Negotiations and International Organizations

Introduction to Capital Flows

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Negotiations and International Organizations

Outline of This Lecture

- National income accounts
  - measures of national income
  - measures of value of production
  - measures of value of expenditure
- National saving, investment, and the current account
- Balance of payments accounts

The National Income Accounts – I

- Records the value of **national income** that results from production and expenditure.
  - Producers earn income from buyers who spend money on goods and services.
  - The amount of expenditure by buyers = the amount of income for sellers = the value of production.
  - National income is often defined to be the income earned by a nation's factors of production.
- **Gross national product** (GNP) is the value of all final goods and services produced by a nation's factors of production in a given time period.

The National Income Accounts – II

  - What are factors of production? Factors that are used to produce goods and services: workers (labor services), physical capital (like buildings and equipment), natural resources and others.
  - The value of final goods and services produced by US-owned factors of production are counted as US GNP.
- GNP is calculated by adding the value of expenditure on final goods and services produced:
  1. Consumption (C): expenditure by domestic consumers
  2. Investment (I): expenditure by firms on buildings & equipment
  3. Government purchases (G): expenditure by governments on goods and services
  4. Current account balance (CA) (exports (EX) minus imports (IM)): net expenditure by foreigners on domestic goods and services

The National Income Accounts – III

- *GNP* is one measure of national income, but a more precise measure of national income is GNP adjusted for following:
  1. **Depreciation** of physical capital results in a loss of income to capital owners, so the amount of depreciation is subtracted from *GNP*.
  2. **Unilateral transfers** to and from other countries can change national income: payments of expatriate workers sent to their home countries, foreign aid and pension payments sent to expatriate retirees.
- Another approximate measure of national income is gross domestic product (*GDP*):
  - Gross domestic product measures the final value of all goods and services that are produced within a country in a given time period.
  - $GDP = GNP$ – payments from foreign countries for factors of production + payments to foreign countries for factors of production.

National Income Accounting for an Open Economy – I

- The national income identity for an open economy is

$$\begin{aligned} Y_{GNP} &= C + I + G + EX - IM \\ &= \underbrace{C + I + G}_{\text{Expenditure by domestic individuals and institutions}} + \underbrace{CA}_{\text{Expenditure by foreign individuals and institutions}} \end{aligned}$$

- So

$$CA = EX - IM = Y_{GNP} - (C + I + G)$$

National Income Accounting for an Open Economy – II

- When production>domestic expenditure, exports>imports: current account > 0 and trade balance > 0
  - when a country exports more than it imports, it earns more income from exports than it spends on imports
  - net foreign wealth is increasing
- When production<domestic expenditure, exports<imports: current account< 0 and trade balance< 0
  - when a country exports less than it imports, it earns less income from exports than it spends on imports
  - net foreign wealth is decreasing

Saving and the Current Account

- National saving (S) = national income (Y) that is not spent on consumption (C) or government purchases (G).

$$S = Y - C - G$$

- An open economy can save by building up its capital stock or by acquiring foreign wealth.

$$S = I + CA.$$

Private and Government Saving

- **Private saving** is the part of disposable income (national income, Y, minus taxes, T) that is saved rather than consumed:

$$S_p = Y - T - C$$

- **Government saving** is net tax revenue, T, minus government purchases, G:

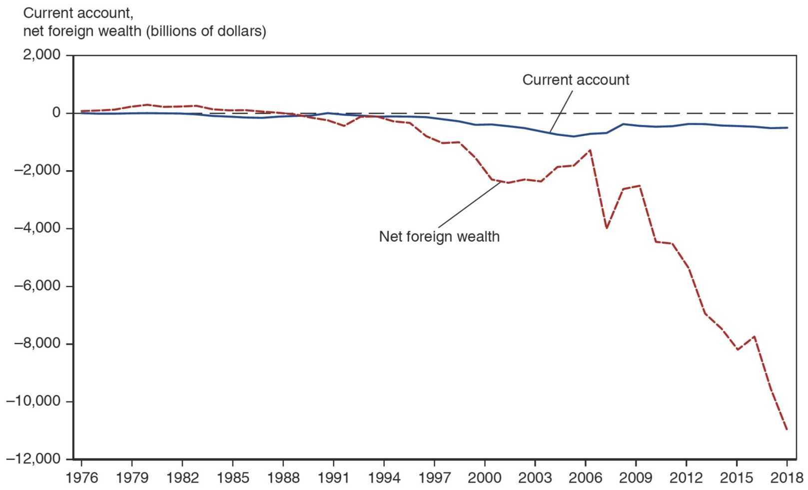
$$S_g = T - G.$$

- Private and government saving add up to national saving:

$$S = (Y - T - C) + (T - G) = S_p + S_g$$

Current Account and Net International Investment Position

Figure: The US Current Account and Net International Investment Position



Balance of Payments Accounts

- A country's balance of payments accounts accounts for its payments to and its receipts from foreigners.
- An international transaction involves two parties, and each transaction enters the accounts twice: once as a credit (+) and once as a debit (–).
- The balance of payments accounts are separated into 3 broad accounts:
  - **current account** (*CA*): accounts for flows of goods and services (imports and exports).
  - **financial account** (*FA*): accounts for flows of financial assets (financial capital).
  - **capital account** (*KA*): flows of special categories of assets (capital): typically nonmarket, non-produced, or intangible assets like debt forgiveness, copyrights and trademarks.

Examples of Balance of Payments Accounting – I

- You import a fax machine from Olivetti.
- Olivetti deposits your check in a U.S. bank.

	Credit	**Debit**
Fax machine		–$1,000
(*current account, U.S. good import*)		
Bank deposit		
(*financial account, U.S. asset sale*)	+$1,000	

- You buy lunch in France and pay by credit card.
- French restaurant receives payment from your credit card company.

Examples of Balance of Payments Accounting – II

	Credit	Debit
Meal purchase		
(*current account, U.S. service import*)		–\$200
Sale of credit card claim		
(*financial account, U.S. asset sale*)	+\$200	

- You buy a share of BP.
- BP deposits the money in a U.S. bank.

	Credit	Debit
Stock purchase		
(*financial account, U.S. asset purchase*)		–\$95
Bank deposit		
(*financial account, U.S. asset sale*)	+\$95	

Examples of Balance of Payments Accounting – III

- U.S. banks forgive a \$50mln debt owed by the government of Argentina through debt restructuring.
- U.S. banks who hold the debt thereby reduce the debt by crediting Argentina's bank accounts.

	Credit	Debit
Debt forgiveness		
(*capital account, U.S. transfer payment*)		–\$50mln
Reduction in bank's claims		
(*financial account, U.S. asset sale*)	+\$50mln	

How Do the Balance of Payments Accounts Balance?

- Due to the double entry of each transaction, the balance of payments accounts will balance by the following equation:

$$\text{Current Account} + \text{Financial Account} + \text{Capital Account} = 0$$
$$CA + FA + KA = 0$$

Balance of Payments Accounts – I

The 3 broad accounts are more finely divided:

- **Current account**: imports and exports
  1. merchandise (goods like DVDs)
  2. services (payments for legal services, shipping services, tourist meals, etc.)
  3. income receipts (interest and dividend payments, earnings of firms and workers operating in foreign countries)
- **Current account**: *net unilateral transfers*
  - gifts (transfers) across countries that do not purchase a good or service nor serve as income for goods and services produced
- **Capital account**: records special transfers of assets, but this is a minor account for the U.S. and most countries in the world including Greece

Balance of Payments Accounts – II

- **Financial account**: the difference between sales of domestic assets to foreigners and purchases of foreign assets by domestic citizens.
- **Financial inflow**
  - Foreigners loan to domestic citizens by buying domestic assets.
  - Domestic assets sold to foreigners are a credit (+) because the domestic economy acquires money during the transaction.
- **Financial outflow**
  - Domestic citizens loan to foreigners by buying foreign assets.
  - Foreign assets purchased by domestic citizens are a debit (–) because the domestic economy gives up money during the transaction.

Balance of Payments Accounts – III

- **Financial account** has at least 3 subcategories:
  1. Official (international) reserve assets
  2. All other assets
  3. Statistical discrepancy
- **Statistical discrepancy**
  - Data from a transaction may come from different sources that differ in coverage, accuracy, and timing.
  - The balance of payments accounts therefore seldom balance in practice.
  - The statistical discrepancy is the account added to or subtracted from the financial account to make it balance with the current account and capital account.

Balance of Payments Accounts – IV

- **Official (international) reserve assets**: foreign assets held by central banks to cushion against financial instability.
  - Assets include government bonds, currency, gold, and accounts at the International Monetary Fund.
  - Official reserve assets owned by (sold to) foreign central banks are a credit (+) because the domestic central bank can spend more money to cushion against instability.
  - Official reserve assets owned by (purchased by) the domestic central bank are a debit (–) because the domestic central bank can spend less money to cushion against instability.

Balance of Payments Accounts – V

- The negative value of the official reserve assets is called the **official settlements balance** or “balance of payments.”
  - It is the sum of the current account, the capital account, the nonreserve portion of the financial account, and the statistical discrepancy.
  - A negative official settlements balance may indicate that a country
    - is **depleting** its official international reserve assets, or
    - may be incurring **large debts to foreign central banks** so that the domestic central bank can spend a lot to protect against financial instability.

US Balance of Payments

TABLE 13-2 U.S. Balance of Payments Accounts for 2019 (billions of dollars)

Current Account	
(1) Exports and current transfer receipts	**3,805.94**
Of which:	
Goods	1,652.44
Services	875.83
Income receipts (primary income)	1,135.69
Current transfer receipts (secondary income)	141.98
(2) Imports and current transfer payments	**4,286.16**
Of which:	
Goods	2,516.77
Services	588.36
Income payments (primary income)	899.35
Current transfer payments (secondary income)	281.69
Balance on current account [(1) − (2)]	**−480.22**
Capital Account	
(3)	−6.24
Financial Account	
(4) Net U.S. acquisition of financial assets, excluding financial derivatives	**440.75**
Of which:	
Official reserve assets	4.66
Other assets	436.09
(5) Net U.S. incurrence of liabilities, excluding financial derivatives	**797.96**
Of which:	
Official reserve liabilities	61.63
Other liabilities	736.33
(6) Financial derivatives other than reserves, net	−38.34
Net financial flows [(4) − (5) + (6)]	−395.54
Statistical Discrepancy [Net financial flows less sum of current and capital accounts]	**90.92**

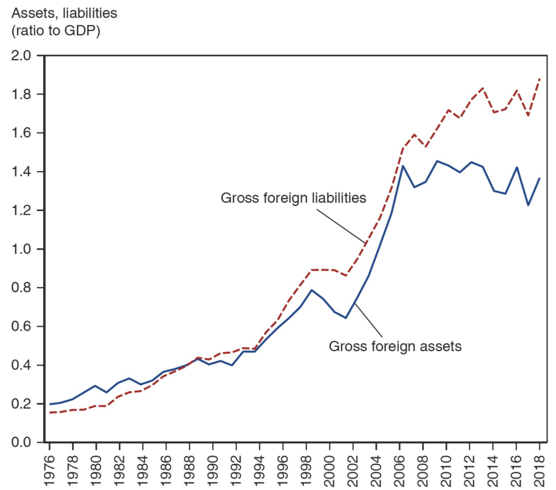
Source: U.S. Department of Commerce, Bureau of Economic Analysis, June 19, 2020, release. Totals may differ from sums because of rounding.

US Balance of Payments Accounts – I

- The U.S. has the most negative net foreign wealth in the world, and so is therefore the world's largest debtor nation.
- Its current account deficit in 2012 was $440 billion dollars, so that net foreign wealth continues to decrease.
- The value of foreign assets held by the U.S. has grown since 1980, but liabilities of the U.S. (debt held by foreigners) has grown faster.

US Balance of Payments Accounts – II

Figure: U.S. Gross Foreign Assets and Liabilities



US Balance of Payments Accounts – III

- About 70% of foreign assets held by the U.S. are denominated in foreign currencies and almost all of U.S. liabilities (debt) are denominated in dollars.
- Changes in the exchange rate influence value of net foreign wealth (gross foreign assets minus gross foreign liabilities).
  - Appreciation of the value of foreign currencies makes foreign assets held by the U.S. more valuable, but does not change the dollar value of dollar-denominated debt for the U.S.