The structure of the balance of payments

147. The meaning of the balance of payments

Item 147 – Grade 3

Ib question

- Outline the role of the balance of payments.
- Distinguish between debit items and credit items in the balance of payments.

Definition

➢ The balance of payments account

→ A record of the value of all the transactions of a country with the rest of the world over a given period of time, usually a year.

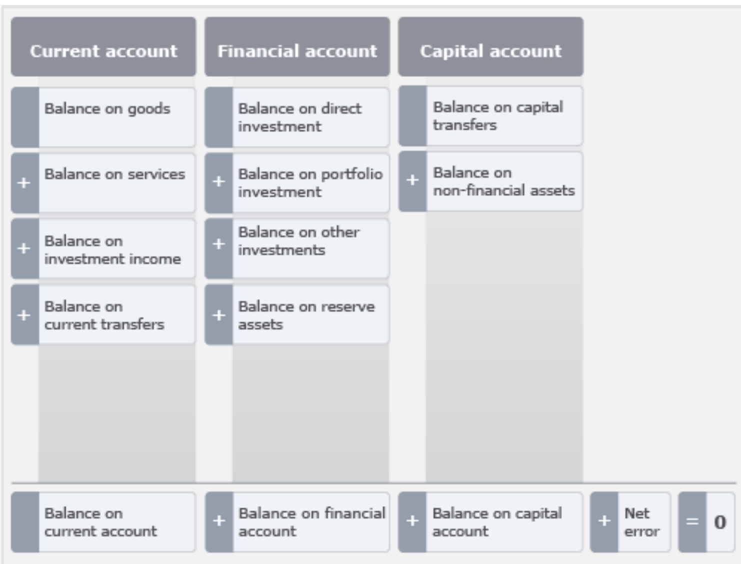
→ There are 3 main parts to the balance of payments account:

1) **The current account**
2) **The capital account**
3) **Financial account**

Sum equals to zero

→ + Positive value = Credit item: Any transaction that leads to money entering the country form abroad (inflow of currency)

→ - Negative value = Debit item: Any transaction that leads to money leaving the country to go abroad (outflow of currency)



148. The components of the balance of payments accounts

Item 148 – Grade 3

Ib question

• Explain the four components of the current account, specifically the balance of trade in goods, the balance of trade in services, income and current transfers.

The current account

→ A measure of the flow of funds from trade in goods and services, plus the income flows

→ It is usually sub-divided into four parts:

1) The balance of trade in goods
2) The balance of trade in services
3) Income
4) Current transfers

1) <u>The balance of trade in goods / The visible trade balance / The merchandise account balance / Balance of trade</u>

→ A measure of the revenue received from the exports of tangible (physical) goods − the expenditure on the imports of tangible goods over a given period of time

→ Ex) Includes trade in all tangible goods, from airplanes to chickens

→ Exports occur when an international transaction relating to goods or services leads to an **inflow of money** into the country ☺

→ Imports occur when an international transaction relating to goods or services leads to an **outflow of money** from the country ☹

→ When export revenue > Import expenditure

= A surplus on the balance of trade in goods

→ When import expenditure > Export revenue

= A deficit on the balance of trade in goods

2) <u>The balance of trade in services / Invisible balance / The services balance / Net services</u>

→ A measure of the revenue received from the exports of services − the expenditure on the imports of services over a given period of time

→ It includes the import and export of all services such as banking, insurance, and tourism

3) Income / Net investment incomes / Net factor income from abroad

→ A measure of the net monetary movement of profit, interest, and dividends moving into and out of the country over a given period of time, as a result of financial investment abroad

→ Profits: Domestic firms may have set up branches in other countries and any profits being repatriated will count as a **positive item** in this account. In the same way, profits sent out of the country by foreign firms set up within the country will count as a **negative item**

→ Interests: Residents and institution in the country may have invested in banks and other financial institutions in other countries and any interest received form these financial investments will count as a **positive item**. In the same way, any payments of interest to foreign investors that leaves the country will count as a **negative item.**

→ Dividends: Residents and institutions may have purchased shares in foreign companies and any dividends received form those companies will count as a **positive item**. In the same way, any dividends paid by domestic firms to foreign shareholders will count as a **negative item**.

4. Current transfers

→ It is the measurement of the net transfers of money, often known as net unilateral transfers from abroad, with nothing received in return. These are payments made between countries when no goods or services change hands.
→ At a government level, they include things such as foreign aid and grants.
→ At an individual level they include foreign workers sending money back to their families in their home country (remittances) or private gifts sent from a person in one country to a person in another.

→ Current account balance = Balance of trade in goods + Balance of trade in services + Net income flows + net transfers

Ib question

• Distinguish between a current account deficit and a current account surplus.

Current account deficit and current account surplus

- The current account balance is an overall balance and may be in deficit (negative value) or in surplus (positive value).
- Ex) Deficit on the trade in goods, a surplus on the trade in services, a surplus on net income flow, and an overall surplus on the current account

Ib question

• Explain the two components of the capital account, specifically capital transfers and transaction in non produced, non-financial assets.

The capital account

→ It is a relatively small part of the balance of payments accounts and does not have a significant effect on the balance

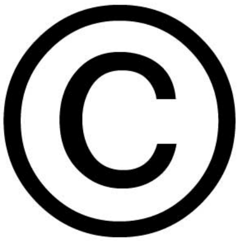
→ The capital account has two components:

1) Capital transfers
2) Transactions in non-produced, non-financial assets

1) Capital transfers

→ A measure of the net monetary movements gained or lost through actions such as the transfers of goods and financial assets by migrants entering or leaving the country, debt forgiveness, transfers relating to the sale of fixed assets, gift taxes, inheritance taxes, and death duties

2) Transactions in non-produced, non-financial assets



→ Consisting of the net international sales and purchases of non-produced assets, such as land or the rights to natural resources, and the net international sales and purchases of intangible assets, such as patents, copyrights, brand names, or franchises

Ib question

• Explain the three main components of the financial account, specifically, direct investment, portfolio investment and reserve assets.

The financial account

→ It measures the net change in foreign ownership of domestic financial assets.

→ It has three components:

1) Direct investment
2) Portfolio investment
3) Reserve assets
4) (Other investments)

→ If foreign ownership of domestic financial assets increases more quickly than domestic ownership of foreign financial assets = A financial account surplus.

→ If domestic ownership of foreign financial assets increasing more quickly than foreign ownership of domestic financial assets = A financial account deficit.

1) Direct investment (FDI)

→ A measure of the purchase of long-term assets, where the purchaser is aiming to gain a lasting interest in a company in another economy

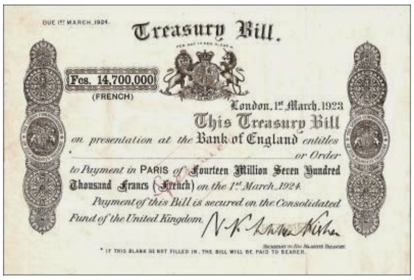
→ It includes things such as the buying of property, the outright purchasing of a business or the purchasing of stocks or shares in a business

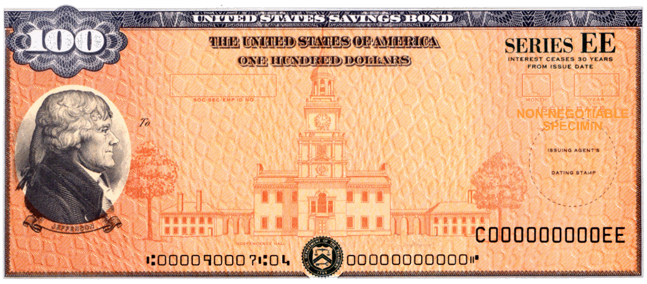
→ In all cases, the asset is expected to have a **positive return** in the future, by making profits or by increasing in value over time.

→ The investment does not have to be paid back and there is no guarantee that it will provide a positive return. (Possibly a **negative return**) The buyer of the asset is taking a risk.

→ Much of the activity is in the form of foreign direct investment (FDI). International Monetary Fund (IMF) guidelines state that an investment in a firm is FDI if it accounts for at least 10 percent of the ownership of the company. However, many countries set a higher percentage of ownership for an investment to count as FDI.

2) Portfolio investment



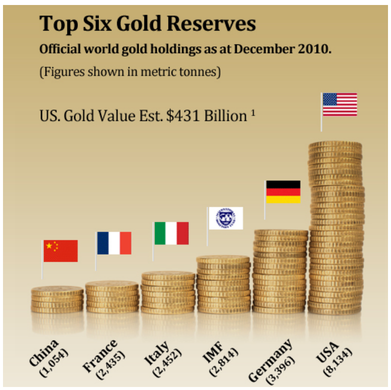


→ A measure of stock and bond purchases, which are not direct investment since they do not lead to a lasting interest in a company

→ They tend to consist of the buying and selling of things such as treasury bills and government bonds. We will also include savings account deposits in this category, although in many countries that comes under the heading of "other investment"

→ In all the portfolio investments mentioned above the investor is putting forward the money in order to purchase the asset, in the expectation that interest will be repaid at a given point in time. These assets are simply borrowing and lending on the international market

3) Reserve assets



→ The reserves of gold and foreign currencies which all countries hold and which are itemized in the official reserve account. It is movements into and out of this account that ensure that the balance of payments will always balance to zero

→ If there is a surplus on all of the other accounts combined, then the official reserve account total will increase. If there is a deficit on all of the other accounts combined, then the official reserve account, over the period of time being considered, that balance the accounts

149. The components of the balance of payments accounts (HL)

Item 149 – Grade 3

Ib question

• Calculate elements of the balance of payments from a set of data.

Notes

- Export of goods + Import of goods = Balance of trade in goods
- Exports of services + Imports of services = Balance of trade in services
- Income receipts (investment income) + Income payments (investment income) = Net income receipts
- Net income receipts + Current transfers (net) = Net income flows
- Current account balance = Balance of trade in goods + Balance of trade in services + Net income flows
- Net of the current account balance + Capital and financial account balance = 0