ECON1270: International monetary economics course notes

TOPICS COVERED:

TOPIC 1 : BALANCE OF PAYMENTS AND NATIONAL INCOME ACCOUNTING

Balance of payments

- One side of the balance of payments is the purchase or sale of good
- The other side is the price paid for the good
- It is constructed on double entry system, each transaction must be recorded as debit and credit

Balance of payments accounting

- Two sub accounts **Current account and capital account (financial account)**
- **Current account**
    - Flow of goods, services, income on assets
- **Capital (financial account)**
    - Flow of assets, currency
- **Official reserves account**
    - Flow of central bank transactions,

Current account

- Measures net exports of goods and services
- And net international income receipts
    - NI= income earned on foreign assets owned by domestic citizens minus income paid on domestic assets owned by foreigners
    - X-M= Trade balance
    - Interest rates, dividends, profits
- **CA= (X-M+NI)**
    - Exports recorded as credit (+) on the current account
    - Imports recorded as debit (-) on the current account
- **Historical Australian current account**

Capital (financial account)

- Measures sale of assets to foreigners compare to purchase of foreign assets
- **FA= Change in Net Foreign assets**

Relationship between current and financial account

- Current account is inversely related to financial account

Balance of payments examples

Example 1

Suppose an Australian resident wants to purchase something in Japan and thus needs Japanese currency to make the purchase.

Financial account

- The Australian currency sold is recorded as **a credit entry in the financial account.** Ownership changes from an Australian resident to a foreign resident.

- The **Japanese yen purchased is recorded as a debit entry** on the **financial account**, valued at the current exchange value.

Example 2

*Assume that the Australian resident uses his yen to purchase a **camera** from a store in Japan and then brings it back to Australia.*

- The item sold in this case is Japanese currency, reflecting a decrease in holdings of foreign exchange. This is recorded as **a credit entry on the financial account**.
- The good imported into Australia is recorded as a **debit entry on the current account**.

Example 3

Assume that the Australian resident uses his yen to purchase a Japanese government bond.

- Decrease in holding of foreign currency. **Credit to financial account**
- Purchase of foreign asset representing an increase in domestic holdings of foreign bonds. **Debit to financial account**

Example 4

Assume a Japanese resident who owns bonds issued by an Australian company receives interest payments.

- The transaction is recorded on the **current account as a debit entry** representing the payment of income to a foreign resident,
- and as a **credit entry on the financial account** reflecting an increase in Japanese financial claims against an Australian bank.
- (reducing the amount, we owe to foreigners is a credit to financial account)

Official reserve transactions (3rd account of BOP)

- Official international reserves are foreign assets held by the central bank
- If Japan is receiving more $AUD than it requires for the purchase of Australian assets (imports), then there is an excess supply of Australian dollars.
    - Therefore price of the $AUD in terms of Yen will decline, and the exchange value of the Yen will increase.

- However, the Bank of Japan may hold the view that the foreign exchange value of the Yen is inappropriately high in which case they might purchase $AUD in exchange for their domestic currency in order to moderate the increase in the exchange value of the Yen.
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Example (less relevant to floating exchange)

- If the Central Bank is adding to its stock of Official Reserves it is recorded in the Balance of Payments statistics as a debit. (Similar to the treatment of a private citizen purchasing foreign assets, which is also recorded as a negative in the Financial Account of the Balance of Payments)
- A reduction in the Central Bank's Stock of Foreign Exchange assets is recorded as a credit in the Balance of Payments.
- Note: Under a pure floating or a flexible exchange rate the Central Bank does not buy or sell foreign exchange

Financing a current account deficit

1. The domestic economy can borrow from the rest of the world by issuing financial claims (liabilities) on itself which are financial assets for the rest of the world. This is recorded as a credit entry in the financial account. This results in a reduction in net foreign assets (increase in net foreign liabilities).

2. Rather than add to debt, the domestic economy can sell off its financial assets, both domestic and foreign, to the rest of the world. This would appear as a capital inflow and therefore as a credit entry in the financial account. This results in a reduction in net foreign assets (increase in net foreign liabilities).

3. The Central Bank can also finance the shortfall by running down its stocks of foreign exchange reserves which also results in a reduction in net foreign assets (increase in net foreign liabilities).

Note: Only borrowing to consume increases net foreign debt

Savings is equal to investment in closed economy

- Makes sense because what we save, we will invest

Opening the economy (GNP)

CA= current account

Now we can derive the following relationships

Savings can be used to aquire phsical assets or foreign investment

If savings is greater than investment we are in surplis (lend to rest of world)

If savings is less than investment then we are in deficit (borrow from rest of world)

Effects of trade deficit

- A trade deficit is not necessarily a bad thing (e.g. when growing domestic industries attract foreign investments)
  - if borrowing is financing investment (which generates economic growth and income in future) then it is not a problem
- However, if a country persistently runs a trade deficit this is something to worry about (e.g. vulnerability to loss of foreign investors' confidence)
  - excessive borrowing on capital account to finance consumption on current account will incur higher interest payments and eventually lead to reduction consumption
  - For the US sustained CA deficit are attributed to GFR via global imbalance