

EC 380: Lecture 14

Global Finance: Balance of Payments

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Prologue

Recap

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- Explore **system** used to track country's international transactions
- Establish relationship between domestic investment, domestic savings and international flows of goods, services, and financial assets
- Examine consequences of **international indebtedness**

Layout

Three separate accounts for the **Balance of Payments**:

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- Exports & imports
- Income on equities
- Income on debt-related assets
- Repatriated income by MNE firms

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⇒ Outflow of goods, services, investment income etc of country are greater than inflows

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- Foreign investment
- Purchase or sales of foreign stock & bonds
- International bank lending

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For the United States, the 2019 USD trade balance was 2,498bn minus 3,114bn, or –616bn. Because the number is negative, the United States had a **trade deficit**.

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All three of these items have credit and debit components in BoP and construction of CA balance.

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Components of Current Account

Type	Credit	Debit
1. Goods and Services	Exports	Imports
2. Primary Income	Investment earnings income received from foreigners and compensation of employees	Investment earnings income paid to foreigners and compensation of employees
3. Secondary Income	Transfers received from abroad	Transfers made to foreigners

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Investment income items not to be confused with the flow of **investment capital** used to buy a business or company shares.

Investment income is the income received or paid on the existing investments.

CA: Primary Income

Useful to think of **primary income** as payments or receipts for use of financial capital.

If a US company invests in Mexico's stock market, the initial investment will not show up in the current account but will be included in the financial account. Subsequent flow of dividends back to the U.S. company will be counted in the United States as income received and in Mexico as income paid. If US company operating in Mexico pays wages from its home in the U.S., the wages are included in the primary income category of the current account and are recorded as a receipt by Mexico and payment by the US.

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In US, payments are small relative to the overall current account.

Transfers are sometimes *very important* to developing countries receiving large volumes of either foreign aid or remittances from their citizens working abroad.

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ID	Description	Credit	Debit
1.	Goods and Services exports	2498	-
1a.	Goods Exports	1653	-
1b.	Service Exports	845	-
2.	Primary income receipts	1123	-
2a.	Investment income received	1116	-
2b.	Compensation of employees received	7	-
3.	Secondary income receipts	143	-
4.	Goods and Services imports	-	3114
4a.	Goods Imports	-	2519
4b.	Service Imports	-	595
5	Primary income payments	-	866
5a.	Investment income paid	-	846
5b.	Compensation of employees paid	-	20
6	Secondary income payments	-	282
7	Total Debit	3764	-
8	Total Credit	-	4262
9	Current Account Balance	-	498

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Rapid economic growth in US **raised income**, increased spending power means greater imports.

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Deficit is not sustainable in the long run and could create **serious future problems**.

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Divided into **three main categories**, each with many subcomponents. The three main categories are:

1. the net acquisition of financial asset
2. the net incurrence of liabilities
3. changes in financial derivatives

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Financial derivatives are assets with a value that is derived from the value of some other asset, such as commodity prices or exchange rates, or one of many other possibilities.

Financial Account: Derivatives

Essentially packages as **financial options** (puts/calls) that allow for hedging against risk.

For example, farmers used them to protect against fluctuations in agricultural prices.

Wheat farmer might sign a contract in March to sell her crop in September at a price agreed when the contract is signed. The value of the contract depends on the fluctuation in wheat prices. If prices go above the agreed price, the contract becomes more valuable to the buyer because they have a guaranteed lower price, and vice versa if prices fall over the summer.

The contract is a derivative since its value depends on the price of wheat.

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If the stocks and bonds are equal in value, then the net change is zero.

Financial Account

The US Balance of Payments, 2019

ID	Description	Billions, USD
1.	Current Account Balance	-498
2.	Capital Account Balance	0
3.	Financial Account	-
3a.	Net U.S. acquisition of financial assets, excluding financial derivatives (increase/outflow (+))	427
3b.	Net U.S. incurrence of liabilities, excluding financial derivatives (increase/inflow (+))	784
3c.	Net change in financial derivatives	-38
4.	Statistical Discrepancy	102
5.	Memoranda	-
5a.	Balance on current and capital accounts (lines 1 + 2)	-498
5b.	Balance on financial account (lines 3a - 3b + 3c)	-396

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Debits viewed as the **inflow received when assets are sold to foreigners** and credit are the **payment outflow when financial assets are purchased by home country residents.**

Conceptually similar to the credits and debits of exports and imports.

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Since each element in the current account must include a financial transaction, *current plus capital account must equal the financial account*.

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Balance on financial account is the **amount lent** minus the **amount borrowed** plus the **net change in derivatives**, **−396** bn.

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While the current and financial accounts are mirror images of each other, *a large share of a nation's gross financial account transactions is not in response to the current account flows of goods, services, or income.*

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As a result, the financial account is a complete picture of **net flows** of financial assets during the year.

Financial Risks

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The degree of mobility of financial flows and the potential of some flows to introduce a large element of volatility into an economy have turned the type of flows that a country receives into a major issue.

Financial Subcomponents

The US Financial Account 2019, by Subcomponent

ID	Description	Billions, USD
3a.	Net U.S. acquisition of financial assets, excluding financial derivatives (increase/outflow (+))	427
3a.i.	Direct investment assets	198
3a.ii	Portfolio investment assets	39
3a.iii	Other investment assets	189
3a.iv	Reserve assets	5
3b.	Net U.S. incurrence of liabilities, excluding financial derivatives (increase/inflow (+))	784
3b.i.	Direct investment liabilities	311
3b.ii	Portfolio investment liabilities	232
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The 2019 financial account for the United States, divided into seven subcategories representing the main components of outflows and inflows, or net assets acquired (outflow) and net liabilities incurred (inflow).

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(3a.i) represents the purchase of real property **outside the United States** by U.S. residents and businesses.

(3b.i) represents asset purchases **in the United States** by foreign residents and businesses.

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In general, FDI varies considerably and is often linked to mergers.

Once made, however, FDI is probably less likely to leave a country, particularly when compared to the next category of items in lines **3a.ii** & **3a.iii** and **3b.ii** & **3b.iii**.

Summary

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- Contents of Balance of Payments indicate net flows
- Financial Accounts should balance with Current + Capital

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Next time

- Macroeconomy implications of BoP state
- International Debt considerations
- Investment Position, maybe some Brexit
- Introducing exchange rates