Balance of Payments

What is the Balance of Payments (BOP)?
The balance of payments (BOP) is a statement of all transactions made between entities in one country and the rest of the world over a defined period of time, such as a quarter or a year.

Foreign exchange (Forex or FX) is the conversion of one currency into another at a specific rate known as the foreign exchange rate. The conversion rates for almost all currencies are constantly floating as they are driven by the market forces of supply and demand. The most traded currencies in the world are the United States dollar, Euro, Japanese yen, British pound, and Australian dollar. The US dollar remains the key currency, accounting for more than 87% of total daily value traded.

Factors that Affect Foreign Exchange Rates

Many factors can potentially influence the market forces behind foreign exchange rates. The factors include various economic, political, and even psychological conditions. The economic factors include a government's economic policies, trade balances, inflation, and economic growth outlook.

Political conditions also exert a significant impact on the forex rate, as events such as political instability and political conflicts may negatively affect the strength of a currency. The psychology of forex market participants can also influence exchange rates.

The Foreign Exchange Market

The foreign exchange market is a decentralized and over-the-counter market where all currency exchange trades occur. It is the largest (in terms of trading volume) and the most liquid market in the world. On average, the daily volume of transactions on the forex market totals $5.1 trillion, according to the Bank of International Settlements' Triennial Central Bank Survey (2016).

The forex market major trading centers are located in major financial hubs around the world, including New York, London, Frankfurt, Tokyo, Hong Kong, and Sydney. Due to this reason, foreign exchange transactions are executed 24 hours, five days a week (except weekends).

Despite the decentralized nature of forex markets, the exchange rates offered in the market are the same among its participants, as arbitrage opportunities can arise otherwise.

The foreign exchange market is probably one of the most accessible financial markets. Market participants range from tourists and amateur traders to large financial institutions (including central banks) and multinational corporations.

Also, the forex market does not only involve a simple conversion of one currency into another. Many large transactions in the market involve the application of a wide variety of financial instruments, including forwards, swaps, options, etc.

KEY TAKEAWAYS

- The balance of payments include both the current account and capital account.
- The current account includes a nation's net trade in goods and services, its net earnings on cross-border investments, and its net transfer payments.
- The capital account consists of a nation's imports and exports of capital and foreign aid.
- The sum of all transactions recorded in the balance of payments should be zero; however, exchange rate fluctuations and differences in accounting practices may hinder this in practice.

Understanding the Balance of Payments (BOP)

The balance of payments (BOP), also known as balance of international payments, summarizes all transactions that a country's individuals, companies, and government bodies complete with individuals, companies, and government bodies outside the country. These transactions consist of imports and exports of goods, services, and capital, as well as transfer payments, such as foreign aid and remittances.

A country's balance of payments and its net international investment position together constitute its international accounts.

The balance of payments divides transactions in two accounts: the current account and the capital account. Sometimes the capital account is called the financial account, with a separate, usually very small, capital account listed separately. The current account includes transactions in goods, services, investment income, and current transfers. The capital account, broadly defined, includes

transactions in financial instruments and central bank reserves. Narrowly defined, it includes only transactions in financial instruments. The current account is included in calculations of national output, while the capital account is not.

The sum of all transactions recorded in the balance of payments must be zero, as long as the capital account is defined broadly. The reason is that every credit appearing in the current account has a corresponding debit in the capital account, and vice-versa. If a country exports an item (a current account transaction), it effectively imports foreign capital when that item is paid for (a capital account transaction).

If a country cannot fund its imports through exports of capital, it must do so by running down its reserves. This situation is often referred to as a balance of payments deficit, using the narrow definition of the capital account that excludes central bank reserves. In reality, however, the broadly defined balance of payments must add up to zero by definition. In practice, statistical discrepancies arise due to the difficulty of accurately counting every transaction between an economy and the rest of the world, including discrepancies caused by foreign currency translations.

Economic Policy and the Balance of Payments

Balance of payments and international investment position data are critical in formulating national and international economic policy. Certain aspects of the balance of payments data, such as payment imbalances and foreign direct investment, are key issues that a nation's policymakers seek to address.

Economic policies are often targeted at specific objectives that, in turn, impact the balance of payments. For example, one country might adopt policies specifically designed to attract foreign investment in a particular sector, while another might attempt to keep its currency at an artificially low level in order to stimulate exports and build up its currency reserves. The impact of these policies is ultimately captured in the balance of payments data.

Imbalances Between Countries

While a nation's balance of payments necessarily zeroes out the current and capital accounts, imbalances can and do appear between different countries' current accounts. According to the World Bank, the U.S. had the world's largest current account deficit in 2018, at $491 billion. Germany had the world's largest surplus, at $291 billion.

Such imbalances can generate tensions between countries. Donald Trump campaigned in 2016 on a platform of reversing the U.S.'s trade deficits, particularly with Mexico and China. The Economist argued in 2017 that Germany's surplus "puts unreasonable strain on the global trading system," since "to offset such surpluses and sustain enough aggregate demand to keep people in work, the rest of the world must borrow and spend with equal abandon."

History of the Balance of Payments (BOP)

Prior to the 19th century, international transactions were denominated in gold, providing little flexibility for countries experiencing trade deficits. Growth was low, so stimulating a trade surplus was the primary method of strengthening a nation's financial position. National economies were not well integrated with each other, however, so steep trade imbalances rarely provoked crises. The industrial revolution increased international economic integration, and balance of payment crises began to occur more frequently.

The Great Depression led countries to abandon the gold standard and engage in competitive devaluation of their currencies, but the Bretton Woods system that prevailed from the end of World War II until the 1970s introduced a gold-convertible dollar with fixed exchange rates to other currencies. As the U.S. money supply increased and its trade deficit deepened, however, the government became unable to fully redeem foreign central banks' dollar reserves for gold, and the system was abandoned.

Since the Nixon shock—as the end of the dollar's convertibility to gold is known—currencies have floated freely, meaning that country experiencing a trade deficit can artificially depress its currency—by hoarding foreign reserves, for example—making its products more attractive and increasing its exports. Due to the increased mobility of capital across borders, balance of payments crises sometimes occur, causing sharp currency devaluations such as the ones that struck in Southeast Asian countries in 1998.

During the Great Recession several countries embarked on competitive devaluation of their currencies to try to boost their exports. All of the world’s major central banks responded to the financial crisis at the time by executing dramatically expansionary monetary policy. This led to other nations’ currencies, especially in emerging markets, appreciating against the U.S. dollar and other major currencies. Many of those nations responded by further loosening the reins on their own monetary policy in order to support their exports, especially those whose exports were under pressure from stagnant global demand during the Great Recession.

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Exchange Rates and Trades

Exchange Rate Definition

What is an Exchange Rate?

An exchange rate is the value of one nation's currency versus the currency of another nation or economic zone. For example, how many U.S. dollars does it take to buy one euro? As of Dec. 13, 2019, the exchange rate is 1.10, meaning it takes $1.10 to buy €1.

KEY TAKEAWAYS

- An exchange rate is the value of a country's currency vs. that of another country or economic zone.
- Most exchange rates are free-floating and will rise or fall based on supply and demand in the market.
- Some currencies are not free-floating and have restrictions.

Types of Exchange Rates

Free Floating

A free-floating exchange rate rises and falls due to changes in the foreign exchange market.

Restricted Currencies

Some countries have restricted currencies, limiting their exchange to within the countries' borders. Also, a restricted currency can have its value set by the government.

Currency Peg

Sometimes a country will peg its currency to that of another nation. For instance, the Hong Kong dollar is pegged to the U.S. dollar in a range of 7.75 to 7.85.2 This means the value of the Hong Kong dollar to the U.S. dollar will remain within this range.

Onshore Vs. Offshore

Exchange rates can also be different for the same country. In some cases, there is an onshore rate and an offshore rate. Generally, a more favorable exchange rate can often be found within a country's border versus outside its borders. China is one major example of a country that has this

rate structure. Additionally, China's yuan is a currency that is controlled by the government. Every day, the Chinese government sets a midpoint value for the currency, allowing the yuan to trade in a band of 2% from the midpoint.

Spot vs. Forward

Exchange rates can have what is called a spot rate, or cash value, which is the current market value. Alternatively, an exchange rate may have a forward value, which is based on expectations for the currency to rise or fall versus its spot price. Forward rate values may fluctuate due to changes in expectations for future interest rates in one country versus another. For example, let's say that traders have the view that the euro zone will ease monetary policy versus the U.S. In this case, traders could buy the dollar versus the euro, resulting in the value of the euro falling.

Quotation

Typically, an exchange rate is quoted using an acronym for the national currency it represents. For example, the acronym USD represents the U.S. dollar, while EUR represents the euro. To quote the currency pair for the dollar and the euro, it would be EUR/USD. In this case, the quotation is euro to dollar, and translates to 1 euro trading for the equivalent of $1.13 if the exchange rate is 1.13. In the case of the Japanese yen, it's USD/JPY, or dollar to yen. An exchange rate of 100 would mean that 1 dollar equals 100 yen.

Real World Example of How Exchange Rates Work

John is traveling to Germany from his home in New York and he wants to make sure he has 200 dollars' worth of euros when he arrives in Germany. He goes to the local currency exchange shop and sees that the current exchange rate is 1.20. It means if he exchanges $200, he will get €166.66 in return.

In this case, the equation is: dollars ÷ exchange rate = euro

-or-

$200 ÷ 1.20 = €166.66

John has returned from the trip, and he now wants to exchange his euros for dollars. He never used his €166.66 and now sees the exchange rate has dropped to 1.15. He exchanges his €166.66, and because the rate fell when he was away, he receives only $191.67. The reason he gets less despite having the same value of euros is that the euro weakened versus the dollar during his time away.

In this case, the equation is the opposite: euros x exchange rate = dollars

-or-

€166.66 x 1.15 = $191.66

However, not all currencies work the same way. For example, the Japanese yen is calculated differently. In this case, the dollar is placed in front of the yen, as in USD/JPY.

The equation for USD/JPY is: dollars x exchange rate = yen

Let's say someone traveling to Japan wants to convert $100 into yen, and the exchange rate is 110. The traveler would get ¥11,000. To convert yen back into dollars one needs to divide the amount of the currency by the exchange rate.

$100 x 110 = ¥11,000.00

-or-

¥11,000.00/110= $100

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