Lesson 3: The Balance of Payments and Trade Organizations

Balance of Payments

The **balance of payments (BOP)** is a double entry bookkeeping system that summarizes a country's economic transactions with the rest of the world over a period of time.

A country's balance of payments is composed of three main accounts

- The current account balance largely reflects trade in goods and services.
- The capital account balance mainly consists of capital transfers and net sales of non-produced, non-financial assets.
- The financial account measures net capital flows based on sales and purchases of domestic and foreign financial assets.

The current account can be decomposed into the following sub-accounts:

- Merchandise trade consists of all commodities and manufactured goods bought, sold or given away.
- Services include tourism, transportation, engineering and business services.
- Income receipts include income from ownership of foreign assets (e.g. interest and dividends).
- Unilateral transfers represent one-way transfer of assets (e.g. worker remittances, foreign aid and gifts).

The capital account can be decomposed into the following sub-accounts:

- Capital transfers include debt forgiveness and migrants' transfers. They also include:
    - Transfer of ownership of fixed assets
    - Transfer of funds received for the sale or acquisition of fixed assets
    - Gift and inheritance taxes
    - Death duties
    - Uninsured damage to fixed assets
- Sales and purchases of non-produced, non-financial assets such as rights to natural resources, intangible assets (e.g. patents, copyrights, etc.)

The financial account can be decomposed into the following sub-accounts:

- Financial assets abroad are composed of:
    - Official reserve assets
    - Government assets
    - Private assets

  These assets include gold, foreign currencies, foreign securities, the government's reserve position at the IMF, direct foreign investment and claims reported by resident banks.

- Foreign owned financial assets in the reporting country are composed of:
    - Official assets
    - Other foreign assets

  These assets include securities issued by the reporting country's government and private sectors, direct investment, and foreign liabilities reported by the reporting country's banking sector.

National Economic Accounts and the Balance of Payments

The national income identity for an open economy is:

$$Y = C + I + G + X - M \; \ldots \; \text{(Equation 1)}$$

The current account balance is important because it measures the size and direction of international borrowing. A current account balance must be offset by an opposite balance in the capital and financial accounts. Therefore:

- A current account deficit must be financed by foreign direct investment, loans by foreign banks, or the sale of domestic debt and equity securities to foreign investors.
- A current account surplus is used to finance the current account deficit of trading partners (through loans and investments in real and financial assets).

A current account deficit occurs when spending in the economy (C + I + G) is relatively high.

- In such times, demand for credit is also high which increases interest rates. These higher interest rates lead to net capital inflows and result in an appreciating currency.

With persistent current account deficits in the long run however, an increase in net borrowing from foreigners results in significant risk being associated with the country's debt, leading to currency depreciation.

World Bank Group

The World Bank's main objective is to fight poverty and enhance environmentally sound economic growth. The World Bank and its affiliated entities:

- Provide cheap loans and grants to countries that have limited or no access to international financial markets.
- Provide analysis, advice and information to countries to encourage social and economic development.
- Share knowledge and promote dialogue to increase the capabilities of their partners and members.
- Help members create the basic economic infrastructure that is essential for the development of domestic financial markets.

World Trade Organization (WTO)

The WTO's primary objective is to enhance and liberalize international trade.

- The WTO's important functions include the implementation, administration, and operation of individual agreements, providing a platform for negotiations and settling trade disputes.
- It also provides technical cooperation and training to developing, under developed and poor countries to bring them in compliance with WTO rules.
- It reviews members' trade policies on a regular basis and ensures coherence and transparency of trade policies through surveillance.
- It is a major source of economic research and analysis.
- Its framework of global trade rules provides a major institutional and regulatory base, without which large multinationals would not be able to operate on such a large scale.

International Monetary Fund

The main objective of the IMF is to ensure the stability of the international monetary system, the system of exchange rates and international payments that enables countries to participate in international trade. More specifically, the IMF:

- Provides a forum for cooperation on international monetary problems.
- Facilitates the growth of international trade, thereby promoting job creation, economic growth, and poverty reduction.
- Promotes exchange rate stability and an open system of international payments.
- Lends foreign exchange to member countries when needed, on a temporary basis and under adequate safeguards, to help them address balance of payments problems.

In the aftermath of the global financial crisis of 2007-2009, the IMF has redefined its operations by:

- Enhancing its lending facilities.
- Strengthening the monitoring of global, regional, and country economies.
- Helping resolve global economic imbalances.
- Analysing capital market developments.
- Assessing financial sector vulnerabilities.
- Working to cut poverty.

From an investment perspective the IMF helps to keep country-specific market risk and global systematic risk under control.