4. INTERNATIONAL MONETARY SYSTEMS AND BALANCE OF PAYMENTS
BALANCE OF PAYMENTS

INTRODUCTION

MAJOR COMPONENTS OF BOP

DEFICIT AND SURPLUS OF BOP
4.1 INTERNATIONAL MONETARY SYSTEM
International Monetary System (IMS)

- Exists because most countries have their own currencies.
- A means of exchanging currencies is needed if business is to be conducted across national boundaries.
- IMS provide rules of exchange of currencies, and mechanism for correcting imbalances between a country’s international payments and its receipts.
The Gold Standard

In the early days, gold was used as a medium of exchange

Advantages:
- Limited supply - made it a highly demanded commodity
- Highly resistant to corrosion - can be stored for years
- Can be melted into bars and coins - good medium of exchange for both small and large purchases

Disadvantages:
- Weight - transporting it very expensive
- Transporting ship sank - gold also sank and was lost
Implications- new way of making international payments without carrying a lot of weight-"gold standard- an international monetary system in which nations link value of paper currencies into specific values of gold”

Par value- A nation fix the value(price) of its currency to an ounce of gold
Collapse of Gold Standard

- War expenses in the First World War - print more paper currency
- Aggressive printing - inflation, USD - devaluated
- Gold Standard links each currency to one another - devaluation affect exchange rates between currencies
- US goods became cheaper. Countries devaluing their currencies - 'competitive devaluation'
- Improving trade balances - chose arbitrary par value to which they devalued their currencies - no longer using gold standard
Bretton Woods System

Why? To balance the strictness of Gold Standard and flexibility of domestic money difficulties

Features

<table>
<thead>
<tr>
<th>Fixed Exchange Rates</th>
<th>Built in Flexibility</th>
<th>Funds for economic development</th>
</tr>
</thead>
</table>
| • Par value of USD-$35 of gold, GBP-$2.4 per pound | • Large devaluation was allowed  
• Fundamental disequilibrium – a deficit causes a permanent negative shift in a country’s balance of payments  
• Devaluation-reflect a permanent economic change | • Funding for countries’ efforts towards economic development  
• Word Bank-International Bank for Reconstruction and Development(IRBD) |
Funds for Economic Development

**INTERNATIONAL MONETARY FUND**

- "AGENCY TO REGULATE THE FIXED EXCHANGE RATES AND ENFORCE RULES OF THE INTERNATIONAL MONETARY SYSTEM"
- Promote monetary corporation
- Facilitate expansion and balance growth of int. trade
- Promoting exchange stability, orderly exchange arrangements, avoiding competitive exchange devaluation
- Making resources temporarily available to members
- Shortening the duration and lessening the degree of disequilibrium in int BOP

**WORLD BANK-IRB**

**INTERNATIONAL DEVELOPMENT ASSOCIATION**

- "FINANCE EUROPEAN RECONSTRUCTION-WW2"
- Soft loans- no interest rates, but small service charge
- Focus-least developed countries

**INTERNATIONAL FINANCE CORPORATION**

- Promote development in private sector
- As an investment banker
- Focus-least developed countries

**MULTILATERAL INVESTMENT GUARANTEE AGENCY**

- Overcome pvt sector reluctance to invest
- Offer insurance against political risks

**REGIONAL DEVELOPMENT BANKS**

- African Dev Bank, Asian Dev Bank
- Promote development in poorer countries in their regions

**REGIONAL DEVELOPMENT BANKS**

- African Dev Bank, Asian Dev Bank
- Promote development in poorer countries in their regions
Collapse of Bretton Woods System
- US-deficit in trade and budget

Triffin Paradox
- Arose because foreigners needed to increase their holdings of dollars to finance expansion of international trade
- More dollars they owned, the less faith they had in the ability of US-want to get gold in return-US didn’t have enough gold

Special Drawing Rights
- Injecting more liquidity into IMS while reducing the demands placed on the dollar
- IMF created SDR—"ASSET, WHERE VALUE IS BASED ON A BASKET OF 4 MEMBERS’ CURRENCIES-EURO, YEN, BRITISH POUND AND USD"
- End of Bretton Woods by President Richard Nixon- Float against each other
4.1.2 PERFORMANCE OF THE INTERNATIONAL MONETARY SYSTEM

- Smithsonian Agreement
  - To restructure and strengthen IMS
  - How?
    - Lowering value of dollars
    - Other countries increased the values of their currencies against the dollar
    - Increasing range to float
  - FAILURE-market forces

- Jamaican Agreement
  - Each country was free to adopt to whatever exchange system that best met its requirement
4.1.3 EUROPEAN MONETARY SYSTEM

- Collapse of Bretton Woods - EU must acquire a system that could stabilize currencies and reduce exchange rate risk
- Created EMS
  - Maintain fixed rates, and float rate against USD
  - Single currency - EURO
4.14 INTERNATIONAL DEBT CRISIS
4.1.4.1 SITUATIONS ALL OVER THE WORLD

**Arab-Israeli War**
- Arab-Israeli War - OPEC quadrupled oil prices
- Currencies of oil strengthened
- Excess money-in US banks - recycled through lending activities

**Many countries borrowed**
- Mexico, Argentina and Brazil could not service their debts
- Asia, Africa, Latin America followed
4.1.4.2 ASIAN FINANCIAL CRISIS

- Shows how a crisis could occur in international financial markets and how this crisis relates to businesses, governments, financial institutions, and international finance markets.
- Thailand-South Korea, Msia and other SEA countries
Asian Financial Crisis-perspectives

**FINANCIAL**
- Started from Thailand
- Foreign debt-owed by private corps
- Weakening exports, growing account deficit, increasing short term company debts

**POLITICAL**
- Poorly controlled financial systems. Government direct lending
- Data problems, lack of transparency-uncertainty
- Governance and political uncertainties-foreigners reluctant to roll short term loans

**MANAGERIAL**
- Booming economy-diversification-expansion of companies
- Needed short term loan-too dependent on them

---

**BAKER PLAN**
- Debt rescheduling, tight IMF imposed controls and continued lending-econ growth
- LITTLE PROGRESS-NEEDED NEW APPROACH

**BRADY PLAN**
- Providing countries with funds to buy back their loan notes at below face value
- IMF loan+tight rescheduling+changes in gov policies-improvements
4.2 BALANCE OF PAYMENTS ACCOUNTING SYSTEMS
4.2.1 INTRODUCTION

- BOP accounting system - a double entry book keeping system
- Records all payments to entities in other countries and all receipts coming into the nation
- Why?
  - Helps identify emerging markets for goods and services
  - Warn possible new policies that may alter a business climate
  - Indicate reduction in a country’s FOREX reserves-currency may depreciate
  - Signal increase in risk of lending
### 4.2.2 MAJOR COMPONENTS

#### 1. CURRENT ACCOUNT
- **Merchandise Trade/Visible Trade**
- **Services Trade/Invisible Trade**
- **Investment Income**
- **Gifts/Unilateral Transfers**

**Balance Everythng, Shows Fund That Cannot Be Accounted For (No Proper Legal Channels/Illegal Money Laundering, Bribery, Insider Trading Etc)**

#### 2. Capital/Financial Account
- **FDI**
- **Portfolio Investment**

**Gifts From One Government To Another, Or Private Transfers**

#### 3. Official Reserves Account
- **Reserves (Gold, Convertible Currencies, SDRS, Etc)**

#### 4. Errors and Omissions Account
- **Current Acc+ Capital+ Official Reserves+Errors & Omissions**
## CURRENT ACCOUNT

<table>
<thead>
<tr>
<th>Category</th>
<th>Exports</th>
<th>Imports</th>
<th>Balance on Trade</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>GOODS</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Exports</td>
<td>+682.6</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Imports</td>
<td></td>
<td>-1166.9</td>
<td></td>
</tr>
<tr>
<td>Balance on Merchandise Trade</td>
<td>-484.3</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>SERVICES</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Exports</td>
<td>+289.3</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Imports</td>
<td></td>
<td>-240.5</td>
<td></td>
</tr>
<tr>
<td>Balance on Services Trade</td>
<td>48.8</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>INVESTMENT INCOME</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Received</td>
<td>+244.6</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Paid</td>
<td>-256.5</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Balance on Investment Income</td>
<td>-11.9</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>UNILATERAL TRANSFERS</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Balance</td>
<td>-56.0</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

## CAPITAL ACCOUNT

<table>
<thead>
<tr>
<th>Category</th>
<th>Exports</th>
<th>Imports</th>
<th>Balance on Capital Account</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>PORTFOLIO, SHORT TERM</strong></td>
<td></td>
<td>+113.0</td>
<td></td>
</tr>
<tr>
<td><strong>PORTFOLIO, LONG TERM</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>New Foreign Investment</td>
<td></td>
<td>+484.8</td>
<td></td>
</tr>
<tr>
<td>New US Investment Abroad</td>
<td></td>
<td>-25.8</td>
<td></td>
</tr>
<tr>
<td><strong>FDI</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>New FDI, US</td>
<td></td>
<td>+30.1</td>
<td></td>
</tr>
<tr>
<td>New US FDI Abroad</td>
<td></td>
<td>-123.5</td>
<td></td>
</tr>
<tr>
<td>Balance on Capital Account</td>
<td></td>
<td></td>
<td>+478.6</td>
</tr>
</tbody>
</table>

## OFFICIAL RESERVES ACCOUNT

<table>
<thead>
<tr>
<th>Category</th>
<th>Exports</th>
<th>Imports</th>
<th>Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Errors and Omissions</strong></td>
<td></td>
<td></td>
<td>-3.7</td>
</tr>
<tr>
<td><strong>Net Balance</strong></td>
<td></td>
<td></td>
<td>0</td>
</tr>
</tbody>
</table>
4.2.3 DEFICIT AND SURPLUSES OF BOP

- BOP-Double bookkeeping system
- Show potential of their investments to venture capitalists, bankers, investors etc as well as risks
- Valuable economic intelligence to the international business organizations and people.
End of Lecture 4