Syllabus Reference 4. 5 : BoP -Main definitions + categories

Balance of Payments

Credit items = In (flow). Creates a demand for domestic currency. Exchange rate rises.

Debit items = Out (flow). Creates a supply of domestic currency. Exchange rate falls.

1. BoP = Record of transactions with the rest of the world
2. Consists of **3** accounts: current and capital (includes a foreign reserve account to cater for (+ or -) in the accounts. Also notable is the financial account (account that records net flow of financial assets for the nation).
3. The key issue is currency flows. BoP must balance. A critical connection to make is the impact that BOP has on the exchange rate.
4. If a current current account surplus exists + capital **in**flows (foreign inflows) are also in surplus = result will be a **(+)** increase in foreign currency reserves. Fort Knox: US buys gold
5. If a current account deficit exists + capital **out**flows (domestic outflows) = (-) decrease in currency reserves. Fort Knox: US sells gold
6. A prolonged (long term) deficit on trade may be a problem especially if it requires national borrowing. The key concern for IB economics here is the impact of deficits on the exchange rate (especially if deficits are solved by borrowing). Use the Welker story of the massive US trade deficit with China to understand how trade flows affect exchange rates and how China manages the currency by buying US sovereign debt (US Treasury/bonds) to strengthen the US $ therefore promoting and supporting the trade deficit between the 2 countries. See link on webpage for syllabus 4.6

Why is it that a balance of payment account must always balance? Answer: when a currency is in equilibrium i.e. supply = demand then all credits and all debits are also equal and so all flows will balance. The issue is whether the balance will occur at a high or a low exchange rate. Remember be careful not to think that a high exchange rate is good for a country i.e. strong currency. See item 6 above

Balance of Payments: Key definitions + explanation of accounts

Webnote 332

Current Account A subaccount of the balance of payments that records the value of net exports in goods and services, net income and net current transfers of a country over a period of time.	**Capital Account** A subaccount of the balance of payments that includes credit and debit entries for non-produced, non-financial assets as well as capital transfers between residents and non-residents.	**Financial Account** In the balance of payments this records inflows and outflows of portfolio and FDI funds over a period of time, official borrowing and changes in reserve assets. Note: 'financial assets' is the key phrase here
Sample items:	Sample items:	Sample items:
Exports (visible + visible)	Capital transfers	FDI
Imports (visible + visible)	Transactions in produced, non financial assets	Portfolio investment
Results in Balance of Trade (trade surplus or deficit. This is evident in AD in terms of (X-M)	Balance on capital account	Reserve assets (official reserves) (e.g. Fort Knox – USA) Balance on financial account

BoP Current account:

1. Short term –1 year
2. Consists of physical and invisible imports and exports
3. Visibles = goods
4. Invisibles = services eg insurance and tourism
5. Balance on visibles : **X > M or M> X**
6. Balance on invisibles : **X > M or M> X**
7. Result will be a current account surplus or deficit
8. Surplus represents an inflow of money into the economy
9. Deficit represents an outflow of money
10. Deficit in current account causes excess supply of currency and value of ER falls. And visa versa.
11. However, note carefully that the flows in the financial account in particular will also have a significant impact on the flow of debits and credits and therefore will also have a major bearing on the value of the domestic exchange rate. This is important.

See Blink pp294-295 for details of the US capital account
Current account has 4 components. See webnote 331.

Alternatively see Cambridge book page 510-513

BoP: Financial account + Capital account:

1. Financial account is where financial assets are recorded e.g. flow of money for government bond purchases from abroad, FDI, Portfolio investment (stocks + bonds), Official borrowing + reserve assets.
   The Financial account along with the current account are the key components of the BOP.
2. Financial account refers specifically to the inflow and outflow of physical capital (assets/investment) e.g. FDI by MNC's.
3. Capital account provides a balance for surplus or shortage in the current account.
4. Financial account flows include:

- Short term capital –following interest + exchange rates
- Portfolio capital invested in equities and bonds
- Fixed or direct capital -goods e. g. factories Includes investment, loans, EU subsidies, dividends, borrowing by government.
- Capital account is relatively unimportant recording capital transfers for debt forgiveness and funds for purchase or use of natural resources e.g. fishing rights

See Blink pp296-297 for details of the US capital account
Note that the Capital and Financial accounts are separate entities and must be considered separately. See IB structure on page 308.