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Module: International Finance

Branch: International Trade
Level: Third year Bachelor

Lecture 05: The Balance of Payments

Financial managers of multi-national corporations monitor the balance of payments so that they can determine how the flow of international transactions is changing over time. The balance of payments can indicate the volume of transactions between specific countries and may even signal potential shifts in specific exchange rates. Thus it can have a major influence on the long-term planning and management by multi-national corporations

1- Definition

The balance of payments is a summary of transactions between domestic and foreign residents for a specific country over a specified period of time. It represents an accounting of a country's international transactions for a period, usually a quarter or a year. It accounts for transactions by businesses, individuals, and the government. A balance-of-payments statement is composed of the current account, the capital account, and the financial account

2- The Accounts of the Balance of Payments

a- Current Account

The current account measures the flow of funds between one country and all other countries due to purchases of goods and services or to income generated by assets. The main components of the current account are payments between two countries for (1) merchandise (goods) and services, (2) primary income, and (3) secondary income.

Payments for Goods and Services Merchandise exports and imports represent tangible products, such as smartphones and clothing, that are transported between countries. Service exports and imports represent tourism and other services (such as legal, insurance, and consulting services) provided for customers based in other countries. Service exports by the United States result in an inflow of funds to the United States, while service imports by the United States result in an outflow of funds.

The difference between total exports and imports is referred to as the balance of trade. A deficit in the U.S. balance of trade means that the value of merchandise and services exported by the United States is less than the value of merchandise and services that it imports. Before 1993, the balance of trade was based solely on merchandise exports and imports. In 1993, it was redefined to also include service exports and imports.

Primary Income Payments A second component of the current account is primary income (also sometimes referred to as factor income in the past), which is mostly composed of income earned by MNCs on their DFI (investment in fixed assets in foreign countries that can be used to conduct business operations), and also income earned by investors on portfolio investment (investments in foreign securities). Thus, primary income received by the United States reflects an inflow of funds into the United

States. Primary income paid by the United States to foreign companies or investors reflects an outflow of funds from the United States. Net primary income represents the difference between the primary income receipts and the primary income payments.

Secondary Income The third main component of the current account is secondary income (also sometimes referred to as transfer payments), which represents aid, grants, and gifts from one country to another. Net secondary income represents the difference between the secondary income receipts and the secondary income payments.

Examples of Payment Entries transactions that would be reflected in the current account. Every transaction generating a U.S. cash inflow (exports and income receipts by the United States) represents a credit to the current account, and every transaction generating a U.S. cash outflow (imports and income payments from the United States) represents a debit to the current account. Therefore, a large current account deficit indicates that the United States is sending more cash abroad to buy goods and services or to pay income than it is receiving for its sales of goods and services.

Actual Current Account Balance The components of a country's current account balance can be evaluated to recognize how its flow of funds with other countries is influenced by international trade and income payments. To illustrate, the U.S. current account balance in the year 2014 is summarized in Exhibit 2.2, segmented by the components described above. Components that result in cash inflows to the United States are denoted by a plus sign, while components that result in cash outflows from the United States have a minus sign.

b- Financial Account

The financial account measures the flow of funds between countries that are due to (1) direct foreign investment, (2) portfolio investment, and (3) other capital investment.

Direct Foreign Investment The financial account keeps track of a country's payments for new DFI over a given period (such as a specific quarter or year). Payments representing DFI in the United States (such as the acquisition of a U.S. firm by a non-U.S. firm) are recorded as a positive number in the U.S. financial account, because funds are flowing into the United States. Conversely, payments representing a U.S.-based MNC's DFI in another country are recorded as a negative number because funds are being sent from the United States to another country. Examples of DFI by the United States include an MNC's payments to complete its acquisition of a foreign company, to construct a new manufacturing plant in a foreign country, or to expand an existing plant in a foreign country.

Portfolio Investment The financial account also keeps track of a country's payments for new portfolio investment (investment in financial assets such as stocks or bonds) over a given period (such as a specific quarter or year). Thus a purchase of Heineken International (Netherlands) stock by a U.S. investor is classified as portfolio investment because it.

represents a purchase of foreign financial assets without changing control of the company. This transaction is recorded as a negative number for the U.S. financial account (a debit), as it reflects a payment from the United States to another country. If a U.S. firm purchased all of Heineken's stock in an acquisition, this transaction would result in a transfer of control and therefore would be classified as DFI instead of portfolio investment.

Other Capital Investment A third component of the financial account consists of other capital investment, which represents transactions involving short-term financial assets (such as money market securities) between countries. In general, DFI measures the expansion of firms' foreign operations, whereas portfolio investment and other capital investment measure the net flow of funds due to financial asset transactions between individual or institutional investors.

c- Capital Account

The capital account measures the flow of funds between one country and all other countries due to

financial assets transferred across country borders by people who move to a different country, or due to sales of patents and trademarks. The sale of patent rights by a U.S. firm to a Canadian firm is recorded as a positive amount (a credit) to the U.S. capital account because funds are being received by the United States as a result of the transaction. Conversely, a U.S. firm's purchase of patent rights from a Canadian firm is recorded as a negative amount (a debit) to the U.S. capital account because funds are being sent from the United States to another country. In general, the financial account items represent very large cash flows between countries, whereas the capital account items are relatively minor (in terms of dollar amounts) when compared with the financial account items. Thus the financial account is given much more attention than the capital account when attempting to understand how a country's investment behavior has affected its flow of funds with other countries during a particular period

d- Relationship between the Accounts

If a country has a negative current account balance, then it should have a positive financial and capital account balance (and vice versa). This implies that if it sends more money out of the country than it receives from other countries due to international trade and income payments, it receives more money from other countries than it spends on foreign investments. For example, if a country's DFI in other countries exceeds the amount of DFI by other countries into that country, this will result in a negative number (debit) for that country's financial account, because more funds are leaving that country than are coming into it. However, DFI in other countries generates primary income receipts for the country engaging in the investment. Therefore, the higher level of DFI by that country will cause it to receive more primary income from other countries, which results in a positive number (credit) for its current account balance because more primary income is coming into that country than is leaving it.

Errors and Omissions and Reserves The balance-of-payments account also includes a category of errors and omissions, because measurement errors commonly occur when attempting to measure the value of funds transferred between two countries.