

Balance of Payments Analysis

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Basic Structure of BP

- Current Account
- Capital and Financial Account
- Net Errors and Omission
- = Overall Balance
- Change of Reserves
- $BP = CA + CFA + NEO + dR$

The Current Account

- Current Account:

- ◆ Trade

- ◆ = Trade Balance

- ◆ + Services

- ◆ = Balance on Goods and Services

- ◆ + Income

- ◆ = Balance on Goods, Serv. & Income

- ◆ + Transfers

- ◆ = Current Account Balance

Capital and Financial Account

- ◆ Capital
 - ◆ Direct Investment
 - ◆ Portfolio Investment
 - ◆ Equity Securities/Debt Securities
 - ◆ Financial Derivatives
 - ◆ Other Investment
 - ◆ Monetary Authorities/Government/Banks

A Simplified Scheme

- With Transfers = 0
- Current Account becomes NX
- Capital and Financial Account CF
- Net Errors and Omissions = 0
- Change of reserves $dR = 0$
- $BP = NX + CF = 0$

$$BP = NX + CF$$

- $NX = EX - IM$

- $CF = CIM + CEX$

- $BP = NX + CF = 0$

- $NX = -CF$

- $-NX = +CF$

- ◆ $EX < IM \longrightarrow CIM > CEX$

- ◆ For $BP = 0$

Reserves

- $dR = -dR'$
- $BP = NX + CF + dR = 0$
- $NX + CF = -dR$
 - ◆ With $CF = 0$
 - ◆ and $NX < 0$
 - ◆ R must fall
 - ◆ $-NX = dR$

Financial Crisis

- With R falling below critical level, country risks default
- $EX - IM + CIM - CEX$
 - ◆ P-, M-, e-, i+, C-, G-, I-, TA+, w-,
 - ◆ Financial crisis becomes economic crisis,
 - ◆ Economic crisis becomes social crisis
 - ◆ Social crisis becomes political crisis
 - ◆ Risk of economic decline

Open Economy Macroeconomics Framework

- $Y = C + IPR + G + NX$
- $Y = C + SPR + TA$
- $C + IPR + G + NX = C + SPR + TA$
- $(EX - IM) = (SPR - IPR) + (TA - G)$
- up down up down up down
- Reduce G, devalue e, raise interest rate i
- Side effects: w, IPR, TA, EX
- Main burden falls on IM

Preventing Financial Crises

- Control money supply
 - ◆ Effect on prices (P), interest rate (i), and exchange rate (e)
- Control government expenditures
 - ◆ Government Savings (TA – G)
- Install Effective system of taxation
- Competitiveness (Property Rights, Innovation, Regulation)

External Position and Savings

- $SPR = \text{private savings}$
- $(TA - G) = \text{public savings (SGOV)}$
- $(SPR + SGOV) = SNAT \text{ (national savings)}$
- $NX = (SPR - IPR) + (TA - G)$
- $NX + I = SPR + SGOV$
- $NX + I = SNAT$
- $S = NX + I$

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