

## The Balance of Payments II

### Capital Account

October-December 2014

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### Balance of payments

**Accounting framework and statistical record of all the economic and financial flows that take place over a specified time period between residents of the reporting country and the rest of the world**

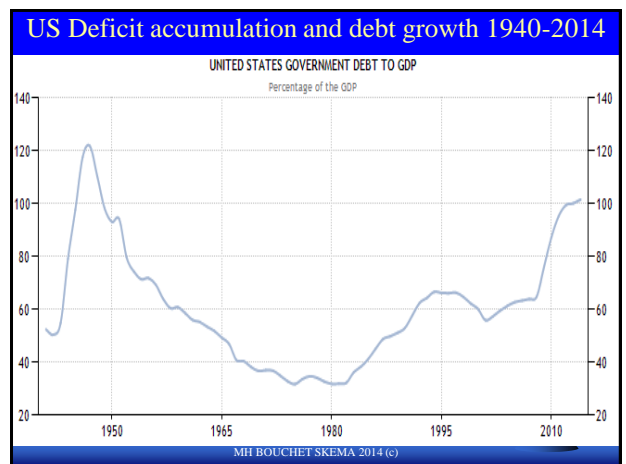
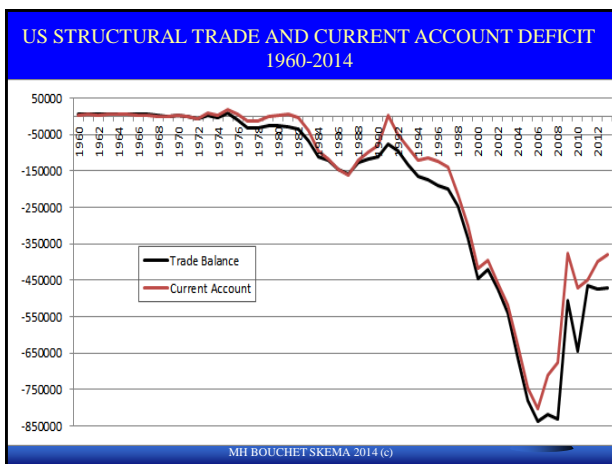
The time period itself is arbitrary but it is common practice to supply balance of payments data on a monthly, quarterly and yearly basis (IMF)

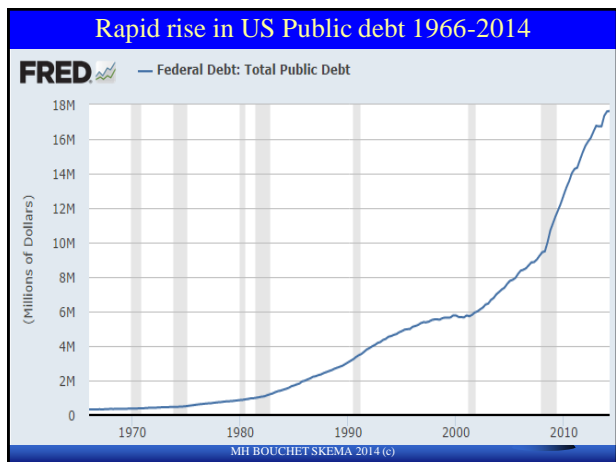
Flows refer to income and expenditure or changes in levels of outstanding assets and liabilities.

The accumulation of flows leads to asset or debt stocks.



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### \* The US CAD dilemma \*

2006-14: average current account deficit= \$500 billion  
CAD= -5% of GDP

- Need to shrink the deficit by boosting exports and reducing import growth with a **weaker \$**
- BUT need to finance the deficit by attracting US\$2 billion/day foreign capital inflows **with stronger \$!**
- Capital sources = surplus countries = Germany + China + Japan + India + Korea
- Need to maintain positive real interest rates to enhance the **dollar attractiveness and competitiveness**

**Engine of world growth or of global crisis?**

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### The US CAD dilemma... revisited (1)

- Large US CAD, though:
  1. The US net liabilities have risen less than the cumulative CAD
  2. Decline in US net liabilities/GDP
  3. Minimal debt servicing burden (the global status of the \$ leads to massive purchases of UST bills, hence low rate of interest)

NYFed staff report n°271 12/2006

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### The US CAD dilemma... revisited (2)

A dollar depreciation alone will NOT curb the US deficit quickly, because:

1. Use of the dollar in international trade transactions (all US exports and imports are invoiced in \$, hence insensitivity to exchange rate changes): Asia
2. Market share concern of foreign exporters, hence desire to remain competitive in the large US market
3. High marketing and distribution costs of US imports might insulate the final consumption price of imported goods

- However, foreign demand for US goods will increase

Fed RB NY, June 2007

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### ☞ Capital account

- Reflects changes in country's ownership of assets
- Reflects international market access
- Financing **flows** lead to changes in external debt stock, and to future debt servicing payment outflows
- Financing sources: debt, equity/FDI, international borrowing in the capital markets (Eurobonds, Eurocredits, official financing, ODA, short-term flows...)




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### Capital account

The financial analyst must focus on :

- ☞ the **volume** of financing to match the financing requirements of the current account deficit
- ☞ the **nature** of financing sources (private/public) and
- ☞ the **sustainability** of the financing (short term/long term, volatility, currency mismatch, floating/fixed rates, repayment conditions...)



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### The Capital Account



**Capital account**

- + (-) Direct investment (non debt creating flows)
- + (-) Portfolio investment (NDCF)
- + (-) Other long-term capital (private + official)
- + (-) Other short-term capital (private + official)
- + (-) Net errors and omissions
- + (-) Counterpart items
- + (-) Change in reserves

= Capital account balance

- + Exceptional Financing (or arrears)

**From less liquid items to more liquid items!**





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### The Capital/Financial Account

- ☞ The *Capital Account* of the balance of payments measures all international economic transactions of financial assets. It is divided into two components:
  - The Capital Account
  - The Financial Account
- ☞ The Capital Account is minor (in magnitude), while the *Financial Account* is significant.


Source: Eiteman/Pearson



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## The Financial Account

- ☞ Financial assets can be classified in a number of different ways including the length of the life of the asset (maturity) and the nature and source of the ownership (public or private).
- ☞ The Financial Account, however, uses a third method. It focuses on the **degree of investor control** over the assets or operations.



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☞ The Financial Account consists of three components:


1. **Direct Investment** – in which the investor exerts some explicit degree of control over the assets
2. **Portfolio Investment** – in which the investor has no control over the assets nor any participation in the management
3. **Other Investment** – consists of various short-term and long-term trade credits, cross-border loans, currency deposits, bank deposits and other capital flows related to cross-border trade



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## Table of Uses and Sources


USES (outflows)	SOURCES (inflows)
1. Imports of goods	☞ Exports of goods
2. Imports of services	☞ Exports of services
3. Interest payments	☞ Transfers & Remittances
4. LT capital outflows	☞ Dividends
5. Principal debt payments	☞ FDI
6. ST capital outflows	☞ ST and LT K inflows
7. E&Os	☞ Debt cancellation
	☞ Arrears



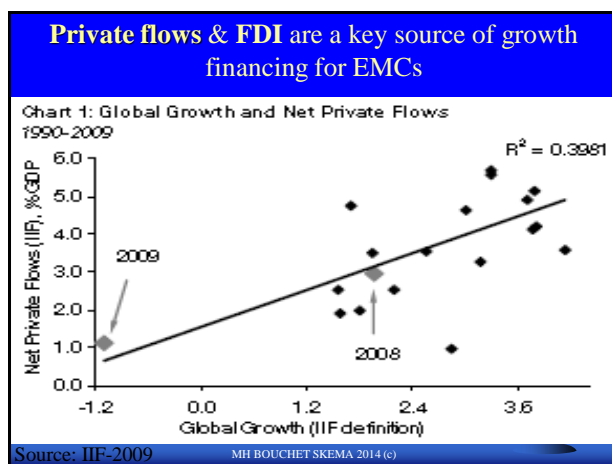
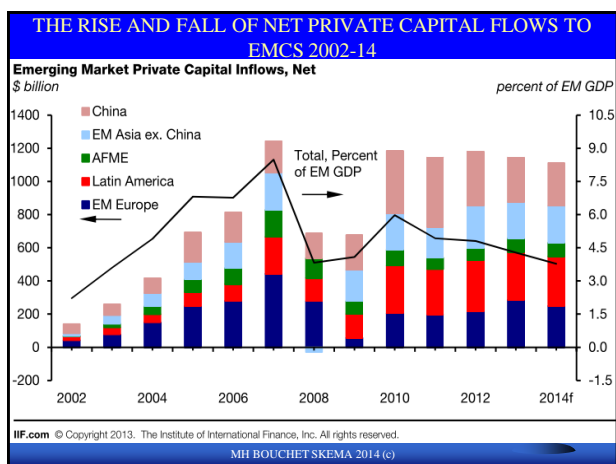
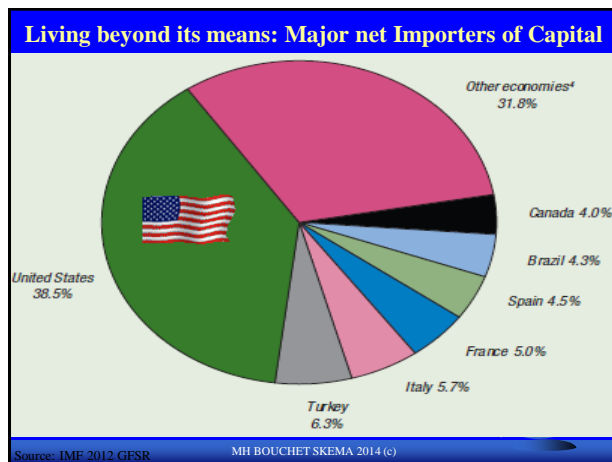
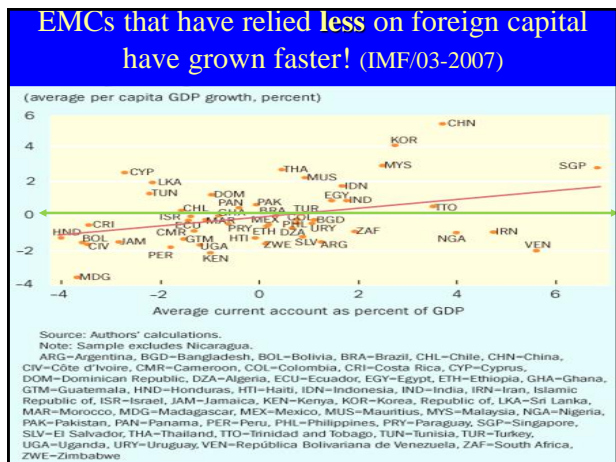
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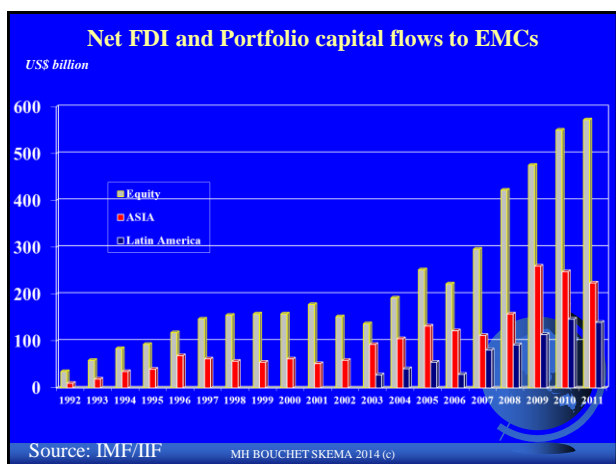
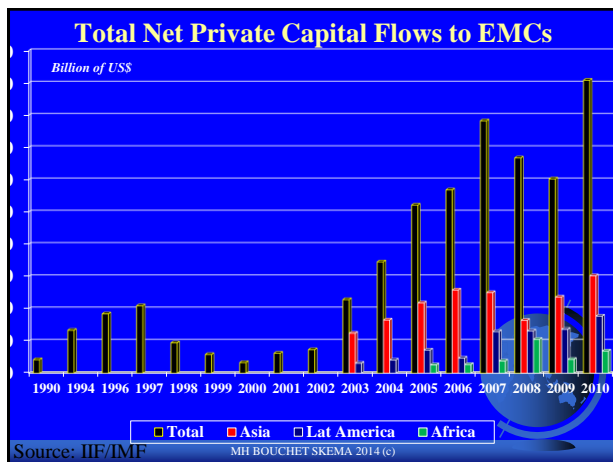
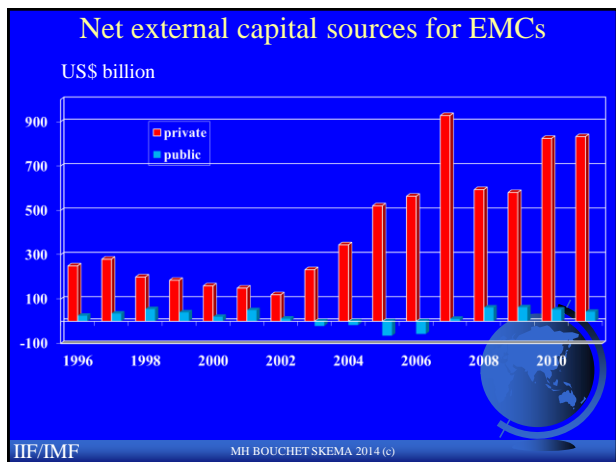
## Sources of external financing

Official (bilateral + multilateral)	Private
<ul style="list-style-type: none"> <li>• Paris Club (government to government credits)</li> <li>• Export insurance credit</li> <li>• IFIs</li> <li>• RDBs</li> <li>• Debt cancellation</li> </ul>	<ul style="list-style-type: none"> <li>• FDI</li> <li>• Portfolio Investment</li> <li>• London Club (International bank loans)</li> <li>• Working capital lines</li> <li>• ST Trade credits</li> <li>• Bonds &amp; International debt securities</li> <li>• Arrears and rescheduling</li> </ul>



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### 1. Direct investment and portfolio investment

The difference between direct investment and portfolio investment resolves around whether or not the investor intends to take an active role in the management of the enterprise whose assets are being acquired.

When the investor's purpose is to have an effective voice in the management of the foreign enterprise, it is considered as a direct investment. Examples:

- ✦ Bonds, debentures and the like are portfolio investments in so far as they confer no management or voting rights on their owners (ST and relatively volatile investment)
- ✦ Foreign branches, wholly owned subsidiaries and joint ventures are clearly direct investments (depending on percentage!)

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### What is FDI?

- Foreign direct investment = purchase of real assets abroad for the purpose of acquiring a lasting interest in an enterprise and exerting a degree of influence on that enterprise's operations.
- Greenfield investment: new investment in a physical structure in an area where no corporate facilities previously existed (complete ownership and therefore full control over management)
- Strategic partnerships: formal alliance (joint venture, licensing agreement, distributorship, or agency contract) between two enterprises, with mutual participation in certain activities (advertising, branding, product development, etc.).
- Mergers and acquisitions: two or more companies decide to pool their assets to form a single new company. Hence, one of the previously existing companies ceases to exist. An acquisition does not necessarily constitute a merger if the preexisting companies continue to exist.

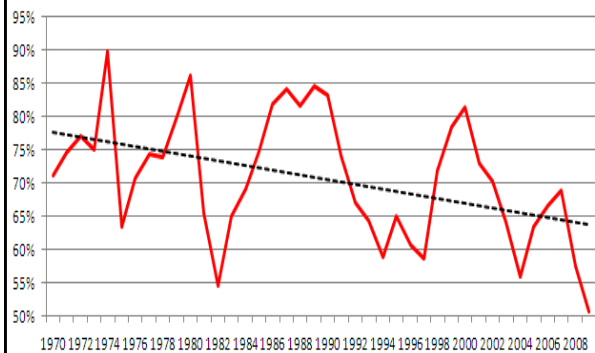
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**Table 1: Selected Laws and Regulations Addressing Foreign Investment Restrictions**

Country	Laws and regulations	Reasons for review or restrictions
Canada	Investment Canada Act, 1985	To ensure net benefit to Canada
China	2006 Regulations for Mergers and Acquisitions of Domestic Enterprises by Foreign Investors, Catalog for the Guidance of Foreign Investment Industries	National economic security, protection of critical industries, purchase of famous trademarks or traditional Chinese brands
France	Law 2004-1343, Decree 2005-1739	Public order, public safety, national defense
Germany	2004 Amendment to the Foreign Trade and Payments Act	Ensure essential security interests, prevent disturbance of peaceful international coexistence or foreign relations
India	Foreign Exchange Management Act, 1999	National security and domestic, cultural, and economic concerns
Japan	1991 Amendment to the Foreign Exchange and Foreign Trade Act of 1949	National security, public order, public safety, or the economy
The Netherlands	Financial Supervision Act of 2006	Competition, financial market oversight
Russia	1999 Federal Law on Foreign Investments	Protection of foundations of the constitutional order, national defense and state security, anti-monopoly
United Arab Emirates	Agencies Law of 1981, Companies Law of 1984	Economic and demographic concerns
United Kingdom	Enterprise Act of 2002	Public interest, control of classified and sensitive technology
United States	Exon-Florio Amendment to the Defense Production Act of 1950, as amended	National security

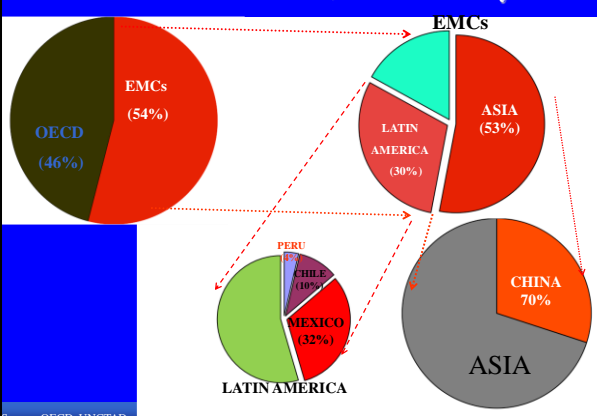
Source: US GAO 02/2008 MH BOUCHET SKEMA 2014 (c)

### OECD Share in Global FDI Flows

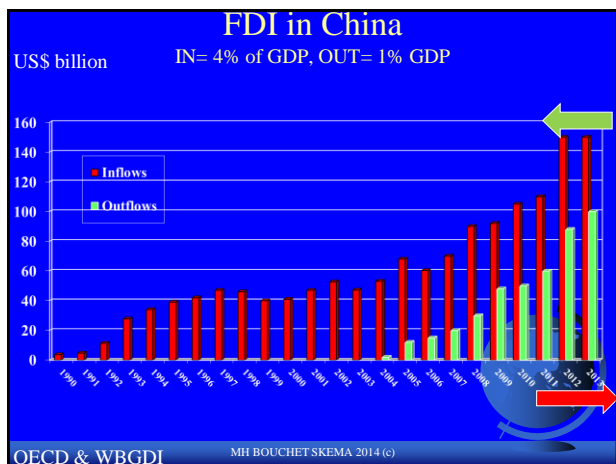
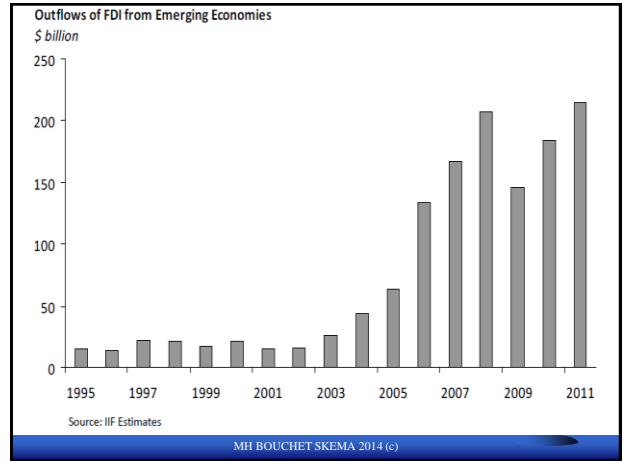
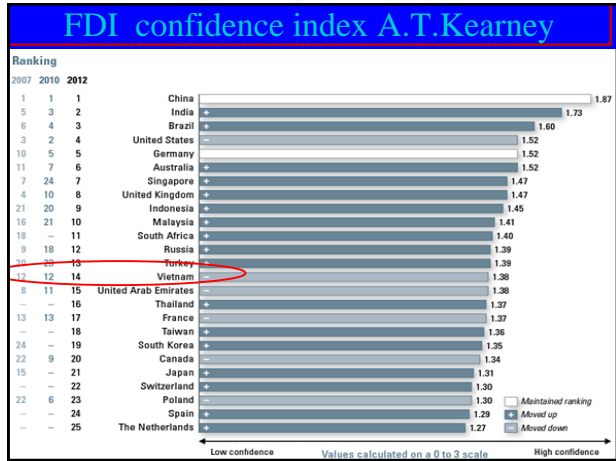


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### GLOBAL FDI FLOWS= \$1200 BILLION/year



Source: OECD, UNCTAD



FDI Benefits	FDI Challenges
<ul style="list-style-type: none"> <li>➤ resources for productive investment</li> <li>➤ Risk sharing with the rest of the world (equity)</li> <li>➤ Greater external market discipline on macroeconomic policy</li> <li>➤ Greater exploitation of comparative economic advantages</li> <li>➤ access to technology, information, ideas and management skills</li> <li>➤ access to export markets with foreign partners</li> <li>➤ Training and better human capital</li> <li>➤ Greater liquidity to meet domestic financing needs</li> <li>➤ Broadening and deepening of national capital markets</li> <li>➤ Improvement of financial sector skills</li> </ul>	<ul style="list-style-type: none"> <li>➤ Currency appreciation</li> <li>➤ Reduced scope for independent macroeconomic policy actions</li> <li>➤ Greater exposure to external shocks</li> <li>➤ Demands for protection in local markets</li> <li>➤ Lesser control of foreign owned domestic industry</li> <li>➤ Disruption of national capital markets, asset inflation</li> <li>➤ Risk of rising volatility in financial and exchange markets</li> </ul>

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**2. Other capital** is a residual category that groups all the capital transactions that have not been included in direct investment, portfolio investment and reserves.

Two categories:

- # Long-term capital
- # Short-term capital

⚡ Non-negotiable instruments > 1 year or more such as London Club bank loans and mortgages, syndicated credits, euroloans...

\* Financial assets < 1 year, such as currency, deposits and bills, interbank credit lines, trade credits... (Source: BIS)



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**3. Change in reserves**

Reserves include:

- ⚡ Hard currency assets + Monetary gold (gold held by the authorities as a financial asset)
- ⚡ Special drawing rights (SDRs): reserves created by IMF as book-keeping entries and credited to the accounts of IMF member countries according to quotas
- ⚡ Reserve position in the Fund: (member's quota + other claims on the Fund)




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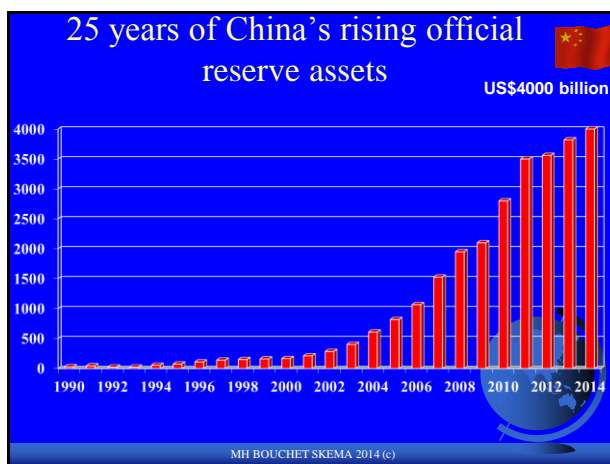
⚡ **Foreign Exchange Reserves**

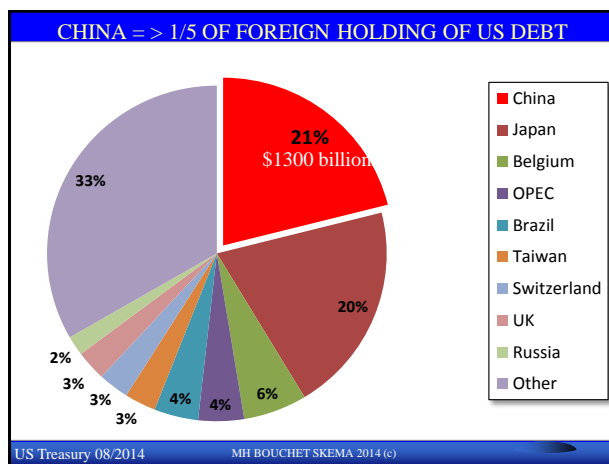
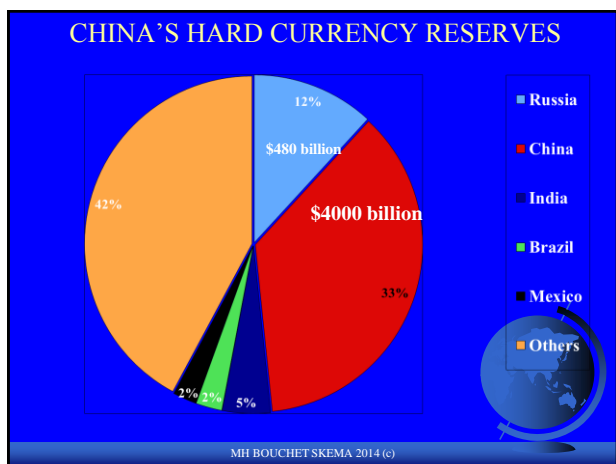
⚡ The largest component of total international liquidity. It includes monetary authorities' claims on non-residents in the form of bank deposits, treasury bills, short-term and long-term government securities, and other claims usable in the event of balance of payments need, including non-marketable claims from inter-central bank and intergovernmental arrangements, without regard as to whether the claim is denominated in the currency of the debtors or the creditors.

⚡ A + sign in the BOP means a financing flow in the capital account, i.e., a decrease in the stock of reserves!



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#### 4. Counterpart items: offsetting amounts

Counterparts items are analogous to unrequited transfers in the current account. They arise because of the double entry system in balance of payments accounting and refer to adjustments in reserves owing to monetization of gold, allocation or cancellation of SDRs and revaluation of the various components of total reserves. These BOP items do not stem from international transactions.

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#### 5. Net errors and omissions

Statistical difficulties involved in gathering balance of payments data (and capital flight!).

Other sources of E&Os:  
 leads and lags in trade flows,  
 underinvoicing of exports and  
 overinvoicing of imports, undeclared  
 short-term capital movements...

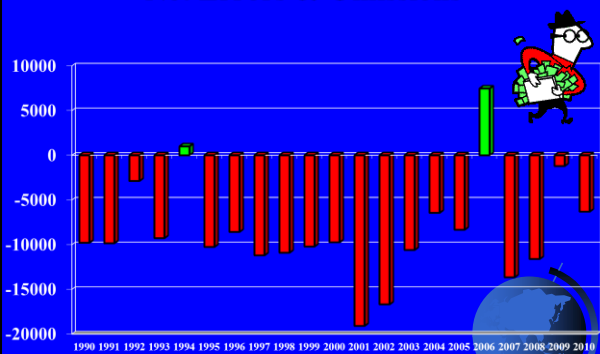
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### Net errors and omissions ?

- ☞ An examination of the size and direction of NE&Os may shed some light on the accuracy of BoP estimates. The adoption of the double entry accounting system means that the net sum of all credit and debit entries should equal zero.
- ☞ In practice, any discrepancies are recorded in NE&Os, reflecting the net effect of differences in coverage, timing and valuation. An amount > 5% of the gross sum of merchandise exports and imports is a source of concern!

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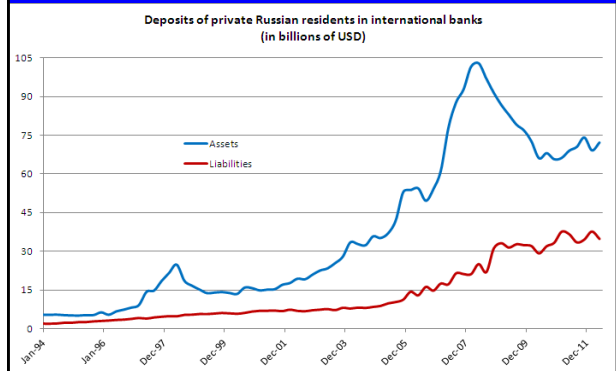
### Russia: Net Errors & Omissions US\$ billion



Source: IMF-IFS/IIF

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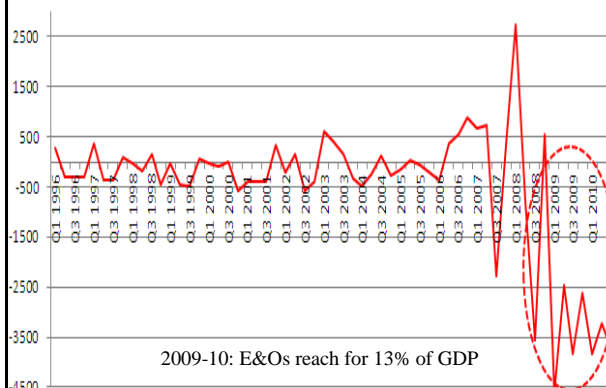
### Capital Flight in Russia (1994-2012)



Source: BIS

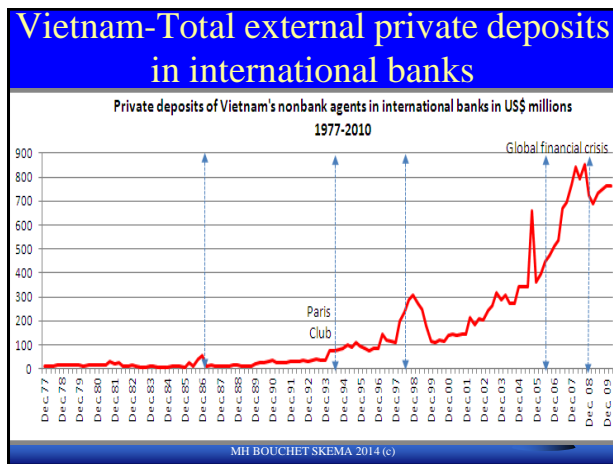
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### Vietnam-Errors & Omissions in US\$ million 1996-2010



2009-10: E&Os reach for 13% of GDP

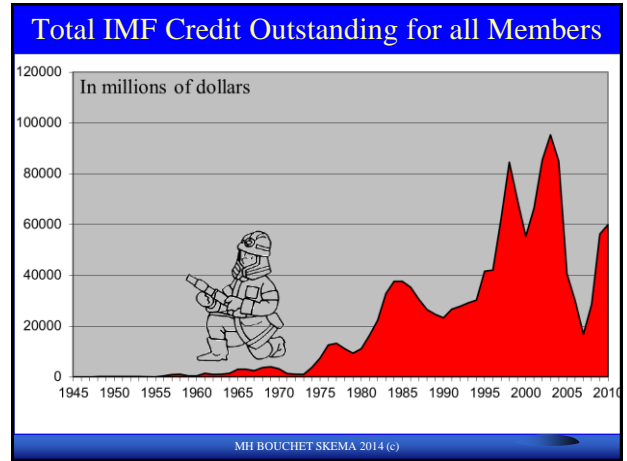
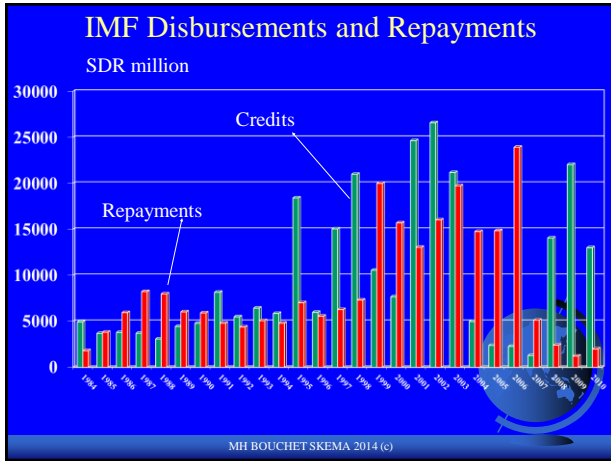
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### 6. Exceptional Financing

- IMF SDR Drawings
- World Bank's HIPC Initiative
- London Club debt reduction and restructuring workouts
- Paris Club debt relief
- Debt swap transactions

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### Risk Management and BOP Analysis

- + Export of goods f.o.b.
- Imports of goods f.o.b.
- = **Trade balance**
- +/- Exports/Imports of non-financial services
- +/- Investment income/expenditures (credit/debit)
- + (-) Private/Official unrequited transfers
- = **Current account balance**
- +/- FDI
- +/- Portfolio capital Flows
- + LT Capital Inflows
- Debt Servicing Payments
- +/- ST Capital Flows
- Reserve Variation

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### External Finance Analysis: The dual face of Country Risk

Liquidity Risk	Solvency Risk
☞ Debt Service Ratio: (P+I/X)	☞ Debt/Export ratio
☞ Interest Ratio (I/X)	☞ Debt/GDP ratio
☞ Current account/GDP	☞ Debt/Reserves
☞ Reserve/Import ratio	☞ ST Debt/Reserves
☞ Elasticity of exports	
☞ Growth rate of exports/ Average external interest rate	

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### Liquidity and Solvency Thresholds

#### Stock variable

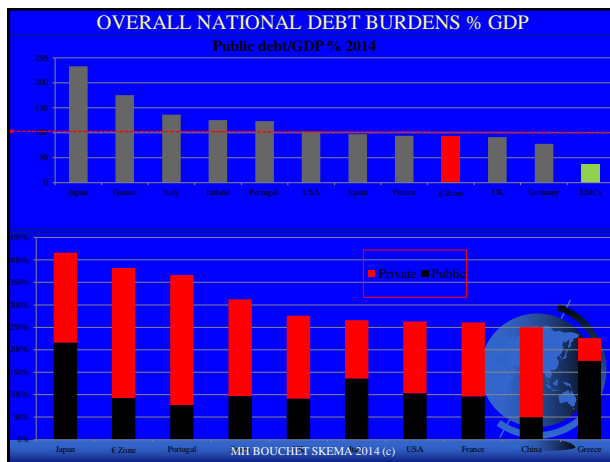
- ☞ **Solvency** = Debt/GDP < 100%
- Debt/Exports < 150%
- Reserves/months of Imports > 6 months

#### Flow variable

- ☞ **Liquidity** = Debt Service ratio < 33% of X
- Interest/X ratio < 25%



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### US Payments statistics: the basic balance

- ☞ Basic balance = balance on current account and long-term capital
- ☞ It puts “below the line” changes in reserves and all short-term capital movements (including errors & omissions).
- ☞ It stresses the importance of demand management policies affecting net international transactions in goods and services



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### US International Investment Position=

US\$ -3469 billion (end-2008)

#### US-owned assets abroad: \$19888

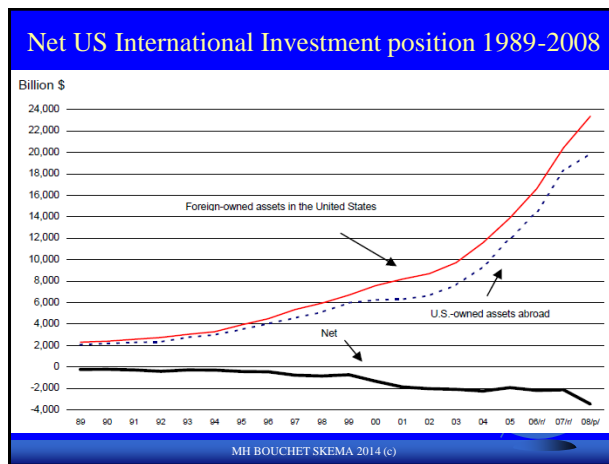
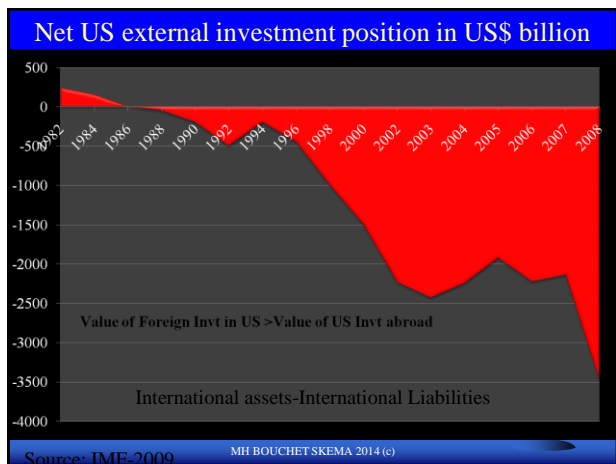
- ☞ US government assets: \$294 (official reserves)
- ☞ Other assets: \$624 billion
- ☞ US private assets: \$12345
  - ✓ (FDI: \$3698)
  - ✓ Foreign securities: \$4244
  - ✓ Non-bank claims: \$992
  - ✓ US Bank claims: \$3410

#### Foreign-owned assets in the US: \$23357

- ☞ Foreign official assets: \$3871
- ☞ Financial derivatives: \$6465
- ☞ Other foreign assets: \$13021 (FDI: \$2647)
- ✓ US Treasury securities: \$884
- ✓ Corporate bonds: \$2866
- ✓ Corporate stocks: \$1838
- ✓ US currency: \$301
- ✓ US bank liabilities: \$4484



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### Net US external investment position in US\$ billion

- FRB of NY: Current issues in economics and finance, December 2005, N°12;
- BEA US Dept of Commerce; June 2009
- End-2004: - 2500 billion, or 22% of GDP, but the US earned US\$36 billion more on its foreign assets than it paid out to service its foreign liabilities!
- End-2008= -3469 billion
- Despite the surge in net liabilities, investment income has remained positive, largely because US MNCs earn a higher rate of return than do foreign firms operating in the US.
- The continuing buildup in liabilities, however, will push the US income balance negative, hence boosting the CAD!

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