

# Readings in International Economics

Autumn-winter 2011-2012

Lecture 1: The balance of payments (BOP)

11 October 2011

# BOP basics I

(from chapter 12)

- Definition #1: an accounting record of all monetary transactions between a country and the rest of the world for a certain year
- Definition #2: the balance of payments records a country's payments to and its receipts from foreigners
- Each international transaction enters the accounts twice:
  - once as a *credit* (+): receipts from foreigners
  - once as a *debit* (-): payments to foreigners

# BOP basics II

- The balance of payments consists of 3 separate accounts
  - **current account:** the transactions that arise from the export or import of goods and services
  - **financial account:** the transactions that arise from the purchase or sale of assets
  - **capital account:** certain transfers of financial assets (such as debt forgiveness), as well as the transactions that arise from the purchase or sale of non-financial assets (such as copyrights and trademarks)

## BOP basics III

- Imbalances are possible on each of the 3 separate accounts
- But due to the double entry of each transaction, the overall balance must be *zero*

*current account + financial account  
+ capital account = 0*

# BOP basics IV

**The current account (CA) is the sum of the trade balance (1+2), the factor income balance (3), and the net transfers (4)**

1. Exports of goods – imports of goods
2. Exports of services – imports of services (legal services, transportation services, tourist services, etc.)
3. Income received from loans to and investments in foreign countries – payments made for loans and investments by foreign countries
4. Transfers such as remittances and aid to foreign countries – transfers from foreign countries

# BOP basics V

- The financial account shows the difference between sales of domestic assets to foreigners (1) and purchases of foreign assets by domestic citizens (2)

**Assets: shares, bonds, bank loans, currency, real estate, factory equipment, etc.**

## 1. Financial (capital) inflow (+)

- For example, foreign companies give loans to or purchase the shares of domestic companies

## 2. Financial (capital) outflow (-)

- For example, domestic companies give loans to or purchase shares of foreign companies

**Key items in the financial account: FDI, portfolio investment, other investment, the reserve account**

# BOP basics VI

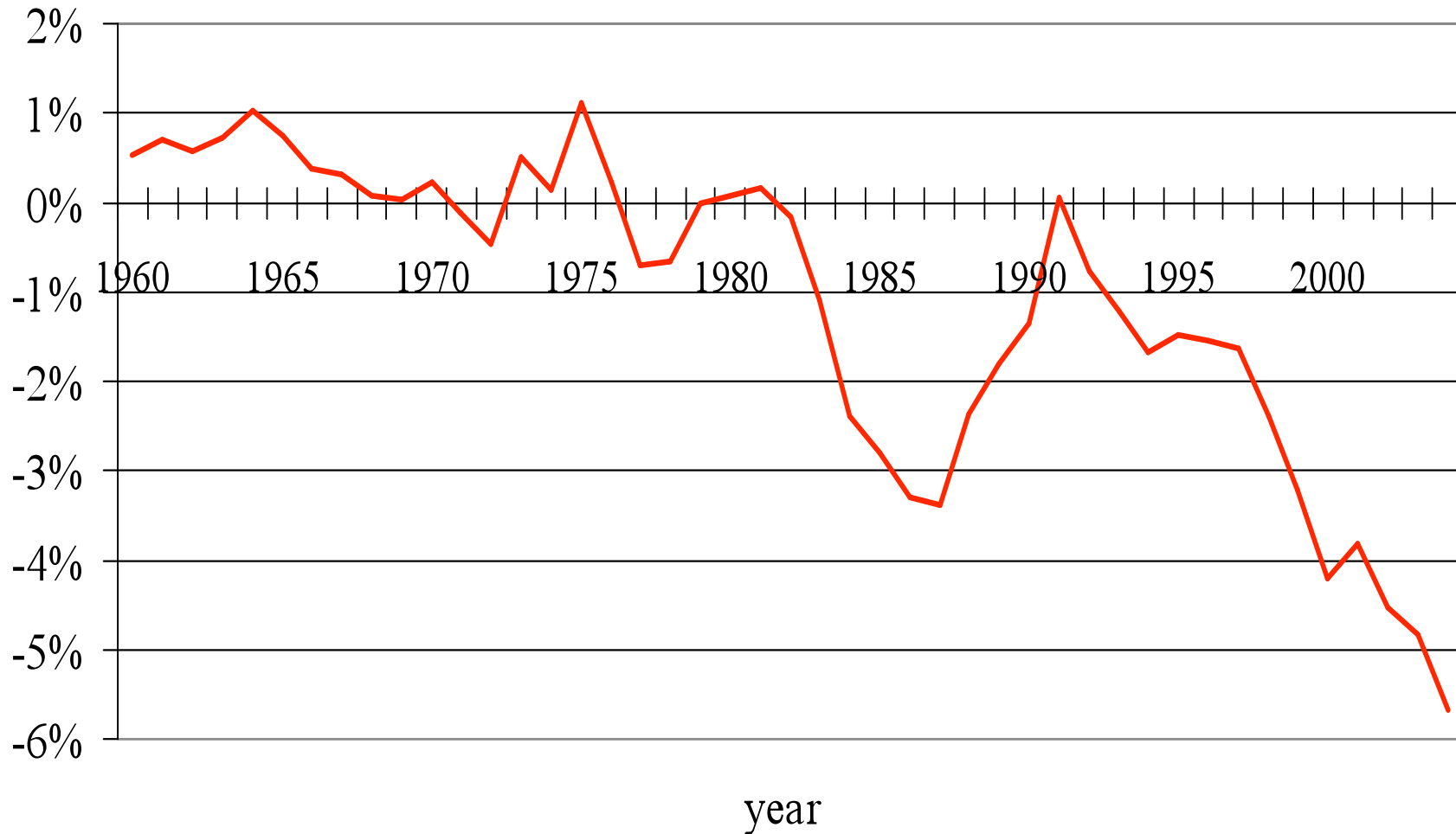
- **The reserve account shows the purchase or sale of international reserve assets (i.e. international reserves) by central banks**
- International reserves: foreign assets held by central banks to cushion against instability in international markets
  - Usually include gold, US government bonds, US dollars, euros or other foreign currencies, SDR accounts at the IMF
  - International reserve assets sold by a country's central bank are a credit (+)
  - International reserve assets purchased by a country's central bank are a debit (-)

# BOP basics VII

**The international reserve transactions balance is the sum of: 1. the current account, 2. the capital account, and 3. the non-reserve portion of the financial account (FDI + portfolio investment + other investment)**

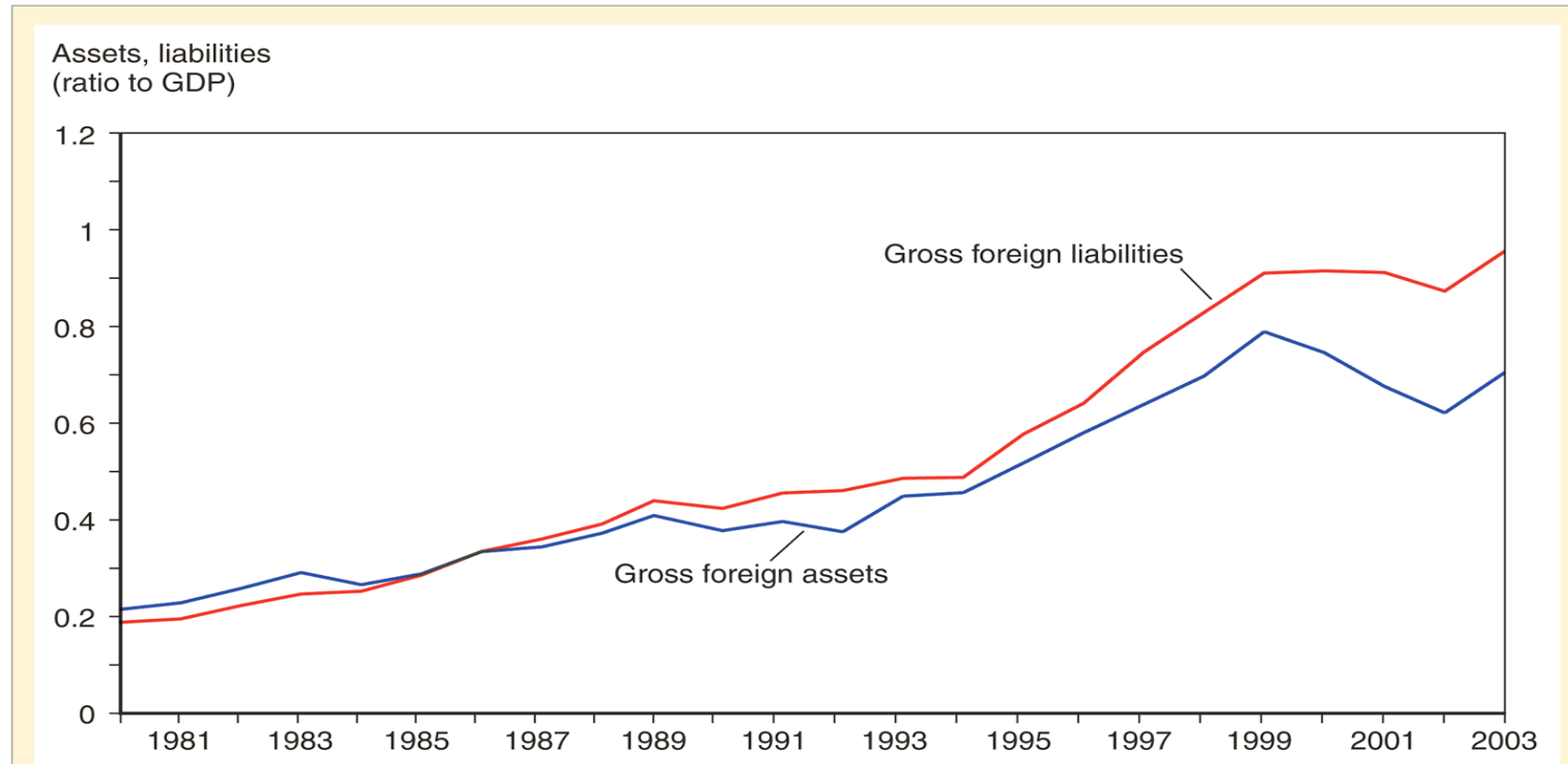
- The international reserve transactions balance shows the net change in a country's international reserves
- That balance was negative (- \$675.8 bln.) for the US in 2008 → a movement of US wealth to foreigners

# The US current account balance as a percentage of GDP



Source: Bureau of Economic Analysis, US Department of Commerce

# An increase of the US external debt



**Figure 12-3**

**U.S. Gross Foreign Assets and Liabilities, 1980–2003**

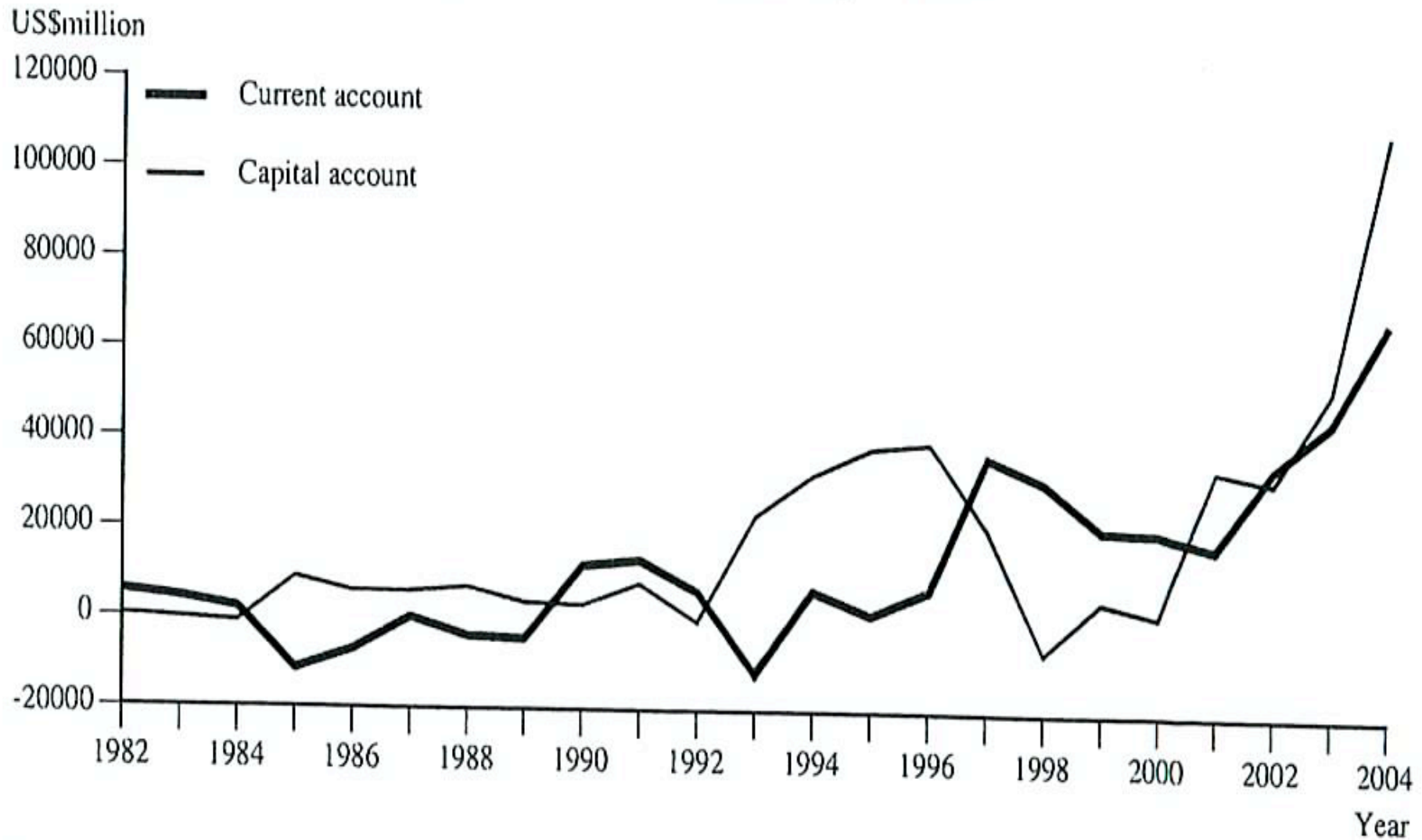
**Note:** Since 1980, both the foreign assets and the liabilities of the United States have increased sharply. But liabilities have risen more quickly, leaving the United States with a substantial net foreign debt.

**Source:** Philip R. Lane and Gian Maria Milesi-Ferretti, "Financial Globalization and Exchange Rates." Photocopy, Trinity College Dublin and IMF, June 2004.

# BOP basics VIII

- **Current account imbalances**
- For instance, large US current account deficit -- large Chinese current account surplus. Or, within the eurozone, large German current account surplus -- large current account deficits of Greece, Spain and Portugal
- Large CA imbalances can have very serious consequences: (1) an increase of the external debt of deficit countries; (2) a rise/fall of the value of the national currency (in the case of CA surplus/deficit)
- To prevent the rise/fall of the value of the national currency, central banks may buy/sell foreign currency (like the Chinese or Japanese central banks buying USD)

# China's "twin surpluses"



Source: International Monetary Fund (2006).

# Possible causes of the CA imbalances

- (1) Exchange rates: the hypothesis that the Chinese RMB being undervalued toward the USD and the euro → China's large CA surplus
- (2) Fiscal balance: fiscal deficits may lead to CA deficits too (the so-called “twin deficits”)
- **(3) Savings-investment balance**
- **(4) The “global savings glut” hypothesis**

Further explanation of (3) and (4)

## (3) The savings-investments balance I

From the national income accounts:

- $Y = C + I + G + (X - M)$

The above equation is transformed into:

$$X - M = Y - (C + I + G)$$

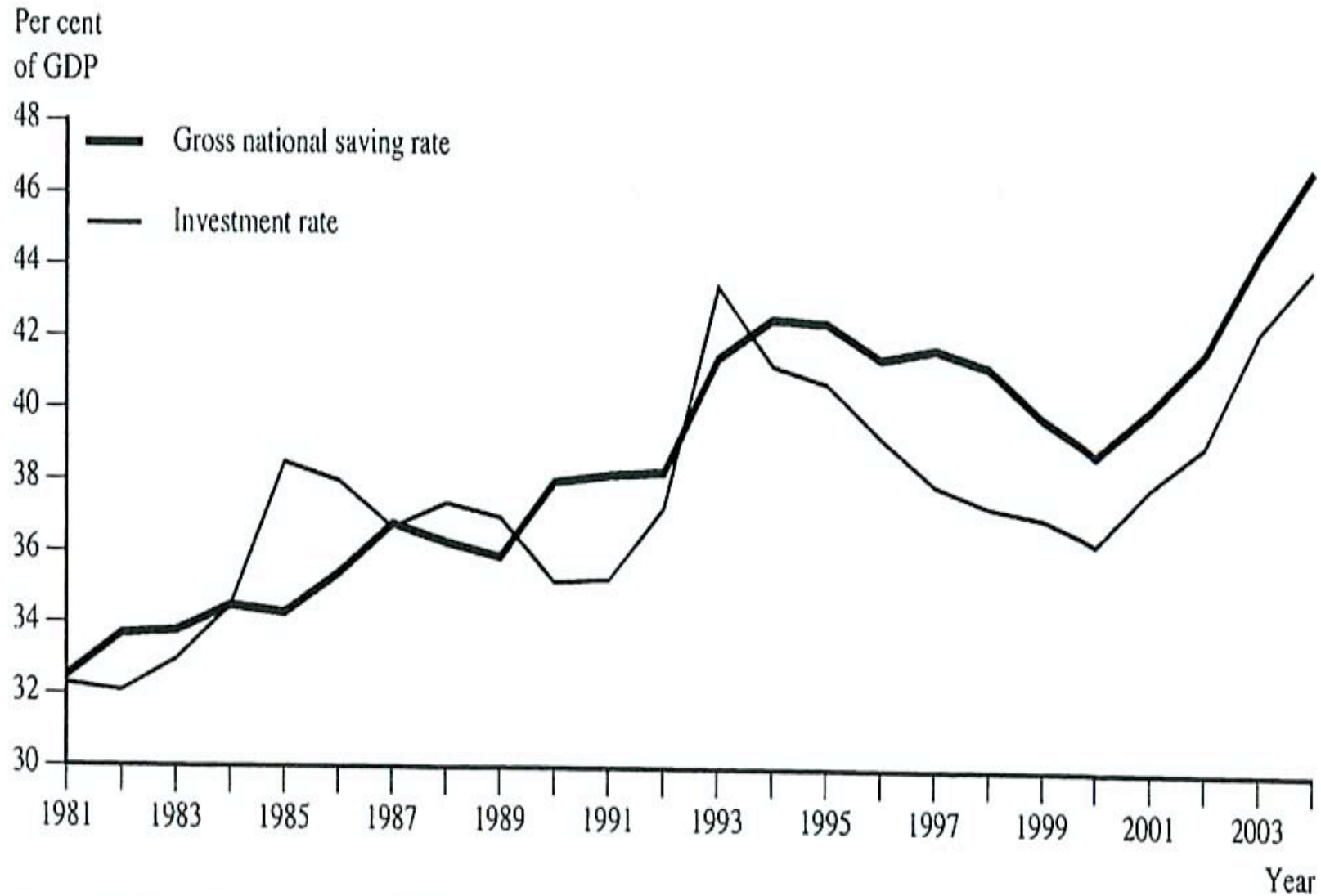
and  $X - M = (Y - C - G) - I$

The result is:  $X - M = S - I$

Or, ***current account = saving – investment***

- The CA surplus/deficit is the result of oversaving/  
undersaving relative to investment ( $S > I$ , or  $S < I$ )

# Oversaving in China



Source: National Statistics Bureau (2005).



## Great fall of China

Chinese household consumption as % of GDP



## (3) The savings-investment balance II

- **$CA\ balance = S - I$       or       $I = S - CA\ balance$**

Countries can finance investment either by increasing domestic savings or by attracting foreign capital equal to their CA deficit

But increasing the domestic savings rate may take some time to accomplish ...

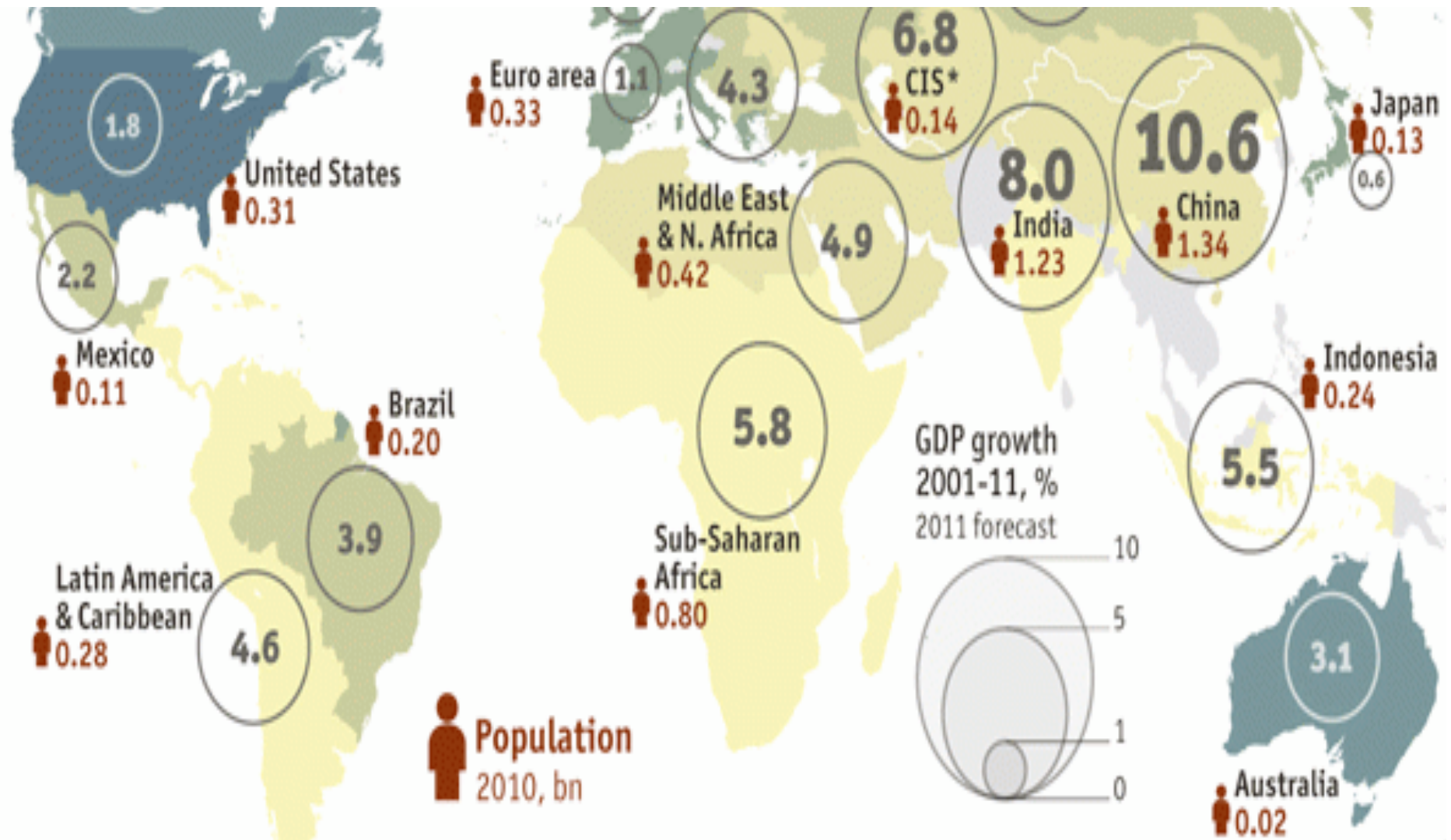
- **A country with a CA deficit ( $S < I$ ) has to attract more FDI, foreign portfolio investment, or obtain foreign loans**
- If the CA deficit cannot be covered by FDI, portfolio investment and foreign loans, the country may lose international reserves → possibility of a BOP or a currency crisis

# A BOP or a currency crisis

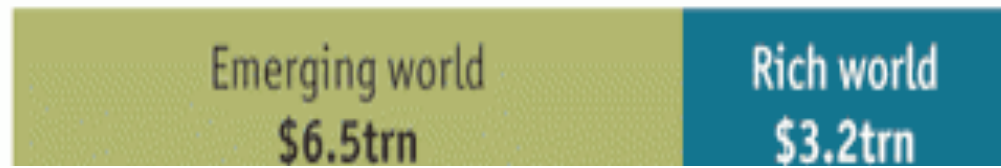
- The crisis occurs when the CA deficit country is unable to pay for its imports and/or service its external debt repayments
- The crisis is triggered by insufficient (declining) international reserves
- The crisis is accompanied by a rapid decline of that country's currency
- The result: an IMF loan and an austerity program

## (4) The “global savings glut” hypothesis

- Proposed by Ben Bernanke in 2005
- Since the beginning of 2000s, too many savings worldwide → lots of “loose money” looking for investment opportunities abroad
- **The main cause: many emerging economies developed large current account surpluses and huge international reserves**
- A large portion of these “loose money” entered the US in 2003-2007, leading to low interest rates and rising asset prices
- Capital inflows in the US pushed up the value of the USD → an increase in the US current account deficit



Official foreign-exchange reserves, Q2 2011



## Written assignment for 18 Oct.

- (1) Please explain the exchange rate (ER) regime and describe the nominal/real exchange rate movements of a country of your choice in 2009-2011
- (2) Has the value of that country's currency increased or decreased during the studied period? What are the main factors that can explain the currency's appreciation/depreciation? Has the currency's appreciation/depreciation influenced that country's CA surplus/deficit?
- (3) Is that country's currency under- or overvalued towards the US dollar (in real terms)?
- E-mail me the file until 5 pm on 17 Oct. and prepare a short talk about your assignment during the class