

The Balance of Payments

Chapter Three

3

Chapter Objective:

This chapter serves to introduce the student to the balance of payments. How it is constructed and how balance of payments data may be interpreted.

Chapter Three Outline

- Balance of Payments Accounting
- Balance of Payments Accounts
 - The Current Account
 - The Capital Account
 - Statistical Discrepancy
 - Official Reserves Account
- The Balance of Payments Identity
- Balance of Payments Trends in Major Countries

Balance of Payments Accounting

- The Balance of Payments is the statistical record of a country's international transactions over a certain period of time presented in the form of double-entry bookkeeping.

N.B. when we say “a country's balance of payments” we are referring to the transactions of its citizens and government.

Balance of Payments Example

- Suppose that Maplewood Bicycle in Maplewood Missouri, USA imports \$100,000 worth of bicycle frames from Mercian Bicycles in Darby England.
- There will exist a \$100,000 credit recorded by Mercian that offsets a \$100,000 debit at Maplewood's bank account.
- This will lead to a rise in the supply of dollars and the demand for British pounds.

Balance of Payments Accounts

- The balance of payments accounts are those that record all transactions between the residents of a country and residents of all foreign nations.
- They are composed of the following:
 - The Current Account
 - The Capital Account
 - Statistical Discrepancy
 - The Official Reserves Account

The Current Account

- Includes all imports and exports of goods and services.
- Includes unilateral transfers of foreign aid.
- If the debits exceed the credits, then a country is running a *trade deficit*.

The Capital Account

- The capital account measures the difference between U.S. sales of assets to foreigners and U.S. purchases of foreign assets.
- The U.S. enjoys about a \$150,000,000,000 capital account surplus—absent of U.S. borrowing from foreigners, this “finances” our trade deficit.
- The capital account is composed of Foreign Direct Investment (FDI), portfolio investments and other investments.

Statistical Discrepancy

- There's going to be some omissions and misrecorded transactions—so we use a “plug” figure to get things to balance.
- Exhibit 3.1 shows a discrepancy of \$96.76 billion in 1997.

The Official Reserves Account

- Official reserves assets include gold, foreign currencies, SDRs, reserve positions in the IMF.

The Balance of Payments Identity

$$BCA + BKA + BRA = 0$$

where

BCA = balance on current account

BKA = balance on capital account

BRA = balance on the reserves account

Under a pure flexible exchange rate regime,

$$BCA + BKA = 0$$

U.S. Balance of Payments Data

		Credits	Debits
Current Account			
1	Exports	\$1,167.61	
2	Imports		(\$1,295.53)
3	Unilateral Transfers	\$6.13	(\$45.01)
Balance on Current Account			(\$166.80)
Capital Account			
4	Direct Investment	\$107.93	(\$119.44)
5	Portfolio Investment	\$387.62	(\$79.28)
6	Other Investments	\$194.95	(\$227.2)
Balance on Capital Account		\$264.58	
7	Statistical Discrepancies		(\$96.76)
Overall Balance		\$1.02	
Official Reserve Account			(\$1.02)

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In 1997, the U.S. imported more than it exported, thus running a current account deficit of \$166.8 billion.

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During the same year, the U.S. attracted net investment of \$264.58 billion—clearly the rest of the world found the U.S. to be a good place to invest.

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Under a pure flexible exchange rate regime, these numbers would balance each other out.

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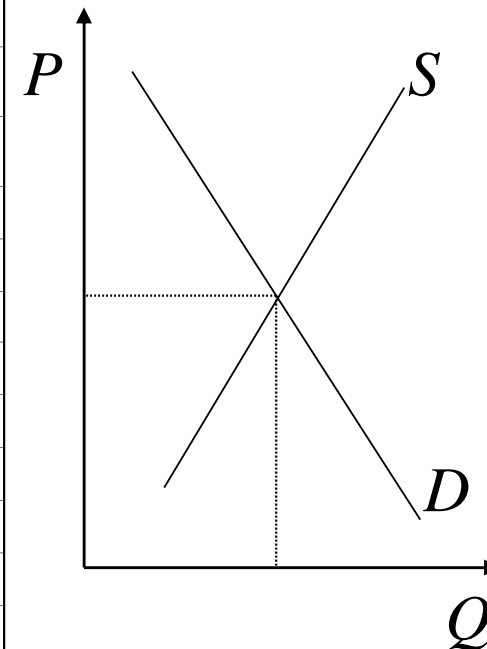
Including that,
the balance of
payments identity
should hold:

$$BCA + BKA = - BRA$$

$$(\$166.80) + \$264.58 + (\$96.76) = \$1.02 = -(\$1.02)$$

Balance of Payments and the Exchange Rate

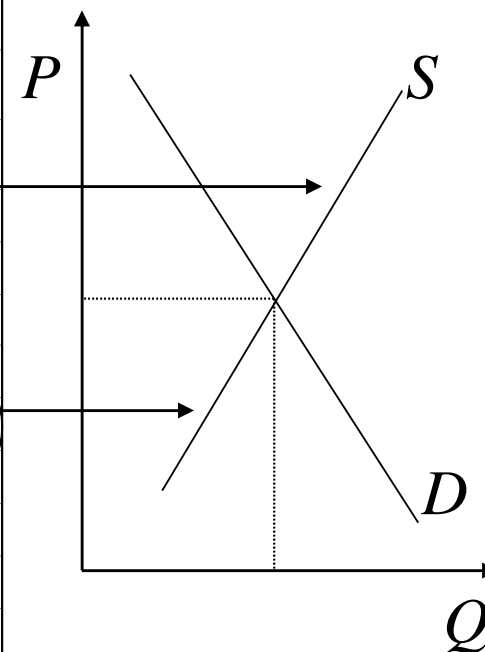
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Exchange rate \$

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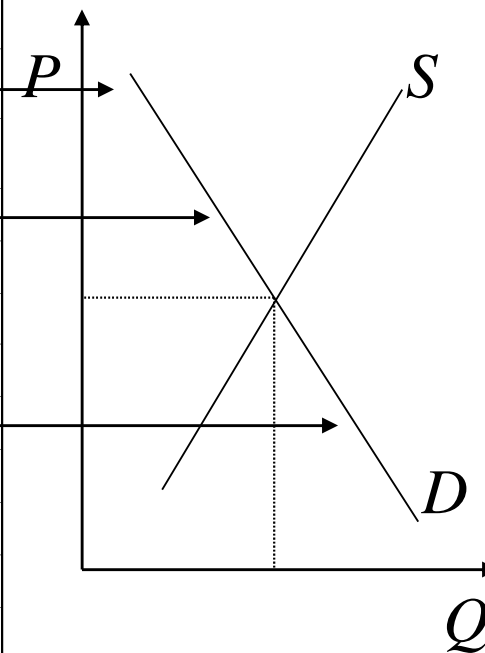


Exchange rate \$

As U.S. citizens import, they are supply dollars to the FOREX market.

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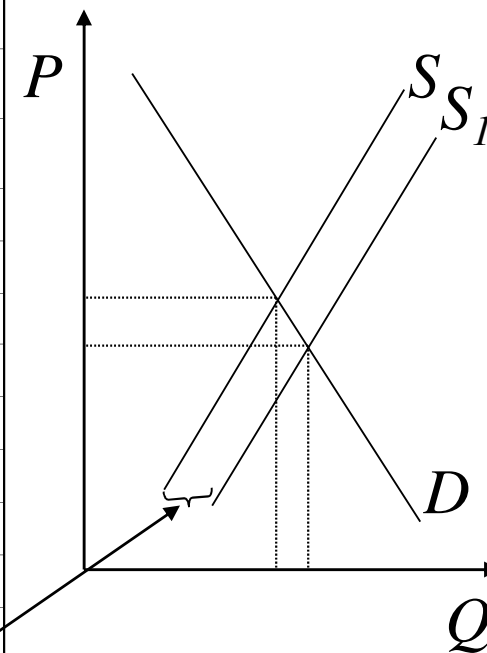


Exchange rate \$

As U.S. citizens export, others demand dollars at the FOREX market.

Balance of Payments and the Exchange Rate

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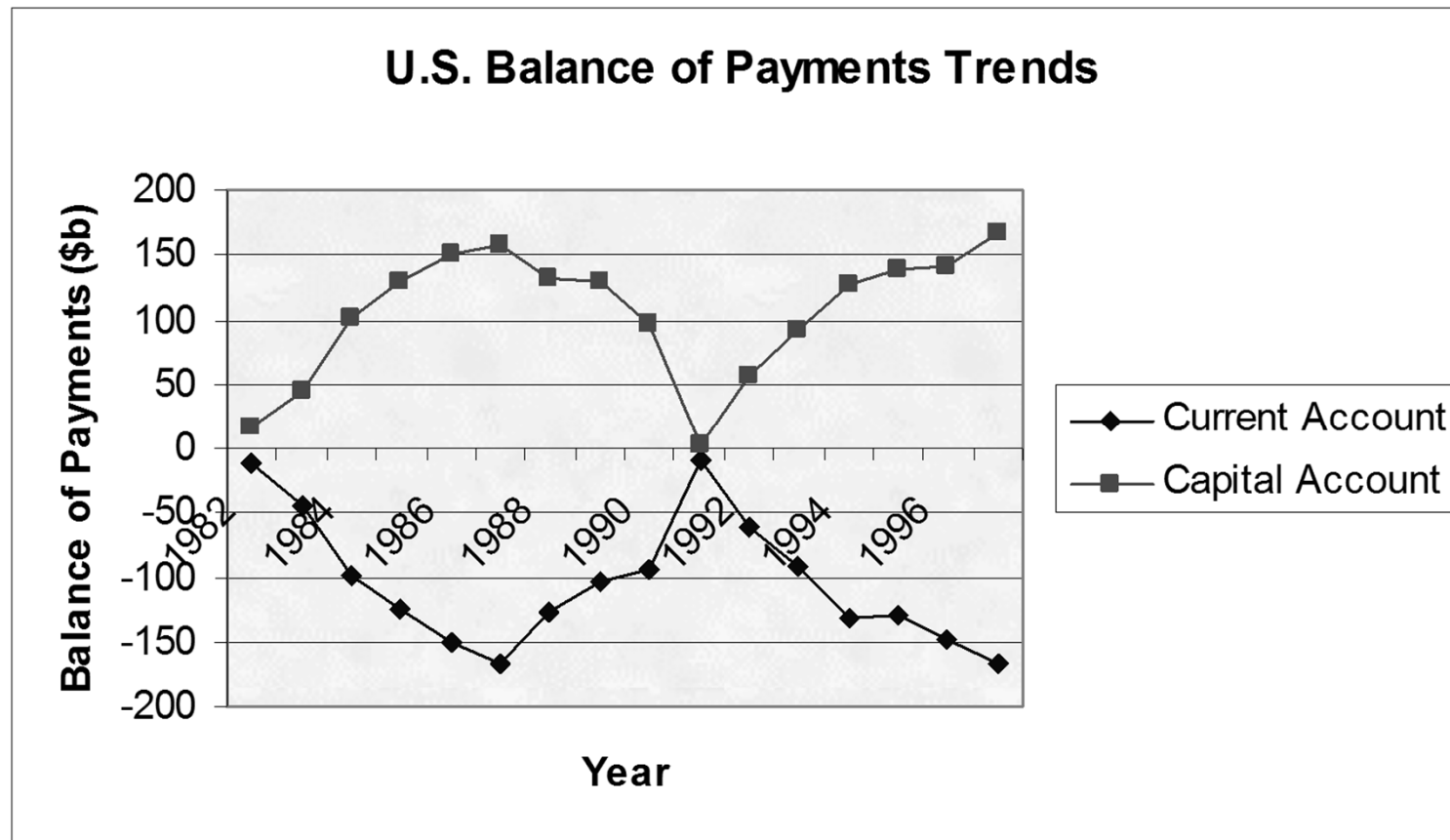
Exchange rate \$

As the U.S. government sells dollars, the supply of dollars increases.

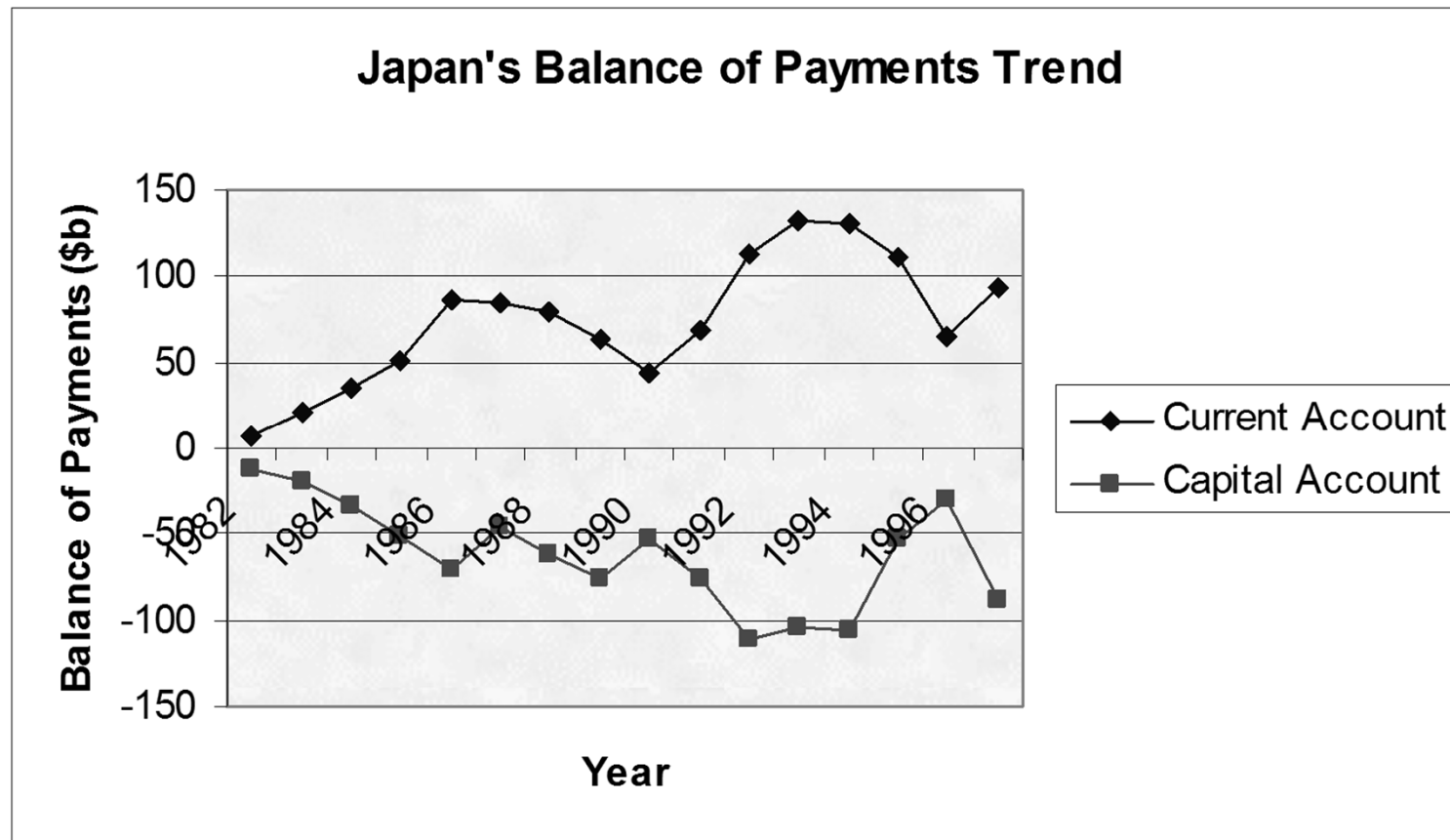
Balance of Payments Trends

- Since 1982 the U.S. has experienced continuous deficits on the current account and continuous surpluses on the capital account.
- During the same period, Japan has experienced the opposite.

Balance of Payments Trends



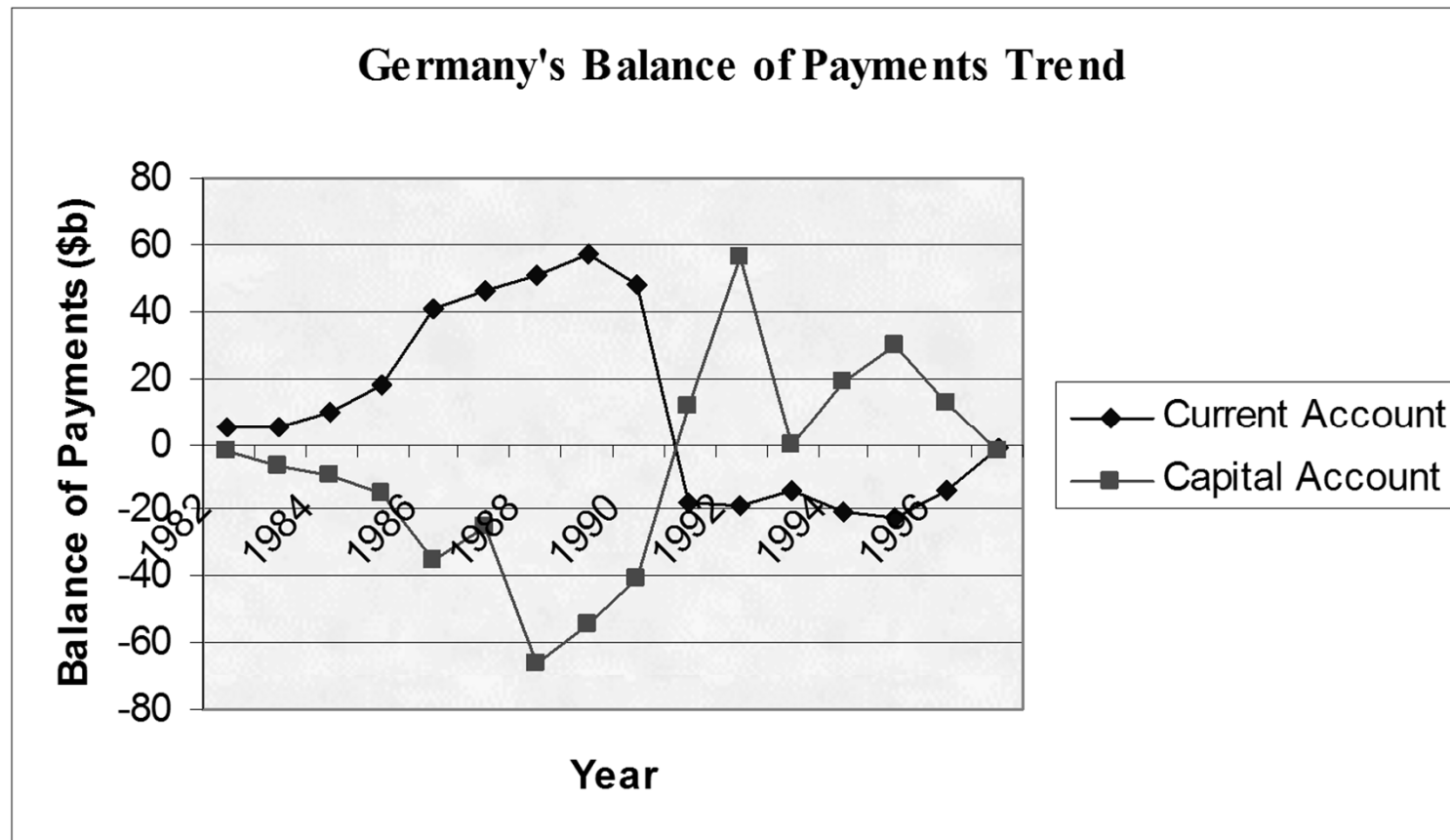
Balance of Payments Trends



Balance of Payments Trends

- Germany traditionally had current account surpluses.
- Since 1991 Germany has been experiencing current account deficits.
- This is largely due to German reunification and the resultant need to absorb more output domestically to rebuild the former East Germany.
- What matters is the nature and causes of the disequilibrium.

Balance of Payments Trends



End Chapter Three