Lecture Notes for Chapter 5

International Financial Markets and Institutions

Chapter 5

The balance of payments

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Road Map

12 Summary of international finance

13 Revision classes

13.1 Main Issues

- What is the balance of payments?
- What does the BOP have to do with the FX rate?

13.2 Balance of Payments

We start with a few facts about Canada:

Canada's trade (exports and imports) make up 83 percent of national income. Almost 85 percent of that trade is with the US. Canada's financial markets are highly integrated with world markets—predominantly with markets in the US.

The Balance of Payments records Canada's commerce with other nations. That includes *payments to foreigners* for things Canadians want from abroad, such as BMW's, Armani clothes, US Government bonds. It also includes *payments to Canadians* for Canadian products that foreigners want, such as oil, gas, softwood lumber, Maple syrup and shares in RBC. All these payments are recorded in CAD.

When Canadians want to *buy foreign* goods, services or financial assets, Canadian dollars must be sold to buy FC for those transactions. Similarly, when foreigners want to *buy Canadian* goods, services or financial assets, they must purchase CAD.

The BOP must balance. But within that balance, there are pressures that can cause the exchange rate to change. Understanding the BOP is our first step to understanding what determines the FX rate.

13.3 Balance of Payments Accounts

Canada's international transactions are grouped into three accounts that make up the Balance of Payments:

1. Current Account

2. Capital Account

3. Reserve Account

The **Current Account** records—on a quarterly or annual basis—flows of exports and imports, investment income and international financial transfers.

Credits—transactions that involve foreigners purchasing CAD (when foreigners purchase Canadian goods or services).

Debits—transactions that involve Canadians purchasing FC (when Canadians purchase foreign goods or services).

The **Capital Account** records flows of capital that move into and out of Canada.

Credits—inflow of capital into Canada, e.g. an American purchases a Canadian government bond.

Debits—outflow of capital from Canada, e.g. a Canadian buys a foreign government bond.

The **Reserve Account** records changes in the amount of official FX reserves held by the Bank of Canada

Example 13.1 (Entries in Canada's Balance of Payments Accounts)
Where in the BOP would you place the following entries? (Current Account or Capital Account or Credit/Debit)

1. The Alberta Natural Gas Company exports natural gas to California.
2. Ford (Canada) buys automobile transmissions from a supplier in Michigan.
3. Bombardier of Montreal sells aircraft to Australia
4. The CN Tower pays an insurance premium to Lloyd's of London.
5. Fidelity Mutual Fund of New York buys 10,000 shares of Nortel Networks (Bramalea).
6. Saskatchewan Teachers Superannuation Commission buys State of Montana bonds.

1. The Alberta Natural Gas Company exports natural gas to California—Current Account Credit

2. Ford (Canada) buys automobile transmissions from a supplier in Michigan—Current Account Debit

3. Bombardier of Montreal sells aircraft to Australia—Current Account Credit

4. The CN Tower pays an insurance premium to Lloyd's of London—Current Account Debit

5. Fidelity Mutual Fund of New York buys 10,000 shares of Nortel Networks (Bramalea)—Capital Account Credit

6. Saskatchewan Teachers Superannuation Commission buys State of Montana bonds—Capital Account Debit

Remember:

- goods, services, dividends and interest are recorded in the Current Account
- securities transactions are recorded in the Capital Account

The Balance of Payments Identity is an accounting relationship that must hold (asides from statistical errors)

$$B_C + B_K = \Delta B_R \tag{13.1}$$

13.4 Current Account

The Balance of the Canadian Current Account for 2002 is positive—the value of Canadian exports and income receipts from abroad exceeds the value of imports and income payments to foreigners.

This is driven by the the positive **Balance of Merchandise Trade**,i.e. 410.3-356.2=.

What are Canada's major exports and imports?

- Exports: Forest products, minerals, energy, agricultural products, airplanes, automobiles.

- Imports: Electronics, clothing, food products.

In **invisible trade** (services), Canada runs a **deficit** of . Services include patent royalties, fees for movies, travel, insurance, consultants and engineering.

13.4.1 The J-Curve Effect

What happens to the Canadian trade balance (exports minus imports) when CAD weakens against the currencies of Canada's major trading partners?

Imports becomes more expensive and exports become cheaper. That decreases the trade balance. But over time, importers start to import less and exporters export more, increasing the trade balance.

13.5 Capital Account

The Capital Account records sales to foreigners of Canadian financial assets and Canadian purchases of foreign financial assets. The Balance on Capital Account is the difference between the value of foreign purchases of Canadian financial assets and Canadian purchases of foreign financial assets.

Two main categories of financial assets recorded in Capital Account—**direct investment** and **portfolio investment**.

13.5.1 Foreign direct investment (FDI)

Suppose McCain sets up a food processing plant in France. The cashflow are:

- Equity injections of CAD 10 M per year in 2004—debit in Capital Account
- Reinvested earnings of CAD 800,000 in 2005—debit in Capital Account, credit in Current Account

13.5.2 Portfolio investment

This refers to:

1. Changes in Canadian holdings of noncontrolling equity in foreign companies

2. foreign holdings of noncontrolling equity in Canadian companies

3. Canadian holdings of debt issued by foreigners,

4. foreign holdings of debt issued by Canadians.

13.6 External Balance and the Exchange Rate

If a country runs a **Current Account deficit**, then it has spent more than it has earned. To finance that deficit the country is a net seller of securities, giving it a **Capital Account surplus**. In theory, the Capital Account surplus balances the Current Account deficit.

For example, the United States has run a Current Account deficit since 1982—based on the enormous capacity of the US to borrow money from the rest of the world (by selling securities).

What can happen if the demand for US securities falls?

Either,

- US interest rates rise to attract investors

  or

- the USD falls to make USD denominated assets cheaper.

In the **short term**, other factors are important:

- any news of an **unexpected** boost to a macroeconomic factor—e.g news that points to greater economic strength or higher interest rates is likely to increase demand for that country's currency, triggering its appreciation.

  For example, the USD/CAD rate is likely to increase on news of the following sort:

- Statistics Canada reports surprise jump in Canadian output
- The Bank of Canada announces higher-than-expected interest rate hike
- Industrial Unemployment is well below forecast values

- Exports up sharply above trend
- Oil and energy prices jump 10 per cent