Balance of Payments

Based on Chap 15 of Pugel and Lindert

(The sun is setting since this is the last topic)

Topics

1. What's in the Balance-of-Payments Accounts? (BOP)

Buing goods, services etc abroad

- What do we as a nation buy from abroad?
- M: Good and services:
  - Imports of goods and services totaling M in local currency.
- C_B: Capital as-sets Bought
  - assets that we are buying from the rest of the world: stocks, bonds, foreign real estate, foreign money, and so on.
- E_P: Investment earning paid to the foreigners for their investment in our country
- U_P: Unilateral Payments abroad:
  - Govt. paying for foreign aid, our gifts to foreigners, or remittances to relatives abroad.

Paying with …(converted in local currency)

- How do we pay for all that we buy from abroad?
- X: Selling good and services abroad
  - Exports of goods and services totaling X in local currency.
- C_S: Capital assets sold to foreigners
  - assets that we are selling the rest of the world: stocks, bonds, foreign real estate, foreign money, and so on.
- E_R: Investment earning received from foreigners for our investment in in other countries
- U_R: Unilateral receipts from abroad:
  - Foreign govt. paying us foreign aid, the gifts from foreigners to our residents, or remittances to relatives from abroad.

Net transactions

- In domestic currency all our purchases and transfers received abroad
  - $M + E_P + U_P + C_B$
- In domestic currency all our sales abroad and transfers received from abroad
  - $X + E_R + U_R + C_S$
- Total sales = total receipts
  - $X + E_R + U_R + C_S = M + E_P + U_P + C_B$
- T+E+U+C = 0, I.e.,
  - $T = (X - M)$: balance-of-trade surplus
  - $E = (E_R - E_P)$: net investment earnings
  - $U = (U_R - U_P)$: net transfers from abroad
  - $C = (C_S - C_B)$: net sale of assets

Components of BOP

- The purpose of BOP account is to reveal the structure of a country's international transactions. To that end, all transactions are put into two main sub accounts:

1. Current account: (T + E + U)
2. Capital account: C
3. The official settlement account

Current Account (in words)

What goes into the current account?

1. Merchandise exports and imports;
2. Imports and exports of military services, travel, and transportation;
3. Current income received and paid on international investments; and
4. Unilateral transfers, including worker remittances and pension payments

- Each category of current-account transactions includes both exports by the U.S. (entered as *credits* [+]) and imports by the U.S. (entered as *debits* [-]).
- *Current-account balance*: equals the sum of all the other entries and represents the difference between total exports by U.S. residents and total imports by U.S. residents

BOP with US example

- **Balance of Payment**: a systematic account of all the exchanges of value between residents of a country and the rest of the world during a given period of time. A **credit** (+) is a flow for which the country is paid. Exports are an example.
  - A **debit** (-) is a flow for which the country must pay. Imports are an example.
- Double entry book-keeping. Any exchange enters into two categories of transactions. The main categories are:
  - Merchandise trade flows (flows of goods)
  - Service flows
  - Income flows
  - Unilateral transfers (gifts)
  - Private capital (asset) flows
  - Official asset flows

US Balance of payments (numbers)

		Credit (+)	Debit (−)
1.	**Exports of goods and services and income received**	**$1,179**	
2.	Merchandise exports	679	
3.	Service exports (travel, business services, etc.)	258	
4.	Income receipts from foreigners	242	
5.	**Imports of goods and services and income paid**		**−1,295**
6.	Merchandise imports		−877
7.	Services imports (travel, business services, etc.)		−171
8.	Income payments to foreigners		−247
9.	**Unilateral transfers, net**		**−39**
10.	U.S. government transfers to foreigners		−16
11.	Private remittances and other transfers		−23
12.	**Changes in U.S. holdings of foreign assets (excluding official international reserves), net**		**−478**
13.	U.S. direct investments abroad		−122
14.	Other U.S. investments abroad		−356
15.	**Changes in foreign holdings of U.S. assets (excluding official international reserves), net**	**718**	
16.	Foreign direct investments in the U.S.	93	
17.	Other foreign investments in the U.S.	625	
18.	**Changes in holdings of official international reserves, net**	**15**	
19.	Foreign official holdings of U.S. assets	16	
20.	U.S. holdings of official reserve assets		−1
21.	**Statistical discrepancy**		**−100**
22.	Net balance of credits minus debits	0	
	Six Key Balances		
23.	Merchandise trade balance (lines 2 and 6)		−198
24.	Goods and services balance (lines 2, 3, 6, and 7)		−110
25.	Goods, services, and income balance (lines 1 and 5)		−116
26.	Current account balance (lines 1, 5, and 9)		−155
27.	Net private capital flows and statistical discrepancy*	140	
28.	Overall balance (lines 26 and 27, or the negative of line 18)		−15

In the source, lines 12 and 20 are included in the category "U.S. assets abroad, net," and lines 15 and 19 are included in the category "Foreign assets in the United States, net."

*Lines 12, 15, and 21.

Source: U.S. Bureau of Economic Analysis, *Survey of Current Business*, July 1998, p. 69.

Capital Account Balance

- Net flows of financial assets and similar claims (excluding official asset flows) (only the principal amount of the asset, dividend and interests payments are included in the current account)
  - – Direct foreign investment
  - – Portfolio investment

- Also read the summary on pages 338-340.

Foreign Exchange

Based on Chapter 16

Concepts

- Foreign Exchange is the act of trading different nation's currencies. Generally, how much of local currency for one unit of the foreign currency. Yen exch rate .01, means to get one yen, you have to pay .01 yen, I.e., for 100 Yen, you have to pay $1.
- Exchange rate: the price at which two national currencies are traded.
- Spot Exchange rate: the price for "immediate" exchange
- Forward Exchange rate: the price for an exchange that will take place sometime in the future.
- floating exchange rate system: a system in which the exchange rate of a currency is determined in the marketplace and not by government or central bank intervention.
- Fixed Exchange Rate: a system in which officials try to keep the exchange rate of a currency pegged even if the rate they choose differs from the equilibrium rate.

Contd.

- Depreciation: a fall in the market price of a floating currency
- Appreciation: a rise in the market price of a floating currency
- Devaluation: a discrete official reduction in the otherwise fixed par value of a currency
- Revaluation: a discrete official increase in the otherwise fixed par value of a currency
- Arbitrage: the process of buying and selling to make a (nearly) riskless pure profit
- Triangular arbitrage: the process of making a riskless profit by arbitraging through three exchange rates.