Unit 4 - Macroeconomics

Topics Covered

- GDP
- Inflation
- Exchange Rate

Remaining Topics

- Balance of Payments
- International Trade

Balance of Payments

Is an official document that records a country's all international transactions during certain time period.

BOP has a prescribed format and so all countries prepare their BOP in the same format. Moreover, BOP is public information which can be viewed over the internet.

International Trade: is when a country is exporting to or importing any good or a service from another country.

International Transaction: is when one country national makes an investment, buys or sells property, works or is running a business in another country; all such transactions are defined as international transactions.

There are 3 accounts of Balance of Payments that record all international transactions of a country.

1. Current Account
2. Capital Account
3. Financial Account

Errors and Omissions - is another section of BOP but is not an account. This is basically a balancing item if any information is missing.

Current Account: is the most important of the 3 accounts of BOP given it lists most valuable transactions including international trade.

a. ***Trade in Good:*** records exports and imports of tangible goods
b. ***Trade in Services:*** records exports and imports of services
c. ***Income:*** records any income that our country nationals earn by working in a foreign country and what foreign nationals earn by working or running a business in our country. It includes salaries, profit from businesses, profit earned on investments like stock exchange, rent etc
d. ***Current Transfers:*** are unilateral transfers which includes a) government level transaction of receiving and giving aid and b) individual transactions like gifts and remittance

How are transactions recorded in BOP?

Every transaction recorded in Balance of Payments is either recorded as a debit or credit entry. All transactions that bring money into the country are recorded as Credit entries and vice versa all transactions taking money out of the country are recorded as Debit entries.

Current Account	***Debit***	***Credit***
a) Trade in Goods		
Exports of Goods		$ 20 million
Import of Goods	$ 56 million	
b) Trade in Services		
Exports of Services		$15 million
Imports of Services	$ 45 million	
c) Income	$ 35 million	$75 millions
d) Current Transfers	$180 million	$360 million
Totals	***$316 million***	***$470 million***
Current Account Surplus		$ 154 million
Capital Account	$100 million	$50 million
Capital Account Deficit	$50 million	
Financial Account		
Direct Investment	$10 million	$ 15 million
Portfolio Investment	$5 million	$ 7 million
Other Investment	$2 million	$6 million
Financial Account Balance	$ 17 million	$ 28 million
Financial Account Surplus		$11 million
Surplus / Change in Foreign Currency Reserves		$ 115 million

Capital Account: records individuals' sale and purchase of property / assets. For instance, if our country national purchases a property abroad then it would be a debit entry.

Any income like rent earned on foreign held assets will be recorded as credit entry in the Current Account Income section.

Financial Account: it records all types of investments that take place between countries.

There are 4 subsections within the Financial Account:

a. ***Direct Investment:*** any foreign company/business opening an office or starting a factory in your country would be recorded as credit transaction and vice versa
b. ***Portfolio Investment:*** takes place in financial assets like stocks, government bonds and other financial instruments
c. ***Other Investments:*** any investment transaction that is not neatly classified in the direct or portfolio investment section will be recorded in this section.
d. ***Change in Foreign Currency Reserves:*** reflects changes in a country's stock of foreign currency which increases when there is a surplus on its BOP and vice versa when there is a deficit the stock of foreign currency depletes.

Why do central banks hold foreign currency?

1. Loan and aid from foreign countries is received in foreign currency
2. Individuals and businesses of a country require foreign currency to make their transactions with other countries.
3. A country pays off its debt in foreign currency

BOP Equilibrium

Is when a country’s BOP surpluses and deficits are being off-set with each other over a long term period.

On the other hand, if a country is experiencing constant deficits or constant surpluses then it is defined as BOP disequilibrium.

Why are constant deficits a problem for an economy?

1. Firstly, constant deficits mean that a country’s stock of foreign currency is depleting and therefore it has less stock of reserves to pay off its international debt. If a country is

unable to honor its international loan payments then it means that the country has defaulted.

2. ***Current Account Deficit:***

a. When a country's products are less competitive due to higher labor costs, or less business friendly policies (higher corporation taxes), or less supply of raw material (which makes raw material expensive etc).
b. When a country's exchange rate is relatively stronger
c. When a country's exports are less value added (like agricultural products or less processed manufactured goods compared) and imports are more value added like services, more processed manufactured goods.

Solution for Current Account Deficits

1. For products imported a country can encourage investment in those sectors to replace imports with good quality locally manufactured products
2. Developing industry linkages where your products could be processed to increase value addition - improving your supply side policies

Supply Side Policies - any government policies or initiatives targeted at enhancing the country's production potential.

3. ***Capital Account Deficits:*** higher living standards abroad and more enforcement of property rights in foreign countries could be major reasons for capital account deficits.

Solution of Capital Account Deficits:

Making your country more livable so people have reasons to buy property in your country.

4. ***Financial Account Deficit:***
    a. The country's population and their purchasing power is low, not justifying the investment that a foreign business has to make.
    b. The country's overall political and economic situation is unstable
    c. The country's cost of production are higher
    d. Fixed exchange rate reduces investors' profit margins on portfolio investment and therefore could be huge deterrence for investment in that country's financial instruments
    e. Government regulations are not business and investor friendly.

Solutions of Financial Account Deficit

a. Making more business and investor friendly policies
b. Having more economic and political stability
c. Having more GDP per capita to attract larger foreign businesses by increasing their profit margins.

What causes a surplus on Current Account

1. More exports and lesser imports (more competitive products)
2. More inflows of income from abroad
3. More remittance coming to your country

What causes a surplus on Capital Account

1. Property prices across countries - generally cheaper properties attract more investors and vice versa
2. Economic and political stability

What causes a surplus on Financial Account

1. Profitability derives investment across countries - higher profit margins attract more investors and vice versa.
2. Economic and Political situation