

SK

SKEMA BUSINESS SCHOOL

Country Risk and the Balance of Payments I

Current account

Michel Henry Bouchet



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► Country risk assessment starts with the Balance of payments!

1. Inflation and trade deficits
2. Currency volatility
3. Exchange rates and competitiveness
4. External financing flows
5. Capital flight
6. Liquidity or solvency problems?
7. Debt crisis!



BALANCE OF PAYMENTS

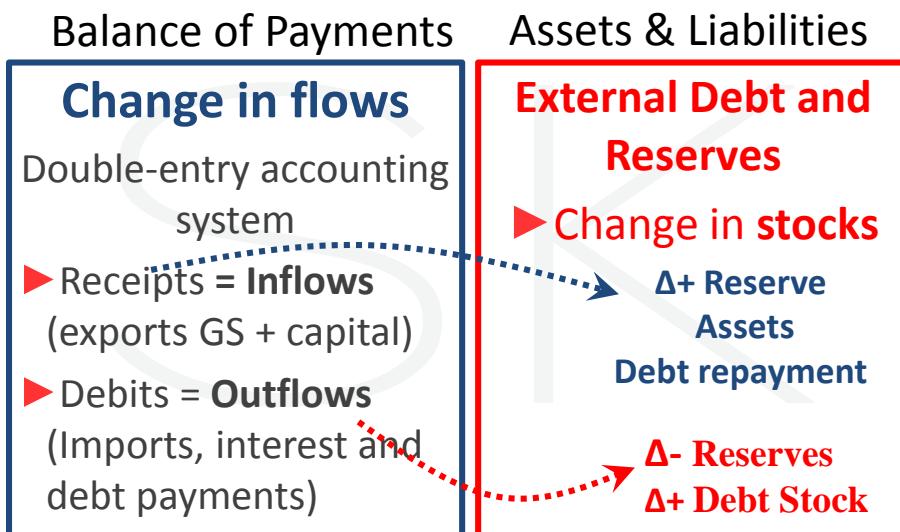
Accounting framework and statistical record of **all** economic and financial flows between residents of the reporting country and the rest of the world

The time period itself is arbitrary:
monthly, quarterly and yearly basis

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BALANCE OF PAYMENTS AND EXTERNAL DEBT



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THE BALANCE IS ALWAYS BALANCED!



Changes in the stock of reserve assets, emergency financing, payment arrears... or debt default, will balance the national accounts

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Residents? = Government, households, individuals, NGOs & private non-profit entities, and firms.

- MNCs are by definition resident in more than one country. The MNC's subsidiaries are treated as resident in the country in which they are located even if their shares are actually owned by foreign residents.
- IFIs are always foreign residents (IMF...)
- Tourists and students are foreign residents if they stay in the reporting country < **1 year**

BALANCE OF PAYMENTS ACCURACY ?

- ▶ Data collection and methodological errors
- ▶ Inconsistencies in the time of recording and valuation of the corresponding debit and credit entries
- ▶ Undercoverage (overinvoicing/underinvoicing)
- ▶ Revisions policy
- ▶ Use of sample surveys rather than complete enumeration
- ▶ Trade-off between accuracy and timeliness!



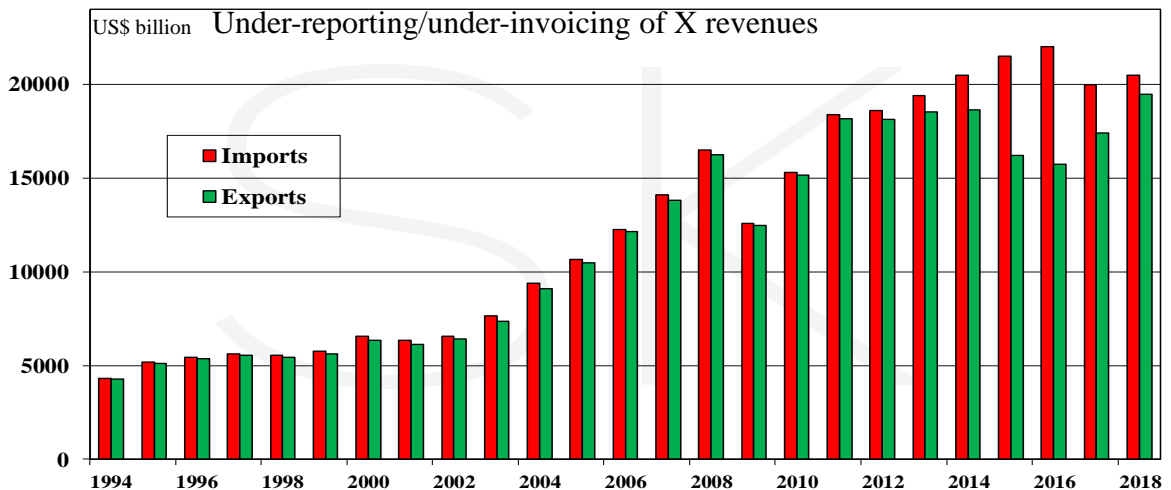
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THE WORLD "MISSING" EXPORTS

A « *black hole* »

>US\$300 b



Source: IMF-2018

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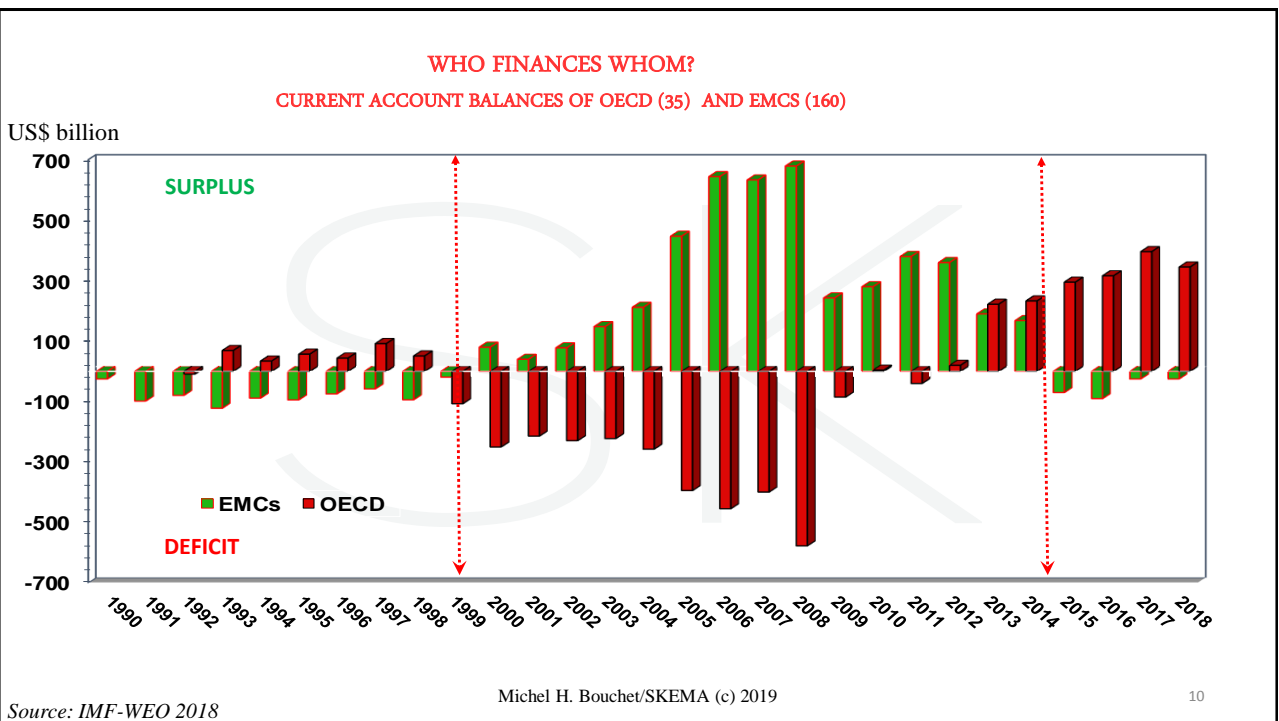
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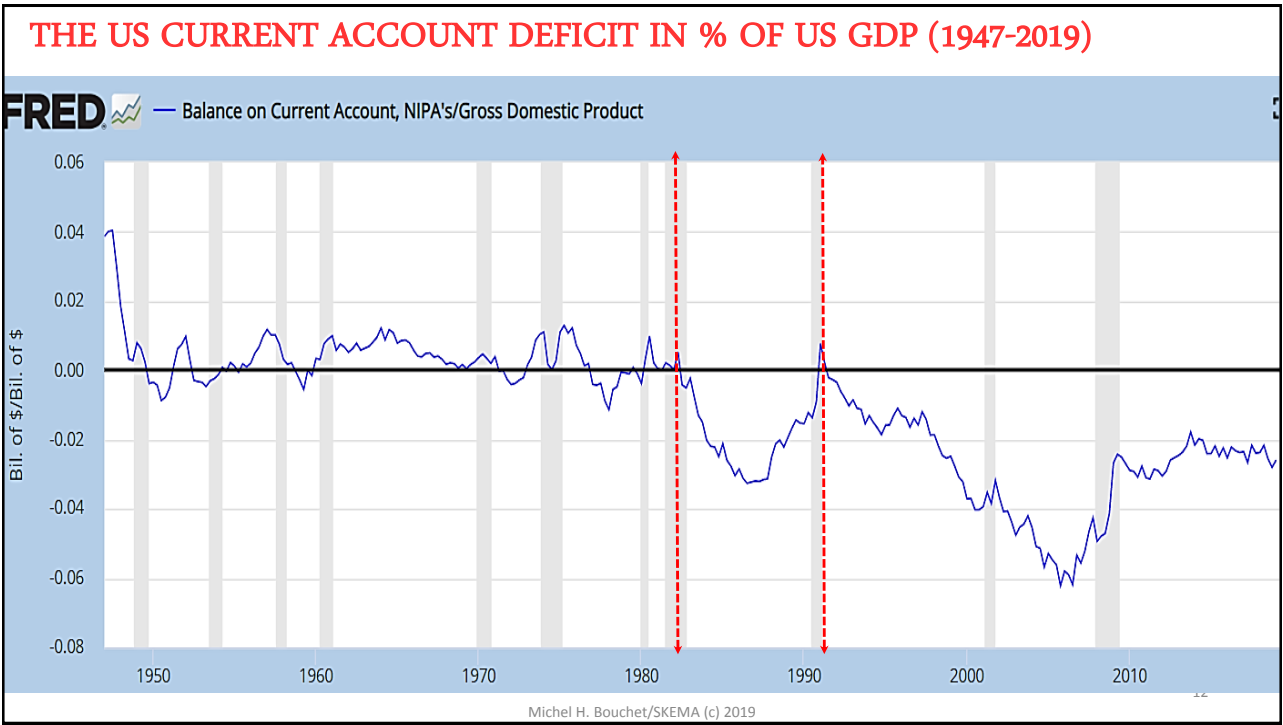
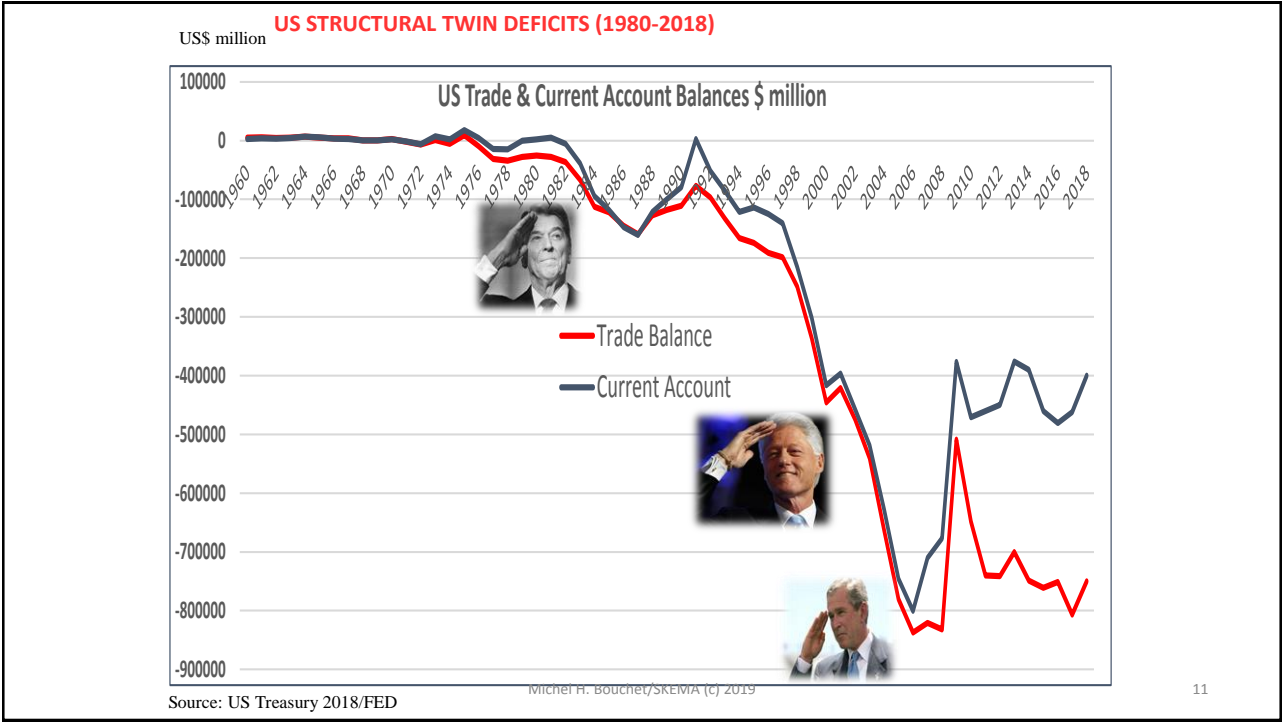
INTERPRETING THE BALANCE OF PAYMENTS

Different accounts in the balance of payments make it possible to see whether or not a country lives **“beyond its means”**

Merchandise exports or imports can be broken down by product and by market source and destination (incompressible imports or volatile exports!)

Useful for determining how a country's balance of payments and overall economic performance will react to different situations (elasticities, exchange rate adjustment, domestic absorption, terms of trade, trade barriers, deflation...)





INTERPRETING THE BALANCE OF PAYMENTS

- Living beyond its means?
- Current account balance = saving - domestic spending
- A country that **saves > it invests** at home sends its surplus abroad to purchase foreign assets
- One that **saves < it invests** finances the shortfall by issuing liabilities to foreign investors = Δ debt!
- The accumulated history of current account surpluses or deficits, along with capital gains and losses on past investments, determines a country's **net international investment position**.

NATIONAL INCOME IDENTITY

Y = National income
C = Domestic Consumption
I = Investment
G = Government expenses
T = Taxes & Government revenues
X = Exports
M = Imports
S = Domestic Savings (income > consumption)

DOMESTIC AND EXTERNAL FINANCIAL EQUILIBRIUM

What is disposable income?

Y = gross income - imports & taxation

$$Y = C + I + G + X - M - T + (KM - K \text{ flight})$$

$$\text{Savings} = Y - C$$

$$(S - I) + (T - G) = (X - M) + (KM - K \text{ flight})$$

Savings Fiscal balance Trade balance Net capital inflows

BOOSTING SAVINGS TO FINANCE INVESTMENT WITHOUT EXTERNAL DEFICIT?

if $S > I \Rightarrow X > M$

If $S < I \Rightarrow M > X$

- ▶ a trade imbalance is always rooted in low savings and excessive domestic spending (absorption)
- ▶ It requires macroeconomic correction (interest rate hike, devaluation, \uparrow taxation, credit reduction, \uparrow reserve requirements...)

Two principal sub-accounts

1. **current account** plays a role similar to a private company's income statement= country's economic performance vis-à-vis the rest of the world.
2. **capital account** shows how the country's economic growth gets financed.

The basic balance draws the line under "other long-term capital" to emphasize the role of economic performance and stable long-term financing. Another presentation is the **Table of Uses & Sources**

BALANCE OF PAYMENTS: CURRENT & CAPITAL ACCOUNTS

1. **Balance of trade** = Exports of merchandise – Imports
2. **Balance of services** ("invisible")
 - = freight, insurance, shipping, banking, tourism, interest and dividend payments (i.e. services of capital!)
3. **Unilateral transfers**
 - = **CURRENT ACCOUNT**

▶ *A deficit in the current account must be financed by a surplus in the capital account!*

THE CURRENT ACCOUNT OF THE BALANCE OF PAYMENTS

- + Export of goods f.o.b.
- Imports of goods f.o.b.
- = **Trade balance**
- + Exports of non-financial services
- Imports of non-financial services
- + Investment income (credit)
- **Interest payments**
- + Private unrequited transfers
- + Official unrequited transfers
- = **Current account balance**

From less liquid items
toward more liquid items!

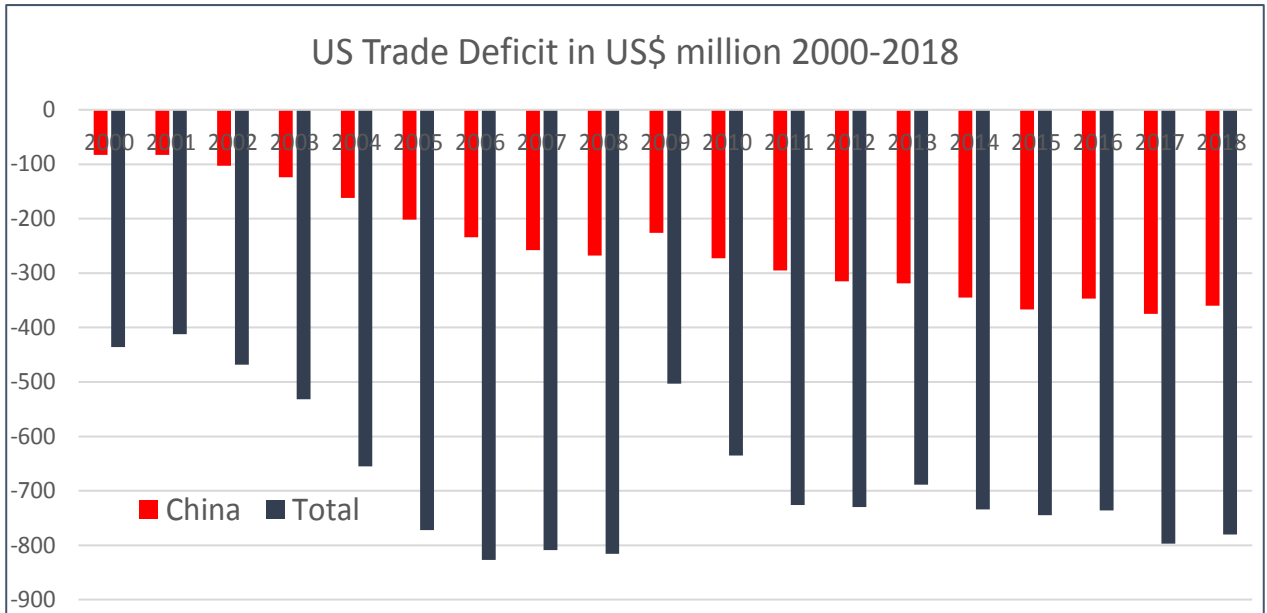


1. **The trade balance** comprises



1. **Merchandise exports:** all movable goods such as equipment, cars, trucks, textile, appliances, oil etc.
2. **Imports are recorded "free on board" (f.o.b.):** services (freight, insurance, shipping and handling performed on goods up to the customs frontier of the economy from which the goods are exported), are **not** included in the trade balance.

BLAMING CHINA?



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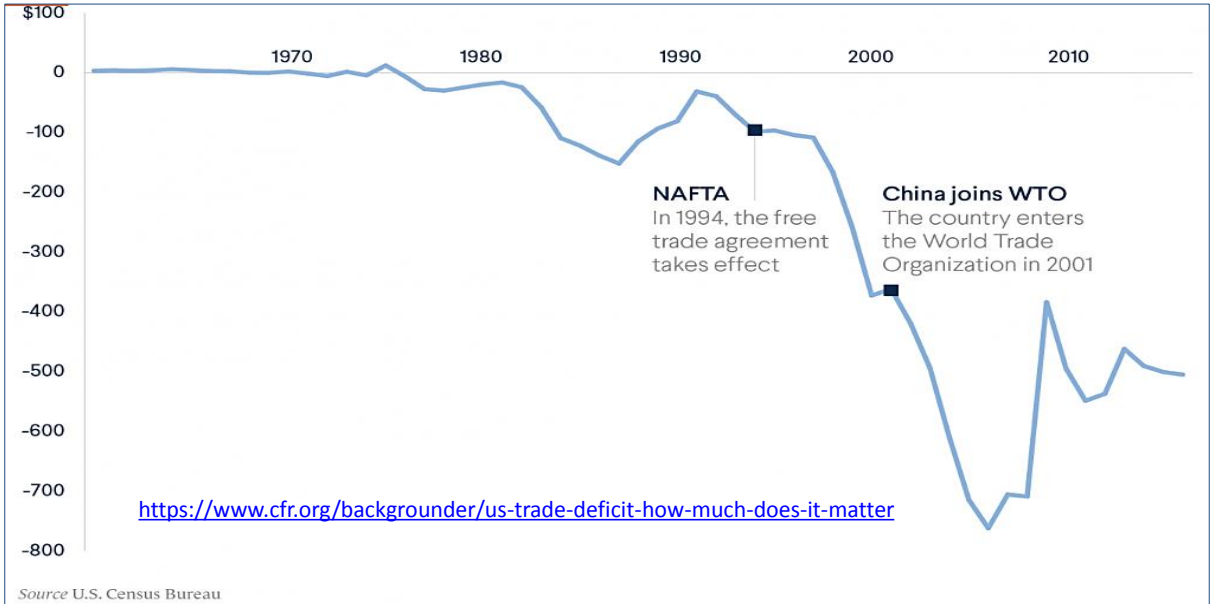
THE US TRADE BALANCE

- ▶ In 2018 the United States exported \$2.500 trillion in goods and services while it imported \$3.121 trillion, hence a **\$621 billion deficit**.
- ▶ Major goods exported include aircraft, medical equipment, refined petroleum, and agricultural commodities.
- ▶ Major imports are dominated by capital goods, such as computers and telecom equipment; consumer goods, such as apparel, electronic devices, and automobiles; and crude oil.
- ▶ Services, such as tourism, intellectual property, and finance, make up roughly one-third of exports.
- ▶ The deficit in goods, at **\$891 billion**, is higher than the overall deficit, since a portion of the goods deficit is offset by the surplus in services trade.

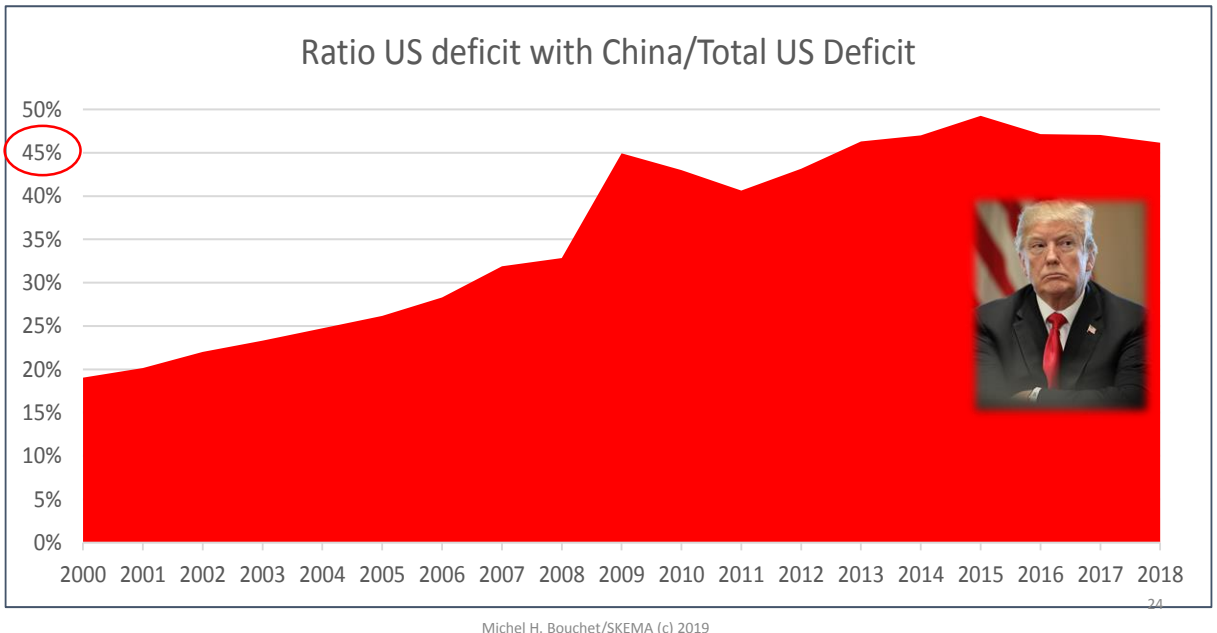
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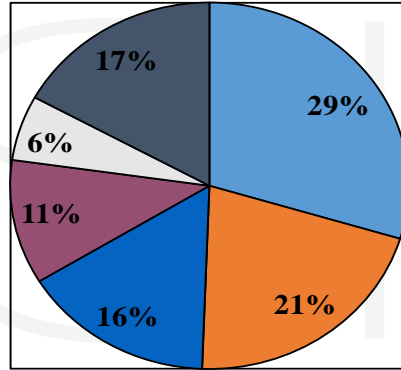
BLAMING FREE TRADE, CHINA AND EMCS? THE US TRADE DEFICIT OVER TIME



BLAMING CHINA??



VIETNAM'S EXPORTS OF GOODS

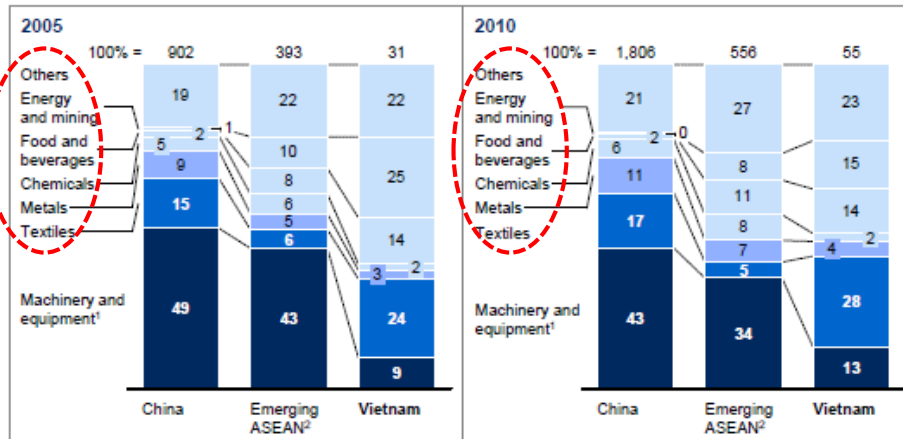


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Vietnam's exports are concentrated in low-value-added products compared with ASEAN countries

Export breakdown by subsector
%; \$ billion



1 Includes electric equipment, electronic products, and general machinery and equipment.

2 Including Indonesia, Malaysia, the Philippines, and Thailand.

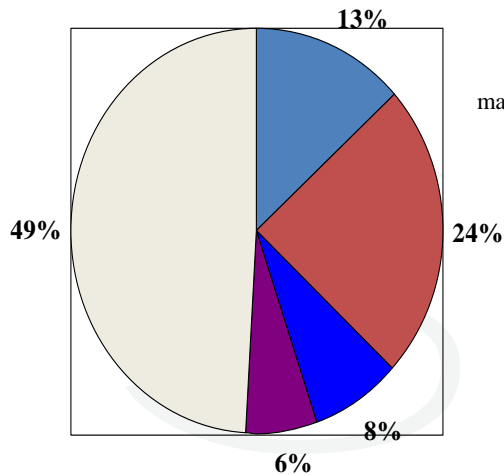
NOTE: Numbers may not sum due to rounding.

SOURCE: Global Insight 2011; McKinsey Global Institute analysis

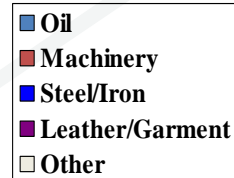
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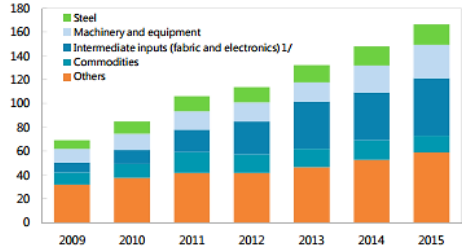
VIETNAM'S IMPORTS OF GOODS



75% of the import value of raw materials, equipment and machinery is transferred to export value



Imports by category
(in millions of USD)



1/ Electronics also include final goods.

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2. Non-financial services =

Freight, insurance, passenger services, tourism, and travel!

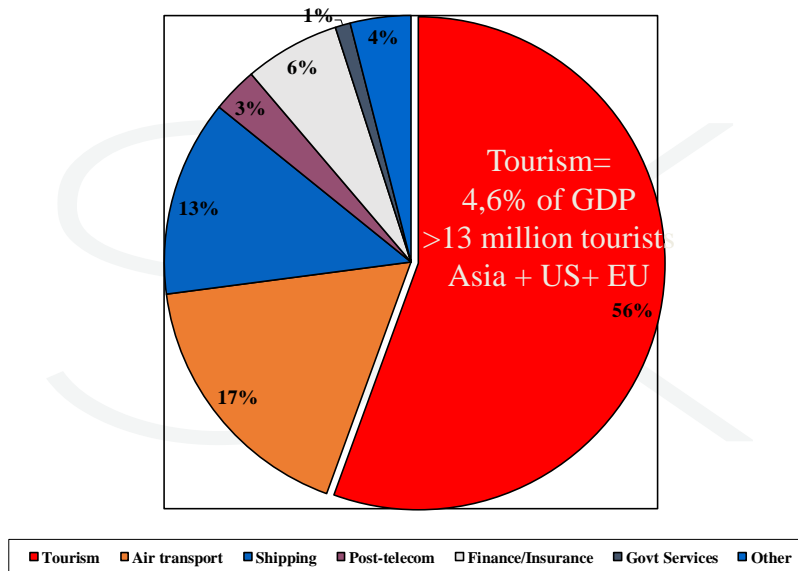
The transportation of persons represents the largest component of passenger services.

Tourism earnings: Cuba, Morocco, Tunisia?, Vietnam, Thailand, Spain, France...

Freight refers mainly to the carriage or transport of goods between national economies (Malta, Cyprus, Liberia, Panama...)

Insurance comprises insurance on movable goods during the course of shipment between economies as well as insurance on the carriers and other types of insurance such as life insurance.

SERVICE EXPORTS OF VIETNAM



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3. Financial services: = Investment income and interest payments

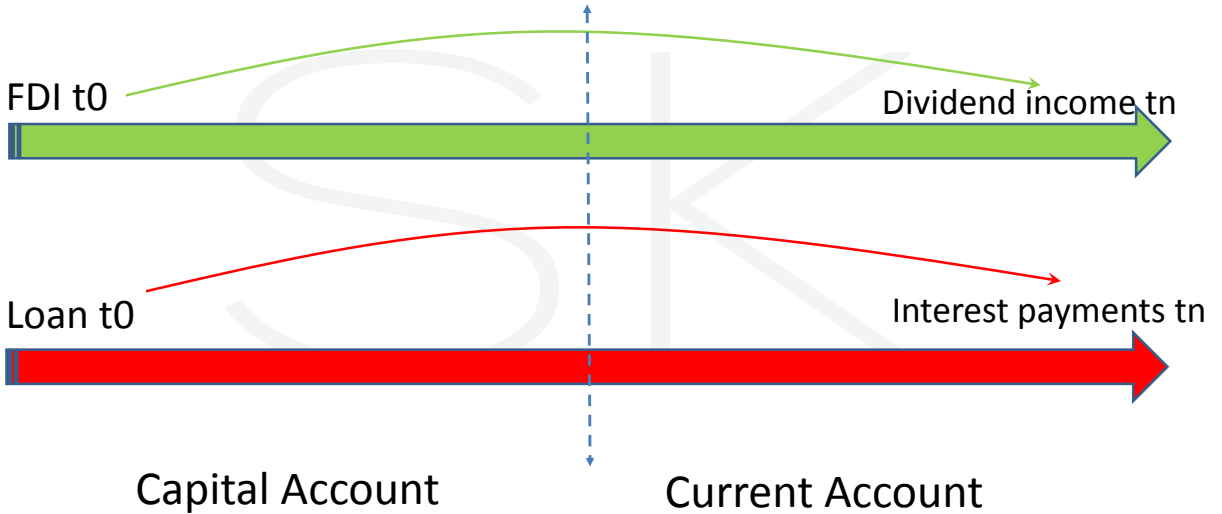
Investment income covers income derived from the ownership of foreign financial assets (interest and dividends for portfolio investment + non-distributed earnings of incorporated enterprises)

Distinction between portfolio investment and direct investment revolves around the investor's intentions concerning the foreign company.

Investment debits= **interest payments** on foreign liabilities (**interest on debt!**)

INTEREST INCOME AND INTEREST PAYMENTS

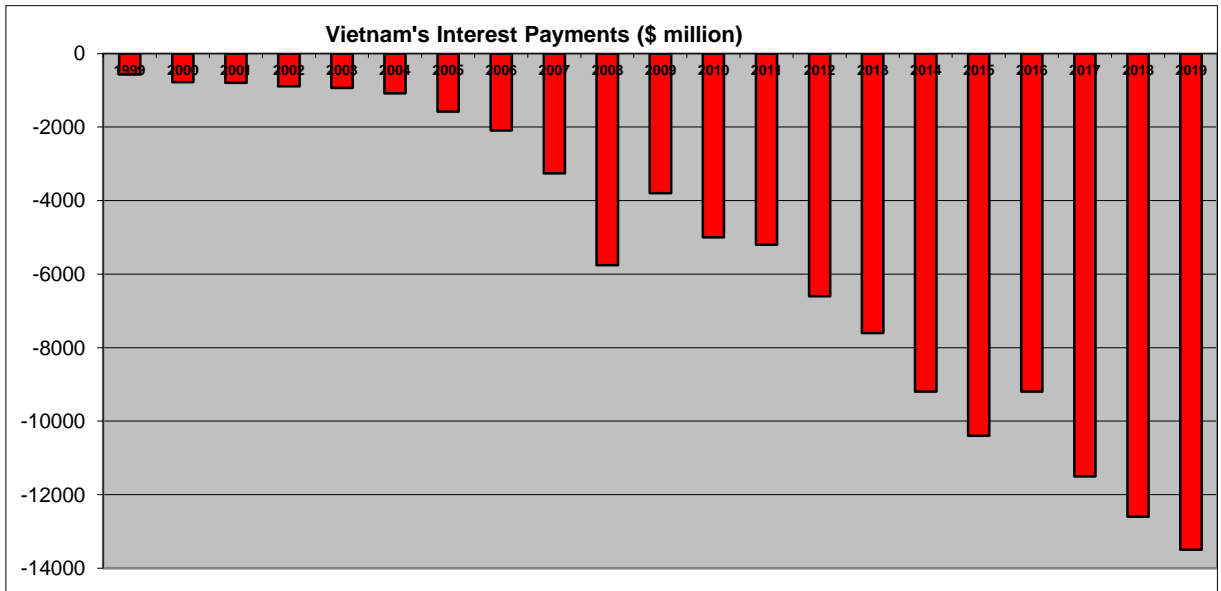
FLows VERSUS STOCKS!



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EXTERNAL DEBT SERVICING BURDEN



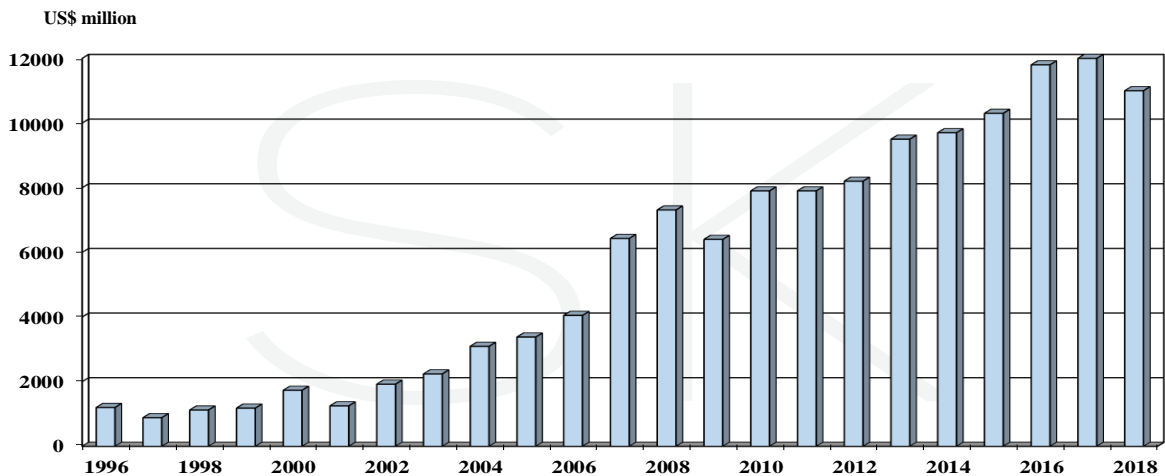
Source: IMF-IFS 2018

4. Private and official unrequited transfers

Private unrequited transfers refer mainly to immigrant workers' remittances to their country of origin as well as gifts, inheritances, prizes, charitable contributions, etc.: Morocco, Mexico, Algeria, Tunisia, India, Pakistan...

Official unrequited transfers include grants, subsidies, military aid, voluntary debt cancellation, contributions to international organizations, indemnities imposed under peace treaties, technical assistance, etc. : Large inflows for most HIPC-eligible countries (Benin, Tanzania, Haiti...)

VIETNAM'S TRANSFERS REVENUES 1996-2018



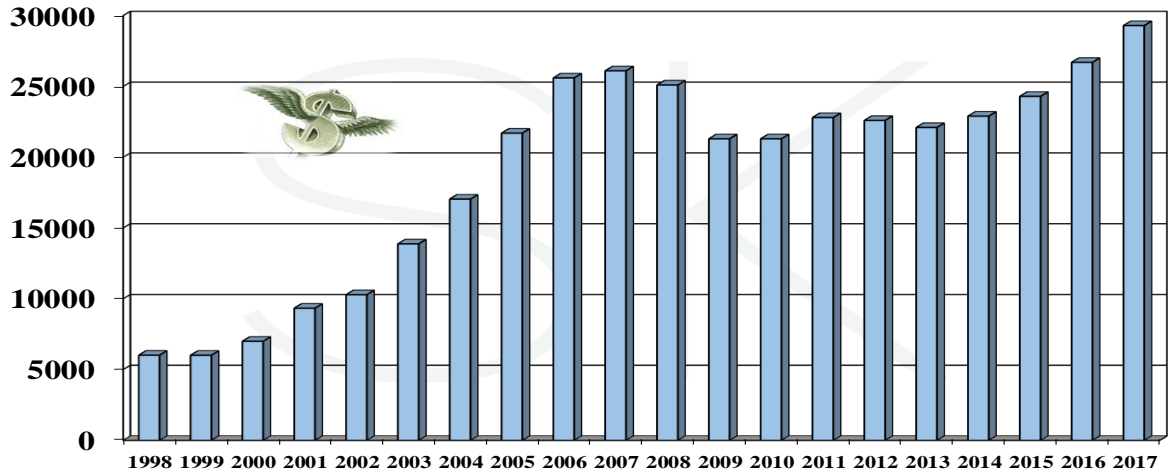
Source: IMF-2018

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MEXICO'S NET CURRENT TRANSFERS INFLOWS (REMITTANCES)

In US\$ million



Source: IMF-IFS/IIF 2017

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REMITTANCES BETWEEN LATIN AMERICA AND THE US UNDER TRUMP??

- ▶ = Migrant worker's earnings sent back from the country of employment to the country of origin
- ▶ Key for Morocco, Tunisia, Indonesia, Vietnam, Philippines, Mexico...
- ▶ What linkages between remittance flows to Latin America and the U.S. business cycle?

All of the evidence suggests that remittance flows are relatively **insensitive** to fluctuations in the U.S. cycle, underlining their role as a stable source of external financing... until the 2008-09 global financial crisis!

Source: IMF Working Paper, 12/2007= <http://www.imf.org/external/pubs/ft/wp/2007/wp07273.pdf>