‘;2012 Topic 4B – Balance of Payment

## List of Definitions

### Balance of Payment (BOP)

* + - A statement of a country’s trade and financial transaction with the rest of the world over a particular period of time, usually a year

### **(A) Current Account**

1. Visible Balance (BOT) physical goods
2. Invisible Balance (services) – tourism, insurance, logistics
3. Income Balance (remittance of profit and dividends)
4. Transfer Balance (remittance- foreign workers)
   * + Monetary transfer for exports and imports of goods and services, income flows and net transfers in and out of the country.

### **(B) Capital Account** (LT term capital inflow)

* + - All inflows and outflows of funds due to financial activities like acquisition and disposal of fixed assets, shares, government grants for overseas project, etc.

### **(C) Financial Account** (inflow of hot money/ equity transaction)

* + - Records investment overseas by local residents and the inward flow of investment funds from foreign residents. International flows of investment funds can be short term or long term.
    - Short term capital flows is bank deposits (affected by interest rate)
    - Long term capital flows include the holdings of securities or bonds by local or foreign residents

### **(D) The Balancing Item**

* + - The balancing item is a statistical item to compensate for the errors and omissions made in recording the value of the country’s international transactions.

### **(E) The Overall Balance**

* + - The sum of the current account balance, capital account balance, financial account balance and the balancing item **(A+B+C+D=E)**

### The Official Financing Account

* + - An accommodating account that shows how the monetary authorities have dealt with the net money flow to reflect that the balance of payments always balances.
    - It consists of Deposits and Withdrawals in IMF, Gold Reserve and Foreign Currency Reserves (SG – keep in foreign reserve – need to maintain ex rate stability

### Explain how equilibrium of BOP will affect exchange rate and its impact

* + - **Surplus in BOP** – inflow of money will be greater than the outflow of money – need to transfer the money into the official financing account – increase in demand for local dollar and decrease in supply of local dollar – **Appreciation**
    - **Impact of surplus BOP** and appreciation will lead to negative effect like asset-based inflation and loss of export competitiveness as price of export will be higher due to appreciation but currency is stable and this will promote Singapore as a financial hub
    - **Deficit in BOP** – inflow of money will be lesser than outflow of money – need to borrow from the IMF or withdrawal from the Gold Reserve or Foreign Currency Reserve – decrease demand for local dollar and increase in supply of local dollar- **Depreciation**
    - **Impact of deficit BOP** and depreciation will contribute to imported inflation and raise the value of foreign debt but the price of exported goods will be lowered, raising export competitiveness

SG – ignore the BOP disequilibrium – 1) SG BOP is always in surplus 2) have exchange rate management to offset exchange rate fluctuation

**benefits of BOP surplus – appreciation**

* curb imported inflation
* maintain the wealth management status – strong exchange rate to encourage saving from foreign countries
* keep wage increment from rising

### J-curve Effect

* + - The effect of depreciation of ER to correct for a BOP deficit.

Surplus

Time

Deficit

In the very SR, ED(X) and ED(M) < 1, inelastic.

-Balance of Trade

-Invisible Balance

-Transfer Balance

-Income Balance

* + - Correct balance of trade deficit – raise export demand and lower import demand – depreciation – lower price of export an raise price of import – improve balance of trade – turn deficit into surplus
    - Effects of depreciation on correcting BOP deficit

🡪SR🡪Pedx + Pedm < 1🡪 BOT deficit worsened

🡪LR🡪Pedx + Pedm > 1🡪 BOT deficit will be narrowed and then turned into surplus

* + - In the very short run, import and exports are price inelastic. Hence depreciation will decrease value of exports and increase value of import, leading to a BOP deficit increase.
    - Inelasticity in SR can be caused by prevailing contracts, and time taken to change preference and to look for substitutes.
    - In the long run, the price elasticity of export demand and import demand becomes price-elastic. Depreciation will lower price of export which will induce increase in export revenue since gain in revenue from increase in quantity demanded is greater than the loss in revenue due to a fall in price of export. At the same time, the depreciation will raise the price of imports which cause the import expenditure to decrease as the reduction in expenditure due to decrease in quantity demanded of import is greater than the increase in import expenditure due to increase in price of imports.

SR – PEDm <1 – increase price of imports – total expenditure on imports increase / - PEDx <1 – lower price of exports – total revenue earned on exports – decrease = increase in imports expenditure and decrease in exports revenue = BOT deficit worsened.

## Causes of BOP Disequilibrium

### Current Account Deficit

### Caused by Cyclical factors: (trade cycle and demand factors)

### Relatively High Domestic Inflation

* When domestic economy experiences inflation Px rises 🡪 Xd falls or Pm falls relatively🡪 Md rises 🡪 BOT worsen (subjected to elasticity of demand)

### Relatively High Economic Growth Rate

* Increase in national income of local economy - ↑Md for local economy.
* Decrease in national income of foreign economy - ↓Xd for local economy

### Caused by Structural Factors: (nature and structure of the economy – eg -capital intensive economy

* Overvalued Domestic Currency 🡪 Px rises 🡪 XD falls or 🡪 Pm falls 🡪 MD rises 🡪 BOT worsen
* Loss in Comparative Advantage (inefficiency of local industries/change in global pattern of production) 🡪 COP rises 🡪 PX rises 🡪 XD falls or price of local goods rise 🡪 PM relatively cheaper 🡪 increase in MD

### Caused by Ambitious Development Programme

* large increase in imports (usually happens in developing countries)

### Capital and Financial Account Deficit

### Structural Factors

### Low domestic interest rates 🡪 short-term capital (or “hot” money) will flow out of the country to earn higher interest rates in other countries 🡪financial account of a country worsen

* Contra trade – low i/r in US – will encourage US citizens and companies to save their fund in Singapore which has a higher interest rate – increase in inflow of hot money

### Poor Expectation of Business Profits (cyclical)🡪 if investors expect business profits to fall in the future (e.g. due to rising costs, higher corporate taxes or political and economic instability), then local investors will want to invest in other countries.

### Current Account Surplus

### Structural Factors

### Undervalued domestic currency 🡪 low export prices and high import prices 🡪 quantity demanded for exports will be high and imports, low 🡪 receipts from exports will be high while payments for imports will be low assuming that the demand for exports and imports is elastic 🡪 current account improves.

### High levels of domestic protection 🡪High tariff rates will result in high prices of imports 🡪 fall in the quantity demanded of imports and thus import expenditure is reduced (assuming that the demand for imports is elastic).

### Factors affecting the Balance of trade (Exports and Imports Demand)

1. Inflation rate – affect cost of production – affect Px and Pm
2. relative income level
3. taste and preference of the products
4. change in exchange rate
5. comparative advantage – affected by the change in cost of production
6. structural changes in the economy – economic development

### Factors affecting financial account

1. interest rate- determined the return on saving
2. change in the exchange rate (encouraging speculative activities)

### Factors affecting capital account (FDI/resident investment)

1. return on business
2. taxation policy
3. market demand- market sentiment – affects FDI
4. efficiency of the industries – return on investment

Explain how current account deficit will occur when there is inflation and global economic downturn. (2 para)

## Consequences of a Balance of Payments Disequilibrium

### In the short-term, temporary and planned balance of payments disequilibrium does not pose a serious problem to an economy. BOP deficit may be necessary to promote economic growth, which will induce import of capital goods and resources – induce production and employment

### In the long-term, persistent and unplanned disequilibrium is a serious problem and indicates a fundamental economic problem in the economy (may induce import of luxury goods –BOT deficit)

### **Is balance of payment deficit a concern to the country?**

1. Duration of disequilibrium

A short and temporary BOP deficit will not prove serious problem as it will temporarily lower exchange rate to enhance competitiveness but a long term and persistent BOP deficit will affect the exchange rate stability which will undermine the trading activities and flow of FDI

1. Causes of the balance of payment deficit

If the cause of the BOP deficit is due to BOT deficit which will indicate a fall in production of exported goods and service, the impact on unemployment will be a serious problem for the economy.

If the BOP deficit is due to outflow of FDI into foreign country, the growth of infrastructural business will be beneficial to the economy in the long run.

Furthermore, if the deficit is due to import of resources and capital equipment, it will be beneficial for the growth of the economy. The growth of expenditure on goods and services may indicate a higher level of standard of living but it will also mean that local industries and losing out.

## Effects of a Balance of Payments Deficit (depreciation)

### On Domestic Economy

* + - Inflationary impact on the economy
    - Fall in national income and level of employment due to lower FDI and export demand
    - Decreases in foreign reserves
    - Affect the confidence of the investors – reduce investment – fall in production and employment

### On External Economy

* + - Fall in exchange rate of a country’s currency
    - Deterioration in terms of trade (TOT)
    - Raise the burden of the public debt – depreciation – rise in the value of external debt – pay more

## Effects of a Balance of Payment Surplus (Appreciation of exchange rate)

### On the Domestic Economy

* + - Increase in national income and level of employment due to higher level of FDI and surplus BOT
    - Increase in foreign reserves
    - Reduces the competitiveness of the export demand and in the attraction
    - Worsen the trading and capital flow condition of the trading partners.

### On the External Economy

* + - Rise in exchange rate of a country’s currency
    - Improvement in terms of trade (TOT)

## Scope of impact

* Xd/Md/FDI/flow of fund – affect BOP equilibrium
* AD (Real GDP)/Potential Growth – Sustainable Economic Growth
* Production/Employment – low unemployment
* COL/COP/SOL – Price stability
* Distribution of Income and Wealth
* Optimization of resource allocation

linking sentence – based on the above impact, the extent can be further analysed in these ways / with these considerations

* Analysis of the impact – how impactful it will be?
* nature of the industries – tourism – exchange rate is a strong influence
* how it affects the production – employment condition – high valued industries – less likely to be affected by the bOP surplus – goods are price-inelastic

|  |  |  |  |
| --- | --- | --- | --- |
| .Balance of Payment of Singapore-2004 | Current Account | Million Dollars | Determinants and |
| Exports of Goods(A) | 333,421.7 | High-valued exports |
| Imports of Goods(B) | 280,667.4 | low-valued imports |
| **i. Visible Balance (Balance of Trade) (A-B)** | 52,754.3 | -High value-added production – export value will be larger  -Raise the wage and pass ⭡COP to consumers – tends to be price-inelastic  🡪low degree of substitution |
| Services Balance (C) | 829.9 | Concentration of tertiary industries  (hotels/insurance)- provide a greater variety of employment/ domestic-based – induce production and employment |
| Income Balance (D) | -4,528.2 | Dividends/Royalties/ Investment returns (high concentration of MNCs due to FDI) |
| Current Transfers (Net) (E) | -1,933.5 | High concentration of foreign workers- needs to raise exchange rate to lower the wage increment of foreign workers. |
| **ii. Invisible Balance** | -5,631.8 | (A-B) + C + D + E |
| 1. Current Account Balance (A-B) + C + D + E ) | 47,122.5 |  |
| 2. Capital Account Balance | -308.4 | -Local MNC’s FDI abroad has increased – led by state enterprises/ Fall in FDI from foreign MNC (Intense competition from neighbouring country)  -local investment flowing outwards |
| 3.Financial Account Balance | -21,825.1 | Outflow of funds by state enterprises/lower relative interest rate |
| 4. Balancing Item | -4,556.0 |  |
| 5.Overall Balance (1+2+3+4) | 20,433.0 | surplus bop |
| 6. Official Financing Account | -20,433.0 | The type of reserve the country holds will affect the value of accumulated wealth. |
|  | | | |

7. Significance of Balance of payment on the indication of the state of Economy.

**Reflect the economic activity that will affect the performance of the economy (based on the aims of government – macroeconomic goals)**

* Change in Real GDP
* Change in AD (FDI/Xd)
* Change in Md (potential growth)
* Change in production and employment
* Price stability/SOL

1. From the **current account**, the level of production of goods services can be noted as seen level of export of goods and services. We can also observe that the industries are mainly producing high valued production and there is the concentration of tertiary services. – affect output and production and employment of labour
2. The value of the **income balance** also reveals that the economy has a concentration of FDI and the increase in the flow of capital account (Long run) will also suggest that Singapore is competition enough to attract FDI. High depend of FDI and the presence of net export will substantiate that the economy is experiencing economic growth as the production capacity is increasing.
3. The **import expenditure** will indicate the level of the resource capacity the country can posses as Singapore relies greatly on import for production. It also indicates the level of standard of living as the rise in the import of services will mean that there is increase in consumption of services from abroad in the areas of tourism
4. High volume of deficit in the **transfer balance** reflects the high degree of dependency on foreign supply of labour.
5. For **financial account**, the flow of the transfer will affect the banking and finance industry which is one of critical industry in the economy and the indicator of the flow of hot money which will affect our short term exchange rate. The change in the exchange rate will affect the trading prices and of cost FDI which is affects the AD that influences production and national income.
6. The **official financing reserve** will reflect the level of stability of the external equilibrium as the amount and the distribution of reserve will affect the country’s ability to stabilize exchange rate.

**Trend Analysis for Balance of Payment**

**Table 1: Japan and US Balance of Payments**

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
|  | 2003 | 2004 | 2005 | 2006 | 2007 |
| **JAPAN** (in billion Yen) |  | | | | |
| Current Account | 15, 766.8 | 18.618.4 | 18,259.1 | 19,848.8 | 24,793.8 |
| Capital & Financial Account | 7,734.1 | 1,737.0 | -14,006.8 | -12,466.5 | -22,538.3 |
| Net Errors & Omissions | -1,972.2 | -3,087.9 | -1,796.0 | -3,662.7 | 2,041.9 |
| Balance of Payments | 21,528.7 | 17,267.5 | 2,456.3 | 3,719.6 | 4,297.4 |
| Real Gross Domestic Product1 | 512,513.0 | 526,577.7 | 536,762.2 | 547,709.3 | 560,816.4 |
| **UNITED STATES** (in billion US Dollar) |  | | | | |
| Current Account | -521.5 | -631.1 | -748.7 | -803.5 | -726.6 |
| Capital & Financial Account 2 | 527.9 | 530.8 | 698.0 | 802.9 | 661.8 |
| Net Errors & Omissions | -7.9 | 97.5 | 36.6 | -1.7 | 64.9 |
| Balance of Payments | -1.52 | -2.80 | -14.10 | -2.38 | 0.12 |
| Real Gross Domestic Product3 | 10,301.0 | 10,675.8 | 10,989.5 | 11,924.8 | 11,523.9 |

1 In billions of chained 2000 Yen

2 Excluding change in US government official reserves

3 In billions of chained 2000 dollars

Note: “Chained dollars/yen” is a method of adjusting nominal values for inflation, thus reflecting purchasing power relative to the reference year.

*Source: US Department of Commerce, Bureau of Economic Analysis*

*Ministry of Finance, Japan*

**a) Compare the trend in Japan’s Balance of Payment with that of United States over the period 2003 to 2007 (2)**

Japan experienced BOP surplus for the period 2003 to 2007 but the BOP surplus reduced from 2003 to 2005 and improves again from 2005 to 2007. On other hand, US experiences BOP deficit for the period 2003 to 2007, except for 2007. US BOP deficit worsened from 2003 to 2005 and improves from 2005 to 2007 and was in surplus in 2007

**b) Account for the differences that you have identified for the cause of trend described (2)**

**For Japan, the cause is due to the capital account deficit as there is an extensive capital outflow due to higher interest in foreign countries and higher rate of return on investment despite improvement in current account surplus.**

**For US, the cause of BOP deficit is due to the worsening of the current account deficit, contributed by balance of trade deficit and income balance deficit. The BOP deficit in US is reduced by the extensive inflow of capital due to the high interest rate in US and higher rate of return on investment in US.**