

ECOS3007 International Macroeconomics

Topic 1: Balance of Payments and Foreign Exchange Markets - Some Basic Concepts and Propositions

The Balance of Payments

The Basic Structure of the Balance of Payments

- The balance of payments (BOP) is a statistical statement that summarises transactions between residents and non-residents during a period.
 - Under the double-entry accounting system that underlies the BOP, each transaction is recorded as consisting of 2 entries, with the sum of the credit entries and debit entries equal to one another.
- The BOP consists of 3 accounts:
 - The current account, which shows flows of goods, services, primary income and secondary income between residents and non-residents.
 - The goods and services account shows transactions in goods and services.
 - The primary income account shows amounts payable and receivable in return for providing temporary use to another entity of labour, financial resources or non-produced non-financial assets.
 - The secondary income account shows redistribution of income (ie when resources for current purposes are provided by one party without anything of economic value being provided in return).
 - The capital account, which shows credit and debit entries for non-produced non-financial assets and capital transfers between residents and non-residents.
 - Non-produced non-financial assets eg embassy land, licenses, leases, intellectual property.
 - Capital transfers eg the provision of resources for capital purposes by one party without anything of economic value being supplied in return.
 - The financial account, which shows net acquisitions and disposals of financial assets and liabilities. The financial account consists of:
 - Direct investment, which is a category of cross-border investment associated with a resident in one economy having control or a significant degree of influence on the management of an enterprise that is resident in another economy. It also includes investment associated with that relationship.
 - Portfolio investment, which is cross-border transactions and positions involving debt or equity securities, other than those included in direct investment or reserve assets.
 - Financial derivatives and employee stock options (ESOs).
 - Other investment, which is a residual category that includes position and transactions other than those included in direct and portfolio investment, financial derivatives and reserve assets eg trade credits, other equity, currency and deposits, loans, non-life insurance technical reserves.
 - Reserve assets, which are those external assets that are readily available to and controlled by monetary authorities for meeting BOP financing needs, for intervention in exchange markets to affect the exchange rate and for other related purposes.
- The sum of the balances on the current and capital accounts represents the net lending (surplus) and borrowing (deficit) by the economy with the rest of the world (the balance on the financial account).
 - Eg if we have a deficit on the current and capital account we must pay for this by either selling local assets or borrowing from other countries, leading to an equivalent decrease in the financial account (net acquisition of assets - net acquisition of liabilities).
- We can also look at the BOPs in terms of the demand and supply of domestic and foreign currency:
 - The demand for fx = imports + net acquisitions of assets, demand for AUD = exports + net acquisitions of liabilities.
- Note that the current and capital accounts show transactions in gross terms whereas the financial account shows transactions in net terms.