Balance of Payments

RIDLEY COLLEGE
SINCE 1889

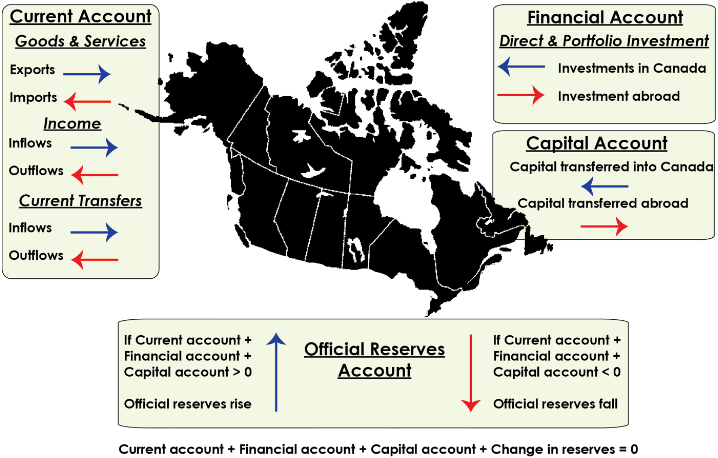
Assessment Objectives

Specific Expectations	
AO2	Explain the balance of payments in terms of the current account, the capital account, and the financial account, and the items that compose each of the three accounts.
AO2	Explain the interdependence between the three accounts in terms of zero balance, the balance between credits and debits, and the balance between deficits and surpluses.
AO4	Calculate items of the balance of payments given a set of data.
AO4	Draw a diagram showing the relationship between the current account balance and the exchange rate.
AO2	Explain the relationship between the exchange rate and financial account.

Role of the Balance of Payments

- **Balance of payments** of a country is a record (usually for a year) of all transactions between the residents of the country and the residents of all other countries.
  - Its role is to show all payments received from other countries, called **credits**, and all payments made to other countries, called **debits**.
  - In the course of a year, all inflows of payments (credits) must exactly equal to the outflow of payments (debits).
  - The sum of all credits is equal to the sum of all debits.
  - All credits (inflows of money into the country) create a foreign demand for the country's currency.
  - All debits (outflows of money from the country) create a supply of the domestic currency.

- Every unit of a country's currency spent on foreign goods and services, ultimately ends up being spent again on something from the country.



Structure of the balance of payments

- The balance of payments consists of three accounts:

  1. **Current account** – consists of the balance of trade in goods and services, net change income and the net change in current transfers
  2. **Capital account** – records the transactions involving ownership of capital, forgiveness of debt, or the acquisition and disposal of intangible assets between a nation and all other nations
  3. **Financial account** – measures the exchanges between a nation and the rest of the world involving ownership of financial and real assets

  - **Surplus** in an account occurs whenever a balance has a positive value, meaning that credits are larger than debits (there is an excess of credits).
  - **Deficit** in an account occurs whenever a balance has negative value, meaning that debits are larger than credits (there is an excess of debits).

Current Account

- **Current account** measures the flow of funds between a nation and the rest of the world for the purchase of goods and services and income transfers.

  $$\text{Current Account} = \text{Balance of trade} + \Delta\text{Income} + \Delta\text{Current transfers}$$

  1. **Balance of trade in goods –** part of the balance of payments, it is the value of exports of goods minus the value of imports of goods over a specific period of time.
  2. **Balance of trade in services –** part of the balance of payments, it is the value of exports of services minus the value of imports of services over a specific period of time.
  3. **Income –** refers to inflows of wages, rent, interest and profits from abroad minus outflows to foreign countries.

     $$\Delta\text{Income} = \text{Inflows} - \text{Outflows}$$

Current Account

4. **Current transfers** – an item in the current account of the balance of payments, refers to inflows and outflows of funds for items including gifts, foreign aid and pensions.

   $\Delta\text{Current transfers} = \text{Inflows} - \text{Outflows}$

- **Current account balance** – the sum of credits plus debits in the current account.
- **Current account surplus** – occurs when the current account balance has a positive value, meaning that credits are larger than debits.
  - The surplus on an account indicates there is an excess demand of the currency in the foreign exchange market.
  - A current account surplus, means a country consumes less than it produces, and part of the income generated from the sale of extra output produced corresponds to a financial account deficit.
- **Current account deficit** – occurs when the current account balance has a negative value, meaning that debits are larger than credits.

Current Account

- The deficit on this account means there is an excess supply of the currency in the foreign exchange market.
- A current account deficit means a country consumes more than it produces; and it pays for extra output consumed through a financial account surplus.

Current Account	
(1) Exports of goods	+40
(2) Imports of goods	−65
Balance of trade in goods (1) + (2)	**−25**
(3) Exports of services	+25
(4) Imports of services	−15
Balance of trade in services (3) + (4)	**+10**
Balance of trade in goods and services	−15
Income (Inflows minus outflows)	−6
Current transfers (inflows minus outflows)	+1
Balance on Current Account	**−20**

Capital Account

- **Capital account** of the balance of payments of a country is composed of inflows minus outflows of funds for capital transfers and transaction in non-produced, non-financial assets.

  $$\text{Capital Account} = \Delta\text{Capital Transfers} + \Delta\text{Intangible Assets}$$

  - The capital account is relatively small compared to the current account and financial account.
  - The capital account does not measure the purchase or sale of capital goods between nations, rather the actual transfer of fixed assets from one nation to another.

  1. **Capital transfers** – when a nation's government or private sector gives money to another nation for the purchase of fixed assets or directly donates capital goods to the residents of another country

     $$\Delta\text{Capital Transfers} = \text{Inflows} - \text{Outflows}$$

Capital Account

2. **Debt forgiveness** – the capital account measures the forgiveness of debt from lenders in one country to debtors in another.

3. **Exchange of intangible assets** – flow of non-produced, non-financial assets such as patents, copyrights, franchises and the acquisition or disposable of land by government or international organizations.

Capital Account	
(7) Capital transfers (inflows minus outflows)	+0.7
(8) Transaction in-produced, non-financial assets	+0.3
Balance of trade in goods (7) + (8)	**+1**

Financial Account

- **Financial account** measures the exchanges between a nation and the rest of the world involving ownership of financial and real assets.

  Financial Account $= \Delta$FDI $+ \Delta$Portfolio Investment $+ \Delta$Reserves

  1. **Foreign direct investment** – refers to investment by firms based in one country (the home country) in productive activities in another country (the host country) with control of at least 10 percent of the firm in the host country.
     - Firms that undertake FDI are called multinational corporations (MNCs).
  2. **Portfolio investment** – financial investment, including investment in stocks and bonds. Appears as an item in the financial account of the balance of payments.
  3. **Official borrowing** – refers to government borrowing from abroad.

Financial Account

4. **Reserve assets (Official reserves)** – refers to foreign currency reserves that the central bank maintains and can buy or sell to influence the value of a country's currency exchange rate.

Financial Account	
(9) Foreign direct investment (inflows minus outflows)	$+23$
(10) Portfolio investment (inflows minus outflows)	-4
(11) Reserve assets (official reserves)	$+1$
(12) Official borrowing	-1
Balance on Financial Account	$\mathbf{+19}$

Current Account Balance

- The current account balance is matched by the sum of the capital account balance and the financial account balance.

  $$\text{Current Account} + \text{Financial Account} + \text{Capital Account} = 0$$

  $$\text{Current Account} = -(\text{Capital Account} + \text{Financial Account})$$

  - If there is a current account deficit, there must be a financial account surplus, which provides it with foreign exchange it needs to pay for the excess of imports over exports.
  - When there is a surplus on the current account, the country is accumulating foreign exchange, which it can use to buy assets abroad.

Balance of Payments	
Balance on Current Account	-20
Balance on Capital Account	$+1$
Balance on Financial Account	$+19$
Balance of Payments	**0**