

INTERNATIONAL FINANCE

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BALANCE of PAYMENTS

International finance

- ▶ System of economic and monetary relations, that cause the **flow of money and capital** between the **domestic** and **foreign** entities.
- ▶ **Inflow** to the home country
- ▶ **Outflow** from the home country to the foreign country
- ▶ Result:
 - International trade
 - International labor market
 - International cooperation



Reasons to go international

- ▶ to expand the markets,
- ▶ to obtain raw materials,
- ▶ to seek new technology,
- ▶ to lower production costs,
- ▶ to avoid trade barriers,
- ▶ to diversify.



Balance of Payments

- ▶ Each country records the details of trade in its balance of payments accounts
- ▶ BP is the statistical record of all **economic transactions** between the „residents“ of the home country and non-residents or foreigners, during the specific time period. (usually 1 year)
- ▶ Reported by NBS
- ▶ **Objective:** BoP has to be balanced
 - (Credit side is equal to debit side,
 - zero result)



What is the BP and from what consist of?

- ▶ BP is the statistical record that summarizes transactions between **residents** and **nonresidents** during the period. PB is presented in the form of **double-entry bookkeeping**.
□
- ▶ The BP contains **subaccounts** that categorize the major types of international economic interactions.

Horizontal structure of BoP

I. Current account

- Net export/import of goods
- Net export/ import of services
- Net income
- Net transfers

II Capital account

- Capital transfers (real estate)

III. Financial account

- Net foreign direct investments
- Net portfolio investment
- Other financial items

IV. Net errors

- Surplus, Deficit of BoP, missing items

V. Reserves and related items

- Changes in official monetary reserves

Current account

- ▶ The **current account** is that balance of payments account in which all short-term flows of payments are listed:
 1. **Goods and services balance** (exports - imports)
 - Merchandise trade balance (exports - imports)
 - Services balance (exports - imports)
 2. **Net Investment income** (profit, dividend, rent, income from interest)
 3. **Unilateral transfers**
 - Private transfer payments
 - Governmental transfers



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Capital account

Two types of investments counted in the capital account:

1. **direct investments - capital transfers**
(investments in foreign properties such as office buildings - real estate, land, manufacturing plants)
2. **Patents, licence, author's rights**

Horizontal structure of BoP

I. Current account

- Net export/import of goods
- Net export/ import of services
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- Capital transfers (real estate)

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Financial Account

financial investment (purchase of stocks and bonds)

- Foreign direct investments
- Net portfolio investment
- Securities (Stocks and Bonds)
- Financial derivatives
- Loans (debt)
- Bank claims and liabilities, Bank deposits



Horizontal structure of BoP

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Reserves and related items

- ▶ Changes in official monetary reserves
- ▶ Reserves - including gold, foreign currency, financial asset...
- ▶ to balance the surplus or deficit of BoP
- ▶ Increasing or decreasing the monetary reserves



Items of the horizontal BoP structure

- goods
- services
- incomes
- transfers (unilateral transfers)
- short-term and long-term capital
- foreign exchange reserves

Balance of Payments

Balance of Payments accounts □

- The current account □
- The capital and financial account □
- Net errors
- Official reserves account

Balance of payments identity states that:

- ▶ Current Account + Capital Account + Financial Account +
+ Statistical discrepancy = Change in Official Reserve
Account

Every transaction is recorded in the balance of payments twice.

→ **vertical structure of the BoP**

Vertical structure of BoP

- ▶ **Credit** - CASH INFLOW, transaction, from the foreign to domestic entity (from USA to SR)
- ▶ **Debit** - CASH OUTFLOW, transaction from the domestic to foreign entity (from SR to USA)

Credit (+)	Debit (-)
<ul style="list-style-type: none">• Export of goods• Export of services• Transfer inflow• Capital inflow• Gifts received from foreign residents• Decrease of reserves	<ul style="list-style-type: none">• Import of goods• Import of services• Transfer outflow• Capital outflow• Gifts to foreigners• Financial help given by home country• Increase of reserves

Exercise 1: Complete the table.

	Payments from abroad	Payments to the abroad	Balance
Export of goods and services	+ 220		
Import of goods and services		- 280	
Current account balance			
Export of capital		- 50	
Import of capital	+ 100		
Financial account balance			
Change in foreign exchange reserves			
Balance of payments			

increase in foreign exchange reserves (-)

decrease in foreign exchange reserves (+)

Vertical structure of BoP

- ▶ **Balanced:**
 - Credit = debit
- ▶ **Active balance of payments**
 - Credit > Debit
 - surplus
- ▶ **Passive balance of payments**
 - Credit < Debit
 - deficit

Balancing BoP

- ▶ The result of Current, Capital and Financial account:
- ▶ **Surplus +** : increase the official reserves, debit site, create supply of foreign currency
- ▶ **Deficit -** : decrease the official reserves, credit site, create demand for foreign currency

Credit	Debit
- Official reserves	+ Official reserves
Supply of foreign currency	Demand for foreign currency



Balance of Payments

- ▶ the **debit items (+)** give rise to the **demand (D)** for foreign exchange, \square
- ▶ the **credits items (-)** give rise to the **supply (S)** of foreign exchange, \square
- ▶ the rate of exchange is determined by demand and supply

Exercise 2:

In 2015, these transactions affected the balance of payments:

- Export of goods and services in 32,0 bil. USD.
- Import of goods and services in 34,5 bil. USD.
- Other non-trade payments

Payment from abroad in 105,0 bil. USD.

Payment to the abroad in 80 bil. USD.

Create the balance of payments for the 2015.

Exercise 2: Complete the table.

	Payments from abroad	Payments to the abroad	Balance
Export of goods and services	+ 32,0		
Import of goods and services		- 34,5	
Current account balance			
Export of capital		- 80,0	
Import of capital	+ 105,0		
Financial account balance			
Change in foreign exchange reserves			
Balance of payments			

How to balance BoP

1. Change in monetary reserves
2. Change in exchange rates

Exchange rate

- ▶ The **exchange rate** is the price of one country's currency in terms of another country's currency
- ▶ **Direct**
 - The price of foreign currency expressed in domestic currency units
 - 0,84 EUR/USD
- ▶ **Indirect**
 - The price of domestic currency expressed in units of foreign currency
 - 1,19 USD/EUR



Titul - SKK/EUR

29.1.2008 13:16

■ Closing Price: 33.64



Movements of Exchange rate

- ▶ **Depreciation** - decrease of value, the fall in the market price of currency
- ▶ **Appreciation** - increase of value the rise in the market price (exchange rate) of the currency
- ▶ **Devaluation** is the official lowering of the value of a currency
- ▶ **Revaluation** is the official raising of the value of a currency

How to balance the BoP – exchange rates system

- ▶ Exports - imports = surplus
- ▶ The currency tends to **increase in value**
- ▶ Negative for exporters

- ▶ Exports - imports = deficit
- ▶ The currency tends to **decrease in value (weaken)**
- ▶ Positive for exporters

A **balanced** BoP is a sign of monetary stability in the country.

An **unbalanced** BoP can have an active or passive balance.

active balance of BoP - appreciation of the domestic currency

passive balance of BoP - depreciation of the domestic currency

Active BoP - surplus

- ▶ Export is higher than import
- ▶ Exporters sell goods and get foreign currency (f.e. dollars)
- ▶ At home they exchange it for domestic currency - increased demand for domestic currency
- ▶ Domestic currency (Euro) increases in value - appreciates
- ▶ Exported goods are more expensive because of appreciation
- ▶ Export declines, Import increases = balance of BoP

Active BoP

- The country has sufficient **means of payment to repay loans**
- The country can **increase its foreign exchange reserves** (ensuring international liquidity)

Kinds of Balance of Payment

export and import of goods	TRADE BALANCE	POWER BALANCE	CURRENT BALANCE	BASIC BALANCE	SUMMARY BALANCE
+ export and import of services					
+ export and import of income + export and import of unilateral current transfers					
+ unilateral capital transfers + export and import of long-term capital					
+ export and import short-term capital + change in domestic currency in abroad + errors and unclassified items					
Change in foreign exchange reserves (+ increase, - decrease)					

Terms

Payment

- transfer of a payment resource (cash, non-cash) from abroad to the home country and from the home country to abroad.

Payment resource - *gold, currencies* (cash, non-cash /*valuty, devízy*/), *financial derivatives*

Turnover balance of payments

- includes the turnover of economic transactions over a period of time

Residual balance of payments

- expresses the state of economic transactions at a certain date
- BoP for the whole economy
- BoP for industry, for enterprises

QUIZ QUESTIONS

...

Quiz Questions

True-False Questions:

1. If a country has BOP deficit, the total of all BOP subaccounts is negative.
2. The current account is a record of all trade in goods and services, while the capital account is a record of direct and portfolio investment and unilateral transfers.

True-False Questions:

3. When the U.S. private sector purchases more goods or make more investments abroad than foreigners purchase or invest in the United States during a year, the Federal Reserve (the U.S. central bank) must make up for the shortfall.
4. All errors and omissions on the BOP are a result of black market transactions.

Multiple-Choice Questions:

Antarctica is the home country, its currency is the **Antarctica dollar (AAD)**; **Greenland** is the foreign country, its currency is the **crown (GRK)**. Choose the correct answer.

1. All else being equal, an increase in income in Greenland leads to:

- A) an increase in consumption in Antarctica, and therefore an increase in imports, resulting in an appreciation of the AAD.
- B) a decrease in consumption in Antarctica, and therefore an increase in exports, resulting in a depreciation of the AAD.
- C) an increase in consumption in Greenland, and therefore an increase in imports, resulting in an appreciation of the AAD.
- D) an increase in consumption in Greenland, and therefore an increase in imports, resulting in a depreciation of the AAD.

Multiple-Choice Questions:

Antarctica is the home country, its currency is the **Antarctica dollar (AAD)**; **Greenland** is the foreign country, its currency is the **crown (GRK)**. Choose the correct answer.

2. All else being equal, a decrease in the interest rate r in Greenland leads to:

- A) decreased demand for assets in Greenland, and therefore a depreciation of the GRK.
- B) decreased demand for assets in Greenland, and therefore a depreciation of the AAD.
- C) an increase in consumption in Greenland, and therefore an increase in imports, resulting in an appreciation of the GRK.
- D) an increase in consumption in Antarctica, and therefore an increase in exports, resulting in a depreciation of the AAD.

Multiple-Choice Questions:

Antarctica is the home country, its currency is the **Antarctica dollar (AAD)**; **Greenland** is the foreign country, its currency is the **crown (GRK)**. Choose the correct answer.

3. All else being equal, a decrease in prices in Greenland leads to:

- A) an increase in exports to Antarctica, and therefore an appreciation of the AAD.
- B) an increase in exports to Antarctica, and therefore a depreciation of the AAD.
- C) an increase in consumption in Greenland, and therefore an increase in imports, resulting in an appreciation of the AAD.
- D) a decrease in consumption in Greenland, and therefore a decrease in imports, resulting in a depreciation of the AAD.

Applications:

1. Suppose that you are an analyst for the Central Bank of Zanzibar. Decide how the BOP accounts are affected by the following.

(A:) An import quota for foreign cars

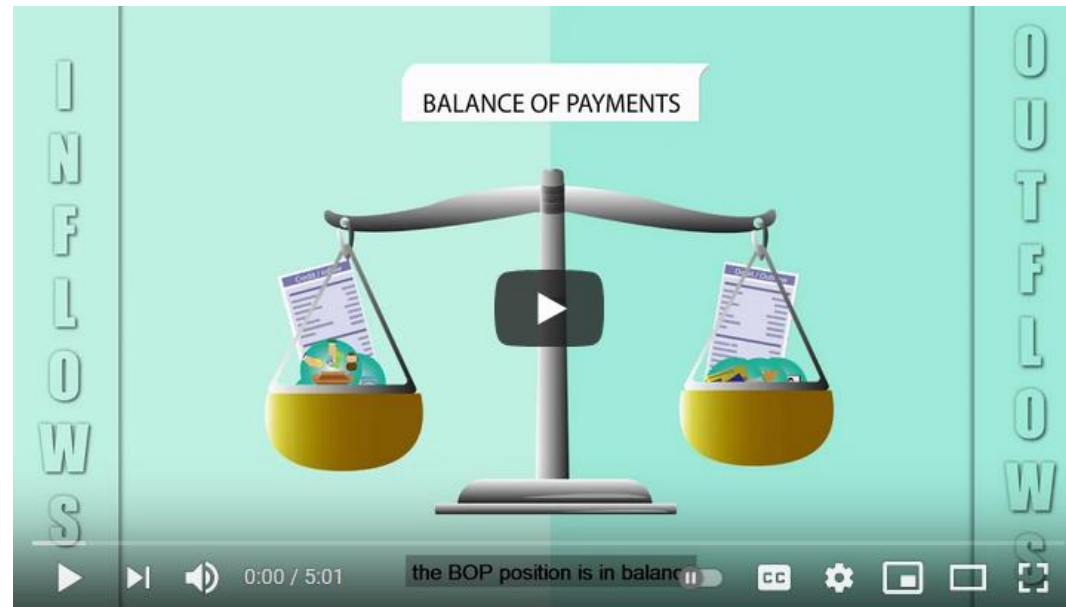
(B:) A purchase of a new embassy in Luxembourg

(C:) A grain embargo

VIDEO 1

Understanding Balance of Payments

https://www.youtube.com/watch?v=5_p5zk5qQos



VIDEO 2

Balance of Payments:

<https://www.youtube.com/watch?v=y3bdt3Scmlg>



Exercise 3:

On the principle of double-entry bookkeeping, record individual operations (1-9) in selected items of the balance of payments.

Calculate the total balance of payments turnover.

1. The domestic company exported machines in amount of 10 mil. USD and provided to a foreign customer a short-term business loan. (maturity next year)
2. A domestic travel agency paid a 100 000 USD deposit to a foreign hotel from its current account at a commercial bank.

Exercise 3:

3. A domestic charity provided material aid in amount of 500 000 USD to help earthquake victims in Asia.
4. The government sold a 5% shareholding in a domestic company in amount of 50 mil. USD to a foreign applicant. It was paid to the government's current account at the National Bank.
5. The Slovak National Bank issued dollar Eurobonds in amount of 100 mil. USD in order to increase foreign exchange reserves.
6. The domestic company provided a long-term financial loan of 8 mil. USD to his 100% owned foreign subsidiary. Non-cash transfer to a foreign commercial bank.

Exercise 3:

7. NBS intervention against EUR depreciation - sale 70 mil. USD.
8. The domestic country draws resources from EU funds in the amount of 200 mil. USD.
9. A foreign company in the domestic country reinvested a profit of 90 mil. USD.

Fill the table BoP.

Fill the table:

	CREDIT (+)	DEBIT (-)
Trade balance		
Balance of services		
Income balance		
Balance of current transfers		
Balance of capital transfers		
Balance of direct investments		
Balance of portfolio investments		
Balance of other capital		
Change in foreign exchange reserves		
BoP total turnover		

Thank you for attention!

Exchange-Rate Regimes

The price that one pays for one unit of the foreign currency is the **exchange rate**.

ER depends on the supply and demand for the foreign currency.

Very often governments instruct their central banks to influence the supply and demand for a currency.

The role of the government intervention is to control or influence the **ER**.

Country's **exchange-rate regime** can be defined as the set of rules that its central banks follows when buying or selling on the interbank market.

Exchange-Rate Regimes

- Fixed Exchange Rates Relative to Gold
- Fixed Exchange Rates vis-a vis a Single Currency
- Fixed Exchange Rates Relative to a Basket
- The 1979-93 Exchange Rate Mechanism of the European Monetary System
- Other Exchange Rate Systems