The Balance of Payments

The balance of payments equation for a country is given by

$$
\begin{aligned}
X^g - M^g \;+\; X^s - M^s \;+\; D^i - D^o \;+\; UT^i - UT^o \\
+\; CI - CO \\
+\; FDI^i - FDI^o \;+\; PI^i - PI^o \;+\; FDR^i - FDR^o \;+\; OI^i - OI^o \\
+\; \Delta FXB \;=\; 0
\end{aligned}
$$

The BOP reports the flows of funds between residents and non-residents of a country.

Residents are:

- individuals who normally stay in the economic territory of the economy

- institutional units whose centre of economic interest is the economic territory of the economy

In BOP accounting, flows of foreign currencies and flows of liabilities are treated in a manner similar to flows of goods and services.

Outflows of foreign currencies are recorded as credits
Inflows of foreign currencies are recorded as debits.

Outflows of liabilities (residents' liabilities to foreigners) are recorded as credits
Inflows of liability (foreigners' liabilities to residents) are recorded as debits

Foreign currency holdings are either private of official

Private currency transactions appear in the financial account

Official currency transactions appear in the official reserves account

The BOP is divided into four subaccounts: The current account, the capital account, the financial account and the official settlements, or official reserves, account.

Double-entry bookkeeping: A transaction recorded as a credit brings about an equivalent debit.

The **current account balance** is given by

$$X^g - M^g \; + \; X^s - M^s \; + \; D^i - D^o \; + \; UT^i - UT^o \; .$$

Unilateral transfers refer to the change in net worth of the donor or recipient of a gift.
Donations can be goods, services, cash, etc..

If goods are donated by residents to non-residents, $X^g \uparrow$ and $UT^o \uparrow$.
If cash is donated, the capital account will be credited (inflow of goodwill)

Immigrants "donate" their wealth to residents (themselves)

The **capital account balance** is given by

$$CI \ - \ CO \ .$$

Transactions involving copyrights, patents, land or real estate are recorded in this account.

This account is sometimes used to offset unilateral transfers.

The **financial account balance** is given by

$$FDI^i - FDI^o \ + \ PI^i - PI^o \ + \ FDR^i - FDR^o \ + \ OI^i - OI^o \ .$$

OI include bank loans, bank deposits, etc., (can be described as intermediated investments).

A loan to a foreigner by a domestic bank will increase OI^o

IO^i increases whenever a resident pays a foreigner with a check drawn on a domestic bank.

The **official settlements account balance** is given by

$$\begin{aligned}\Delta FXB &= \text{official reserves out} - \text{official reserves in} \\ &= OR^o - OR^i\end{aligned}$$

In practice, transactions are not all recorded perfectly due to missing data or illegal trades so there is another item that has to be incorporated into the balance of payments equation, which is **net errors and omissions**.

Describe how the following transactions are recorded in the balance of payments.

1. A Canadian business exports $80 million of soybeans to China and receives payment in the form of a check drawn on a Canadian bank.

2. The Canadian government provides refugee assistance to Somalia in the form of corn valued at $1 million.

3. A Canadian company invests $500 million in a chemical plant in Germany financed by issuing bonds in London.

4. A Canadian corporation pays \$500,000 in dividends to foreign residents, who choose to hold the dividends in the form of bank deposits in New York.

5. A Mexican company sells \$2 million worth of cement to a Canadian company and deposits the check in a bank in Toronto.