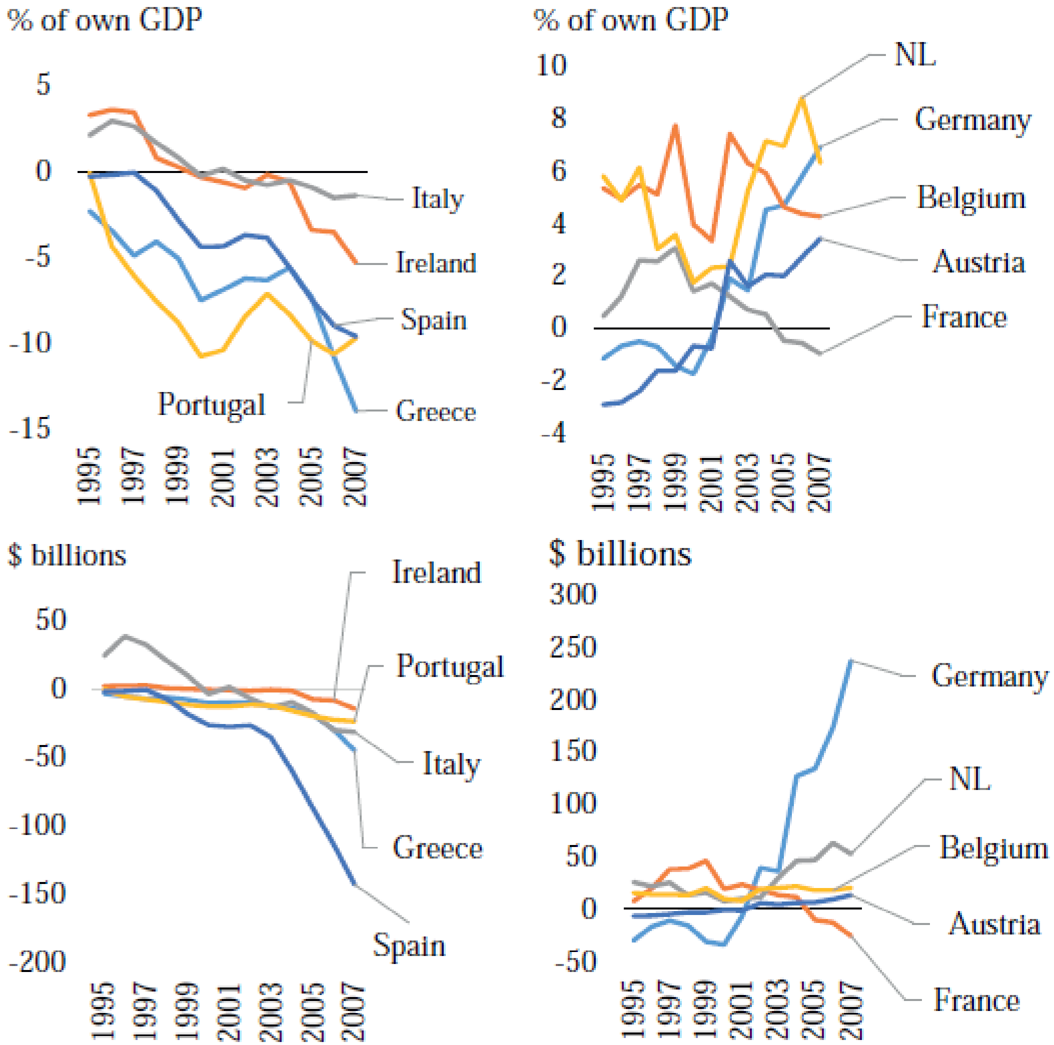
Net Capital Flows
Asian Crisis Countries (Indonesia, Korea, Malaysia, the Philippines, Thailand)

(billions of U.S. dollars)

	1995	*1996*	*1997*	*1998*	*1999*	*2000*
Current account	-40,4	-53,0	-25,0	69,1	62,9	43,1
Net capital flows	74,2	65,8	-20,4	-25,6	-24,6	-40,6
direct investment	7,5	8,4	10,3	8,6	10,2	12,0
portfolio investment	17,4	20,3	12,9	-6,0	6,3	6,6
other investment	49,2	37,1	-43,6	-28,2	-41,1	-59,2
Net official flows	0,7	-0,4	17,9	19,7	-4,7	5,0
Change in reserves	-18,5	-5,4	30,5	-52,1	-44,5	-17,2

Źródło: "*World Economic Outlook*", May 2000, IMF, p. 51

Figure 2. Current accounts: The core lent to the GIIPS from 2000 to 2007



Source: WEO online database with authors' elaboration. Note: Current account deficit (-) and surplus (+).

Source: Baldwin, Giavazzi, 2015; The Eurozone crisis