Course Title: International Economics

Course Code: ECON3019

Course Instructor: Mr. Bidhubhusan Mishra

BALANCE OF PAYMENTS

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The Balance of Payments

- ***Balance of Payments (BOP):*** measures all international economic transactions b/n residents & foreign residents.

  - Monetary and fiscal policy must take the BOP into account at the national level
  - BOP data may be important
    - Indicates pressure on exchange rate
    - May signal imposition/ removal of controls over payments, dividends, interest.
    - Helps forecast country’s market potential

- Balance of payments issues such as trade deficits and foreign indebtedness are controversial topics.
- Balance of payments accounts provide insights into the country’s economic performance relative to the rest of the world.
- The study of the economics of balance of payments allows proper evaluation of the various arguments and government policies recommended to eliminate trade imbalances.

Features of the BOP

- BOP follows the accounting procedure of double-entry bookkeeping (debits & credits).
  - A credit entry records an item or transaction that brings foreign exchange into the country.
  - A debit entry represents a loss of foreign exchange.

- BOP will always balance.
- A BOP deficit (surplus) means that the debit entries exceed (are less than) the credits. This imbalance applies only to a particular account or component of the BOP.

Components of the BOP

- The Current Account
- The Capital Account
- Official Reserves Account
- Errors and Omissions

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.
- If the credits exceed the debits, then a country is running a trade surplus.

CURRENT ACCOUNT

- Export & Import of Merchandise & Services.
- Income Account (The income account accounts mostly for investment income from dividends and interest on credit and payments on foreign taxes.)
- Transfer payment

CURRENT ACCOUNT= BALANCE OF TRADE +NET FACTOR INCOME FROM ABROAD+NET UNILATERAL TRANSFER FROM ABROAD

CAPITAL ACCOUNT

- If foreign ownership of domestic financial assets has increased more quickly than domestic ownership of foreign assets in a given year, then the domestic country has a capital account surplus.

- On the other hand, if domestic ownership of foreign financial assets has increased more quickly than foreign ownership of domestic assets, then the domestic country has a capital account deficit.

Official International Reserves

- The official international reserve account records the change in stock of official international reserve assets (also known as foreign exchange reserves) at the countrys monetary authority .
- Official reserves assets include gold reserves, foreign currencies, SDRs, reserve positions in the IMF.
- {Special Drawing Rights (SDRs) are potential claims on the freely usable currencies of IMF members.}

NET ERROR AND OMMISSION

- This is the last component of the balance of payments and principally exists to correct any possible errors made in accounting for the three other accounts.
- They are often referred to as "balancing items".

Drawing a Line in the BOP

- If we draw a line at the current account balance, then:
  1. Items “above the line” refer to the current account trade in goods, services, income, and unilateral transfers.
  2. Items “below the line” are the capital and financial account transactions (purchases and sales of financial assets).

Since the BOP always balances, then a current account deficit (above the line) implies that the country is running a net surplus below the line, so that the country is a net borrower from the rest of the world.

What if…?

- BOP shows surplus:
  - D > S for that currency.
  - Allow currency value to increase,
  - Or accumulate foreign reserves.

- BOP shows deficit:
  - S > D for that currency.
  - Devalue currency,
  - Or use official reserves to support currency.

National Saving, Investment, and the Current Account

Given the national income accounting identity:

$$Y = C + I + G + X$$

- where Y is national income or GDP, C is consumption spending, I investment, G government spending, and X is net exports or the current account, we can rearrange this identity as:

$$Y - C - G = S = I + X$$

- where $Y - C - G$ is national income less consumption less government spending, which we can call national saving S. Thus, saving equals the sum of investment and the current account.

- Rearranging further, we get:

This states that if domestic saving exceeds investment, there will be a current account surplus.

- A country that spends more than its income (I > S) will experience a current account deficit. This overspending must be financed by foreign investment, so there will be a financial account surplus to match the current account deficit.

Link between
Saving and the Current Account

- Given two kinds of saving (private and government):

$$S=(Y-T-C)\ \ +(T-G)$$

where private saving equals income less taxes (T) less consumption, and government saving equals taxes less government spending.


THANK
YOU