

Ch. 3 Balance of Payments



Topics

- Balance of Payments
- International Trade Flows
- International Capital Flows
- Agencies that Facilitate International Flows

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Balance of Payments



- Balance of Payments: Measurement of all transactions between domestic and foreign residents over a specified period of time.
 1. Current Account
 2. Capital Account
 3. Finance Account
- BOP data may be important for the following reasons:
 - BOP is important indicator of pressure on a country's exchange rate, thus potential to either gain or lose if firm is trading with that country or currency.
 - Changes in a country's BOP may signal imposition (or removal) of controls over payments, dividends, interest, etc.
 - BOP helps to forecast a country's market potential, especially in the short run.

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Typical BOP Transactions



- Examples of BOP transactions from US perspective
 - Honda US is the distributor of cars manufactured in Japan by its parent, Honda of Japan.
 - US based firm, Fluor Corp., manages the construction of a major water treatment facility in Bangkok, Thailand.
 - US subsidiary of French firm, Saint Gobain, pays profits (dividends) back to parent firm in Paris.
 - An American tourist purchases a small Lapponia necklace in Finland.
 - A Mexican lawyer purchases a US corporate bond through an investment broker in Des Moines.
- A rule of thumb that aids in understanding the BOP is to "follow the cash flow."
 - The BOP is often misunderstood as a balance sheet, whereas in fact it is a **cash flow statement**.

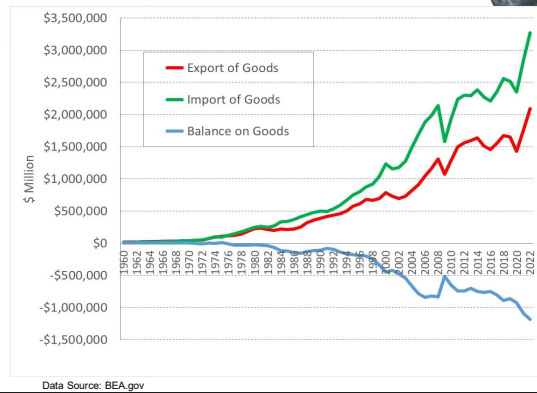
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Current Account

- **Definition:** Summary of the flow of funds between one specified country and all other countries due to the purchases of goods or services, the provision of income on financial assets.
- 1. **Merchandise Export and Imports / Balance of Trade**
- 2. **Service Exports and Imports**
- 3. **Factor Income:** Interests and dividends received by investors on foreign investments in financial assets.
- 4. **Transfer Payments:** International aid, grants and gifts.

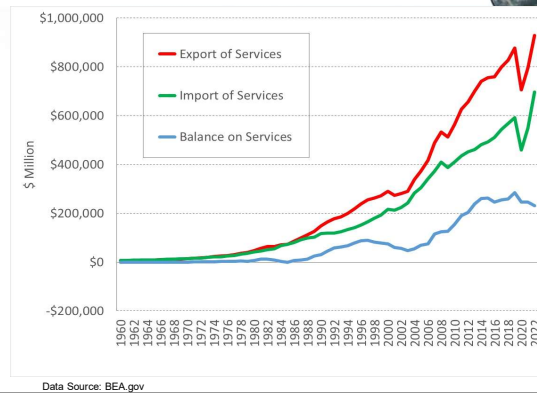
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Exports, Imports & Trade Balance

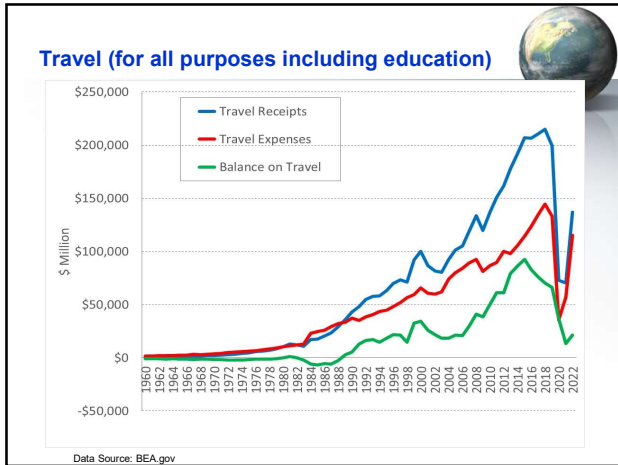


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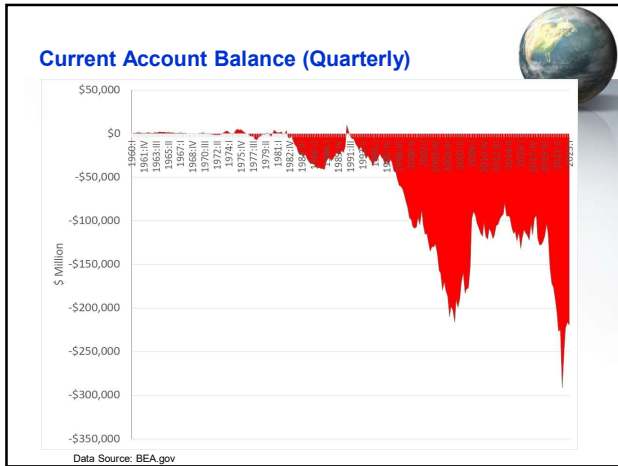
Service Exports & Imports



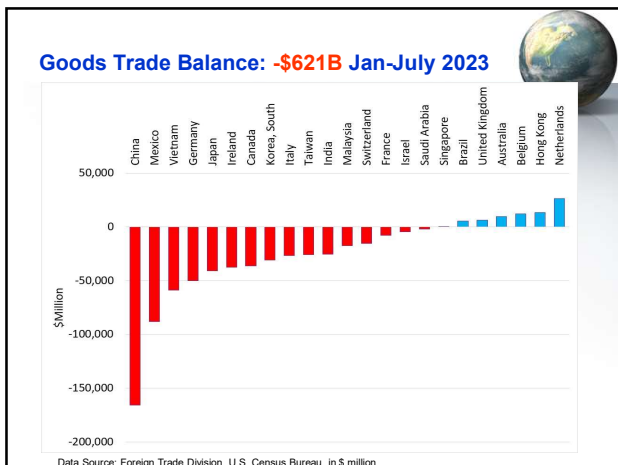
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Capital Account

- The new capital account is adopted by the U.S. in 1999.
- It includes unilateral current transfers that are really shifts in assets, not current income.
 - Debt forgiveness
 - Transfers by immigrants
 - Sale or purchase of rights to natural resources or patents
- Capital account is made up of transfers of fixed assets such as real estate and acquisitions/disposal of non-produced/non-financial assets.



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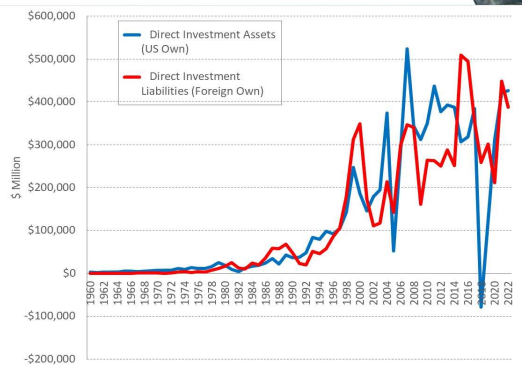
Financial Account

- Previously called as the capital account.
- Definition: Summary of the flow of funds resulting from the sale of assets between one specified country and all other countries over a specified period of time.
- Assets include official reserves, other government assets, direct foreign investments, investments in securities, etc.
 - Portfolio Investment
 - Foreign Direct Investment
 - Other Investment Assets/Liabilities: Consists of various short and long-term trade credits, cross-border loans, currency and bank deposits and other accounts receivable and payable related to cross-border trade.



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Financial Account



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Balance of Payments Interaction with Key Macroeconomic Variables



- In a static (accounting) sense, a nation's GDP can be represented by the following equation:

$$GDP = C + I + G + X - M$$

C	= consumption spending	
I	= capital investment spending	
G	= government spending	
X	= exports of goods and services	} X - M = Current account balance
M	= imports of goods and services	

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Factors Affecting Int'l Trade Flows



1. **Inflation:** A relative increase in a country's inflation rate will decrease its current account, as imports increase and exports decrease.
 2. **National Income:** A relative increase in a country's income level will decrease its current account, as imports increase.
 3. **Government Restrictions**
 4. **Exchange Rates:** If a country's currency begins to rise in value, its current account balance will decrease as imports increase and exports decrease.
- By reconsidering the factors that affect the balance of trade, some common correction methods can be developed. (e.g. floating exchange rate system)

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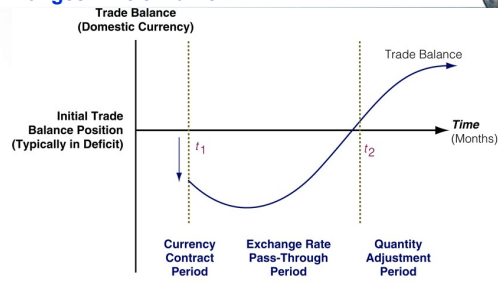
Correcting a Balance of Trade Deficit



- Why a Weak Home Currency is not a Perfect Solution to Trade Deficit:
 - Foreign companies may lower their prices to maintain their competitiveness.
 - Some other currencies may weaken too.
 - The impact of exchange rate movements on **intracompany trade** (purchasing products from firms' foreign subsidiaries) is limited.
 - Many trade transactions are prearranged and cannot be adjusted immediately. This is known as the **J-curve effect**.

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Trade Balance Adjustment to Exchange Rate Changes: The J-Curve



If export products are predominantly priced and invoiced in domestic currency, and imports are predominantly priced and invoiced in foreign currency, a sudden devaluation of the domestic currency can possibly result—initially—in a deterioration of the balance on trade. After exchange rate changes are passed-through to product prices, and markets have time to respond to price changes by altering market demands, the trade balance will improve. The currency contract period may last from three to six months, with pass-through and quantity adjustment following for an additional three to six months.

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International Trade Flows

- Different countries rely on trade to different extents.
- The trade volume of European countries is typically between 30 – 40% of their respective GDP, while the trade volume of U.S. and Japan is typically between 10 – 20% of their respective GDP.
- Nevertheless, the volume of trade has grown over time for most countries.

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International Trade Flows

- **Changes in North American Trade**
 - In 1998, a 1989 free trade pact between U.S. and Canada was fully phased in.
 - Passed in 1993, the North American Free Trade Agreement (NAFTA) removes numerous trade restrictions among Canada, Mexico, and the U.S.
 - In 2001, trade negotiations were initiated for a free trade area of the Americas. 34 countries are involved.
 - North American Free Trade Agreement (NAFTA) is replaced by the United States–Mexico–Canada Agreement (USMCA) in 2018.

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International Trade Flows



Changes in European Trade

- The Single European Act of 1987 was implemented to remove explicit and implicit trade barriers among European countries.
- Consumers in Eastern Europe now have more freedom to purchase imported goods.
- Eurozone/Euro area: The single currency system implemented in 1999 eliminated the need to convert currencies among participating countries.
- Brexit: The United Kingdom (UK) withdrew from the European Union (EU) on January 31, 2020. It was a result from the referendum held in the UK on June 23, 2016. The UK had spent 47 years as a member state of the EU.

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International Trade Flows



Trade Agreements Around the World

- In 1993, a General Agreement on Tariffs and Trade (GATT) accord calling for lower tariffs was made among 117 countries.
- Other trade agreements include:
 - European Community
 - Association of Southeast Asian Nations (ASEAN): A regional intergovernmental organization comprising ten countries in SE Asia.
 - Central American Common Market - Mercado Común Centroamericano (MCCA): Association of five Central American nations that was formed to facilitate regional economic development through free trade and economic integration.
 - Mercosur (in Spanish) or Mercosul (in Portuguese): South American trade bloc established by the Treaty of Asunción in 1991.
 - North American Free Trade Agreement (NAFTA) and United States–Mexico–Canada Agreement (USMCA)

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International Trade Flows



Friction Surrounding Trade Agreements

- Trade agreements are sometimes broken when one country is harmed by another country's actions.
- Dumping refers to the exporting of products by one country to other countries at prices below cost.
- Another situation that can break a trade agreement is copyright piracy.

Trade Wars

- Tariffs / Non-trade barriers
- Currency wars

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