Reading the balance of payments accounts

The balance of payments refers to both:

- All the various payments between a country and the rest of the world
- The particular system of accounting we use to keep track of those payments

When we talk about the *balance of payments constraint*, or about the balance of payments as a target of policy, we mean the steps that government must take to ensure that payments out of the country don't rise too much relative to payments into the country.

We classify items as *credit* or *debit* based on whether they involve payments into or out of the country. Credit items include:

- exports
- income payments we receive from abroad (interest or dividends from foreign investment, wages earned in other countries, etc.)
- sales of foreign assets
- borrowing from abroad (when you take out a loan, you initially receive money)

Similarly, debit items include:

- imports
- income payments we make to foreigners
- purchases of foreign assets
- lending to abroad (when you take out a loan, you initially receive money)

Often, credit items are all given as positive numbers and debit items as negative numbers.

If correctly measured, the balance of payments as a whole should always sum to zero.

- A surplus in one part of the BoP should be balanced by a deficit somewhere else. For example, a country with a trade deficit may have a surplus on income, or on the financial account.
- In practice, the items never sum exactly to zero; the difference is recorded under "errors and omissions."
- We sometimes describe a country as having a balance of payments surplus or deficit by adding up everything except changes in*official reserves*.

The balance of payments acccounts group various payments into a few broad categories. The most common division is:

- The **current account**: imports, exports, income flows and transfers.
  - Imports and exports consist of trade flows – purchases of goods and services from one country by a person, business or government in a different country. Trade flows

can be further divided between goods and services. Tourism is considered a service export from the country visited.

  - Income flows are the payments for the use of *factors of production* – labor, capital, or money – from one country for production in a different country. The most important income flows are profits paid out to owners of foreign investment. For instance, if an American company owns a factor in Mexico, and profits made by that factory are counted as an income payment from Mexico to the US. Interest and on foreign loans is also counted as income. (New loans however show up in the financial account). Wages count as income flows in the balance of payments when a person resides in one country but works in a different one.

    Income flows are counted in Gross National Product (GNP), but not in Gross Domestic Product (GDP).

  - Transfers are payments for which nothing is received in return. The most important transfers in the balance of payments are foreign aid and *remittances* by immigrants to family members in their country of origin.

- The **capital account**. This includes cases where asset ownership changes between countries without a sale or purchase. In practice it is very small and can be safely ignored. Note that what is now called the financial account used to be called the capital account, and many people still say "capital account" when they mean the financial account.

- The **financial account** consists of international lending and borrowing and asset sales, and is divided into portfolio investment, direct investment and other investment. Purchases of assets in another country are also called *foreign investment.*

  - Foreign investment that that involves only financial assets is called *portfolio investment.* Inward portfolio investment is when someone abroad buys a stock or bond from someone in this country; outward portfolio invstment is when someone in this country buys a foreign stock or bond.

  - Foreign investment that involves changes in control of real productive assets like land, buildings or businesses is called *foreign direct investment (FDI).* Again, inward FDI is when a foreign business buys an existing company here, or opens a new one; outward direct investment is where a business here creats or acquires a subsidiary abroad. Note that when a comopany that earns profits abroad uses them to expand its foreign subsidiary, rather than bringing them back to the country where the parent company is located, that is considered FDI even though no mney actually changes hands.

  - Other investment consists mainly of new bank loans (and repayment of existing bank loans) and changes in bank deposits.

- Official **foreign exchange reserves.** This item is *changes* in the foreign-currency assets held by the central bank. It usually is reported separately but sometimes included in the financial account.

Why might the balance of payments change?

Exports of goods and services tell us how much of our products are being bought by the rest of the world. An increase in exports moves the trade balance and current account balance toward surplus. Exports rise when

- demand rises for things we produce
- the economies we trade with grow faster
- our costs decline, making our products cheaper.

Exports will fall in the opposite cases.

One important reason our goods might become cheaper is if our exchange rate *depreciates*. But depreciation does not always raise exports. If demand for our products is *inelastic*, a depreciation might actually reduce our export earnings.

Imports of goods and services tell us how much we are spending on goods and services from the rest of the world. Imports rise when

- demand shifts toward goods that are not produced at home
- our incomes rise more rapidly.
- imported goods become cheaper relative to home goods

Imports will fall in the opposite cases.

A fall in the price of imports will normally increase imports and move the trade balance toward deficit, but it may reduce total imports if the demand for imported goods is sufficiently *inelastic*.

Primary income receipts are mainly profits and interest from our investment abroad.

- Income from assets we own in the rest of the world.
- All profits on foreign investment are counted, whether or not they are brought back to our country as dividends
- Wages of residents of our country who work in other countries are also counted. Trivial for the US but may be important for smaller countries

Primary income payments are mainly profits and interest that we pay to owners of foreign investment in our country.

- Reflect past borrowing from abroad.
- Large income payments can create problems because there is no way to adjust them in the short run, short of defaulting on foreign debt.

Secondary income receipts and payments are also called *transfers*. These are mainly:

- *Remittances* from immigrants to family members in their country of origin
- Foreign aid and other transfers between governments

Foreign direct investment is investment by businesses based in one country in foreign businesses *that they control* (at least partially). It mostly consists of spending by *multinational corporations* to create or expand foreign operations and subsidiaries. Companies engage in FDI in order to

- get control of raw materials not available domestically (e.g. oil or minerals)
- shift production to countries where costs, particularly wages, are lower
- produce goods closer to their final markets (especially in countries that limit imports)

Because FDI involves active management and is integrated into multinational operations, it is stable – does not change in response to short-term movements in exchange rates, interest rates, etc.

Outward FDI is counted as a *debit* item – it involves money flowing out of the country.

Portfolio investment is purchases by households and businesses of marketable foreign securities (i.e. stocks and bonds issued by foreign companies and governments). Portfolio investment is driven by

- interest rates – investors prefer to hold bonds in countries where interest rates are higher
- expected exchange rate changes – investors will try to sell in advance of any expected decline in the value of a currency
- risk and liquidity – in periods of uncertainty, investors want to hold assets whose value is expected to be stable and which are easy to sell in an emergency. This means that global crises are associated with portfolio inflows to the US (and to a few other "safe" countries like Switzerland or Japan)
- economic conditions – investors prefer to hold assets in countries experiencing rapid growth, and do not want to hold assets in countries experiencing downturns or instability

Portfolio flows can be highly unstable and are subject to *herding*.

Outward portfolio investment is counted as a *debit* item. Inward portfolio investment (i.e. foreign borrowing) is counted as a *credit* item.

Other investment is mainly bank loans and deposits. An increase in deposits at a foreign bank is equivalent to a loan to that bank; it counts as outward foreign investment, and is a debit item.

Some changes in other investment are driven by the same factors that affect portfolio investment. But most changes in cross-border bank loans and deposits happen automatically as a result of international payments. For example:

- You spend $1,000 to buy a foreign bond, using a US bank account.
- Bank now owes the deposits to foreign seller instead of to you. This counts as flow of other investment to the US.
- The balance of payments would show a $1,000 debit item for the US under portfolio investment and $1,000 credit item under other investment.

In the short run, changes in bank loans and deposits are normally what ensures th the balance of payments balances.

Official reserves are foreign assets held by a country's central bank.

- Central banks hold reserves in order to ensure that the country is able to make international payments.
- Reserves are especially important when a country maintains a fixed exchange rate.
- An increase in foreign exchange reserves is a debit item, and a decrease in reserves is a credit item.
- Changes in reserves are another important blanacing item.

When one flow changes some other flow must change to cancel it out. This might happen automatically but if it does not we say that the country faces balance of payments *constraints*. To satisfy the constraints, there must be a macroeconomic *adjustment*.

Balance of payments adjustments:

- are a major source of instability in the global economy.
- limit the actions that can be taken by national governments.
- help determine how the gains of economic activity are distributed between countries.

Stories We Tell with the Balance of Payments

1. Trade flows change. A country's exports or imports may increase or decrease. In the short run, this is usually due to either

    - relative price changes – often due to changes in exchange rates
    - income changes – when income rises more quickly, countries import more, when it grows more slowly or fall, they import less

    When a country's net exports rise, either there must be an equivalent financial outflow. If not, something must happen to cause imports to rise also, or bring exports back down.

2. Surpluses must be recycled. A country with a positive current account balance must be a lender to the rest of the world

    - by reducing its liabilities to the rest of the world, or more usually
    - by increasing its foreign assets.

    Example: During the 2000s, Germany's trade surplus increased. BoP balance was maintained by large portfolios investment flows to other countries, especially southern Europe.

3. Current account deficits must be financed. A country with a negative current account must somehow generate a surplus on the financial account

    - by reducing its official reserves

- by reducing its foreign assets, or most usually
- by increasing its foreign liabilities (i.e. borrowing from abroad).

A country dependent on foreign borrowing to finance a current account deficit depends on the *confidence* of foreign investors.

Example: During the 1990s, Korea, Malaysia and other Asian countries had large trade deficits, financed by portfolio inflows from investors who believed there would be large gains on assets in those countries. When investors abruptly changed beliefs about returns in these countries, portfolio inflows reversed, and the need to rapidly close current account deficit caused economic crisis.

4. Portfolio flows change.

   Inward portfolio flows depend on

   - Interest rate differentials – investors prefer bonds, etc. in countries where rates are higher
   - Speculation over *capital gains* from changes in exchange rates or asset prices

   Outward portfolio flows

   - also are affected by interest rate differentials, and expected returns on investment at home
   - may be very large if there is an expectation that the currency will be *devalued*
   - can reflect *capital flight* if rich people want to move wealth abroad

   Portfolio flows are the most unstable component of the balance of payments and most common reason for rapid adjustment.

   Example: An increase in interest rates in the US may cause foreign investors to sell foreign bonds and buy US bonds. The resulting *capital outflow* can create serious problems for developing countries.

Economic theory describes various automatic mechanisms that maintain payments balance:

- Prices might fall in the country with a deficit, which will raise net exports, restoring balance. (This is the oldest theory of balance of payments adjustment, in the form of the *price-specie flow mechanism* of David Hume.)
- The exchange rate of the country with a deficit might depreciate, again raising net exports.
- Interest rates might rise in the country with a deficit, leading to inflows of portfolio investment.
- Output might fall (or grow more slowly) in the country with a deficit, reducing imports. (Balance of payments constrained growth.)

In reality there is no automatic mechanism that maintains payments balance. Various different adjustments are possible.