Economics Grade 11

Week 6; Date: 05/06/2020

9.2 Balance of Payments

At the end of this section, you will be able to: -

- Define balance of payments;
- Define and identify the components of current account;
- Define trade balance and show how trade balance is computed;
- Define net services;
- Define current account balance;
- Identify the components of current account balance;
- Compute and interpret change in countries — assets held abroad; and
- Compute and interpret change in foreign assets held in a country.

Key Terms and Concepts

Trade balance Net service Current account

Capital account Direct investment Portfolio investment

Private transactions Official transactions

Meaning of Balance of Payments

The principal tool for the analysis of the monetary aspects of international trade is the balance of international payments statement. This statement, also simply 1known as the balance of payments (BOP), is a systematic record of all international economic transactions, visible and invisible, of a country during a given period, usually a year. In other words, the statement

is a device for recording all the economic transactions within a given period between the residents of a country and the residents of other countries.

All payments and receipts of foreign exchange arising from such transactions are listed in the balance of payments accounts. It is, thus, a complete statement of a country's payments and receipts of foreign exchange in the given period of one year. Note that the trade of merchandise (goods) is only one of the many items on account of which a country makes payment or receives it. There are many other items, such as shipping and insurance services, interest and dividends, tourist traffic, etc., which give rise to payments or receipts of foreign exchange. They too are recorded, along with many others, to make a complete statement of accounts of how much foreign currency a country has to pay and how much of it is to receive in a given year.

Balance of payments accounts are prepared using the double-entry system of accounting, in which the sum of all debits equals the sum of all credits, and the accounts are always in balance. If a transaction earns foreign currency for the country, it is called a credit and is recorded using a plus sign. On the other hand, if a transaction refers to a spending of foreign currency by the country, it is called a debit and is recorded in BOP accounts using a minus sign.

In other words, all receipts of foreign currency are credit items, whereas all payments of foreign currency are debit items. If the total of the debit items and the total of the credit items are equal in value, the country's international payments are balanced. If the credit items are larger, so that there is a net balance due to it, the country is said to have a favorable balance. If the debit items are larger, so that there is a net balance due to foreigners, the country is said to have an unfavorable balance. Although, the terms "favorable" and "unfavorable" are 2misleading, they have the sanction of long usage.

Components (or Elements) of BOP

The balance of payment account is divided into two parts:

I: Current account

II: Capital account 3

Current Account

The current account records inflows and outflows of foreign currency resulting from flows of goods, flows of services and unrequited (or unilateral) transfers. Accordingly, a current account has three parts — trade balance, net services, and net transfers.

Trade Balance: The difference between the export and import of goods is called the trade balance. The export and import of goods is also called visible trade, since goods are visible items.

Net Services: The difference between the export and import of services is called net services. There are many services that are made use of in international trade, for example shipping, insurance and banking services. Ships have to be hired for transporting goods from one country to another. The merchandise carried by the ships has to be insured for any loss and damage in transit. Banking services are used to facilitate receipts from and payments to foreign dealers. When foreign ships (for example, ships from a company in the USA) are hired by a country to bring in goods imported from the USA, then, in addition to the payment for the import of goods, payment has to be made to the US shipping company in foreign currency. Conversely, if foreign countries use the services of, say, Ethiopian insurance companies and banks, Ethiopia will receive foreign currency from such countries on account of these services. Nowadays, tourism and travel among countries has also become an important item on balance of payments. When foreign tourists come to Ethiopia, they bring foreign

currency in with them and convert it into our currency to spend it in our domestic market.

The country thus receives foreign currency. Similarly, when Ethiopian tourists go abroad, they have to convert Ethiopian currency into foreign currency to spend it abroad. This involves an outflow or payment of foreign exchange.

We may conclude that the difference between the inflow and outflow of foreign currency as a result of the export and import of services, such as banking, insurance, transport, tourism, etc., constitutes what we call net services. Note that the export and import of services is called invisible trade.

Net Transfers: Transactions such as gifts, remittances, donations, etc., are unrequited or unilateral receipts and payments, because residents of a country receive them ‘for free’. Nothing has to be paid in return, either at present or in the future, for such receipts. The difference between receipts and payments of such transfers is known as net transfers.44the sum total of the above mentioned three components-trade balance, net services, and net transfers-is called balance of payments on current account or simply current account balance (CAB).4

II: Capital Account

The capital account of BOP records all such transactions between residents of a country and the rest of the world which cause a change in the assets or liability status of residents of a country or its government. It represents the international flow of loans and investments that change the country’s foreign assets and liabilities. A capital account is made up of two major parts: the country’s assets held abroad (which are recorded as a negative

entry) and the assets held by foreigners in the country (recorded as a positive entry).

The sum total of these two components gives the balance of payments on capital account or simply the capital account balance.

Various forms of capital account transactions are as given below:

Private Transactions: These are transactions which affect the assets and liabilities of individuals, businesses, and other non-government entities.

Official Transactions: These include transactions affecting the assets and liabilities of the government and its agencies.

Direct Investment: It means purchasing an asset and, at the same time, acquiring control of it. For example, the acquisition of a firm in one country by a firm in another country or the purchase of a house by individuals abroad.

Portfolio Investment: It is the acquisition of an asset that does not give the purchaser control over the asset. Examples are the purchase of shares in a foreign country or the purchase of bonds issued by a foreign 5Government.

Balance of Payments: Complete Account

By adding the balance on the capital account and the balance on the current account, we get the complete balance of the payments account. When receipts and payments are equal, the balance of payments is said to be in balance. If the total BOP receipts are more than the payments, the excess goes to a third account, the Foreign Exchange Reserves. And when payments exceed receipts, there is a depletion of foreign exchange reserves.

9.3 FOREIGN EXCHANGE RATES

At the end of this section, you will be able to:

- Assess the impact of foreign trade on the economy;
- Classify exchange rates;
- Define fixed exchange rate and identify the types of fixed exchange rates;
- ‡Define the revaluation and devaluation of fixed exchange rates;
- ‡Explain what floating exchange is; and
- Distinguish the differences between appreciation and depreciation floating exchange rate.

Every country has its own currency which is used as a medium of exchange within the national borders of that country (and not outside the country). For instance, the currency of Ethiopia is the Birr; of America it is the US dollar that of the UK is the British pound that of Japan is the Yen, etc. There is no problem of payment if 6transactions (sales and purchases) are made within the national border of a country.

For instance, if a seller in Addis Ababa sells goods to a buyer in Dire Dawa, he/she is paid in birr. There is no problem because both use the same currency. But if a seller sells goods to a buyer in England, the problem of foreign currency occurs because the seller wants to receive payment in birr, whereas the buyer wants to pay in pounds. Payments across national borders give rise to a new situation that of international payments. Currency which is used for making international payments is called Foreign Exchange. Thus foreign exchange refers to all currencies other than the domestic currency of a given country. For instance, for Ethiopia, all currencies other than birr are foreign exchange, and similarly for

America, all currencies other than its US dollar is foreign exchange. Now this problem arises: at what rate should currencies of two countries be exchanged? We discuss this in the following paragraphs.

Foreign Exchange Rate and its Types

Foreign Exchange Rate

The price of one currency in terms of another is known as their foreign exchange rate. It is the rate at which one unit of a foreign currency is exchanged for domestic currency. Since there is symmetry between two currencies, their exchange rate can be quoted in two ways, i.e., foreign currency expressed in terms of domestic currency or domestic currency expressed in terms of foreign currency.

There are various concepts of exchange rate system. Its two broad types are Fixed Exchange Rate and Floating Exchange Rate. In between these two extreme rates, there are some hybrid systems like Crawling Peg, Managed Floating, Adjustable

Fixed Exchange Rate

The fixed exchange rate is the rate which is officially fixed (or pegged) in terms of gold or any other currency by the government and adjusted only infrequently. Only a very small deviation from this fixed value is possible. In this system, foreign central banks stand ready to buy and sell their currencies at a fixed price.

In case there is disequilibrium in the balance of payments, causing excess demand or excess supply of foreign exchange, the central bank of the country has to buy or sell the quantities of foreign exchange required to eliminate the excess demand or supply.

Remark: The value of a currency fixed in terms of another currency or in terms of gold is known as the parity value of the currency.

Floating Exchange Rate

The floating exchange rate is the rate which is determined by forces of supply and demand in the foreign exchange market. There is no (official) government intervention. Here the value of a currency is to be left completely free to be determined by market forces of demand and supply of foreign exchange.

Under this system, the central banks, without intervention, allow the exchange rate to adjust so as to equate the demand and supply for foreign currency.

The foreign exchange market is busy at all times with changes in the exchange rate. Just like

the market price of a commodity, the exchange rate of a currency is determined by demand and supply of foreign exchange in a freely fluctuating exchange market.

Changes in the Value of a Currency

The value of a currency in terms of foreign currency may increase or decrease under these two systems of exchange rate, i.e., fixed and floating. Under the fixed exchange rate system, these changes take place as a result of a policy decision by he monetary authority (government) of the country, whereas under the floating exchange rate system, these changes are the result of changes in the demand and supply of the currency in the free exchange market.

Under a fixed exchange regime, when a country raises the value of its currency in terms of foreign currency, it is called revaluation. On the other hand, when a country brings down the value of its currency in terms of foreign currency it is called devaluation. For example, in 1983 E.C., the Ethiopian transitional government devalued the exchange rate of birr from birr 2.07 per US dollar to birr 5 per US dollar. Thus, because of devaluation, more birr was required to buy

one US dollar, i.e., the value of birr in terms of dollar went down.

Under the floating exchange rate system, an increase in the value of a currency in terms of foreign currency is called appreciation. On the other hand, a fall in the

value of a currency in terms of foreign currency is called depreciation. Remarks:

Under the floating exchange system, the exchange value of a currency frequently appreciates or depreciates, depending upon the change in the demand for and supply of the currency in the free exchange market.

Managed Floating: Managed floating is a hybrid of the fixed and floating exchange rate systems. It is characterized by some intervention in the exchange rate movements by the government of the country when a particular situation requires it. Currently, the exchange rate of the

birr is determined by the managed floating exchange rate system.

The US dollar, British pound, French franc, and Japanese yen are considered to be strong or hard currencies because, worldwide, people have faith in their general acceptance as money. The Ethiopian birr and currencies of other developing countries are called soft currencies

since their exchange value is weak.

Impacts of Foreign Exchange Rate on BOP

The balance of payments account of a country largely indicates the monetary aspect of its foreign trade, i.e., exports and imports. Also exports earn foreign currency for a country, whereas imports imply the spending of foreign currency by the country. Naturally, a change in the value of the currency of the country, in terms of foreign currency, has an impact on its balance of payments. An increase in the value of the currency of a country

makes its imports cheaper and its exports costlier (for foreign countries). In such a situation, imports increase and exports decrease, thus leading to a trade deficit, i.e., an unfavorable balance of payments. On the other hand, a decrease in the value of the currency of a country in terms of foreign currency, makes its imports costlier (for the local buyers) and exports cheaper (for the foreign buyers). In this situation, imports decrease and exports increase, thus leading to a trade surplus or favorable balance of payments.

Thus, for example, under a fixed exchange rate system if countries face a deficit in trade balance, they devalue their currency. If countries have a surplus in their trade balance, they revalue their currency.

Exercise

Direction l: if the statement is correct write true and if its incorrect write false.

1.Trade restrictions are a measure to protect domestic industries of a country.

2.The birr is considered to be a hard currency.

3. The Japanese yen is considered to be a strong currency.

4.The value of a currency fixed in terms of another currency or in terms of gold is known as the parity value of the currency.

5.Export and import of material goods is visible trade.

Direction ll: For each of the following, four choices are given, but only one is correct. Choose the correct one.

1.Which of the following is a soft currency?

A. Indian rupee

B. US dollar

C. British pound

D. French franc

2._____ is the rate which is determined by forces of supply and demand in the foreign exchange market.

A. foreign exchange rate B floating exchange rate C. fixed exchange rate D. all

3.An increase in the international value of the currency of a country:

A. makes its imports costlier

B. makes its imports cheaper

C. makes its exports cheaper

D. none of these

Direction llI: Write very short answers to the following questions and instructions:

1.Name two export items of Ethiopia.

2. How does a surplus of imports over exports of a country affect its GDP?

3.Name the three components of a current account.

4.Name the two elements of BOP.

5.What types of transaction are recorded with a minus sign in BOP accounts?

6.Name an element of a current account which is treated as invisible trade.

7.What are the two major parts of a capital account?

8.What do you mean by parity value of a currency?