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THE BALANCE OF PAYMENTS II
CURRENT ACCOUNT DEFICIT ADJUSTMENT

CIFE SEMINAR NICE MAY 6-8, 2020

MICHEL-HENRY BOUCHET

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THE CURRENT ACCOUNT OF THE BALANCE OF PAYMENTS

From less liquid items toward more liquid items!

- \+ 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**

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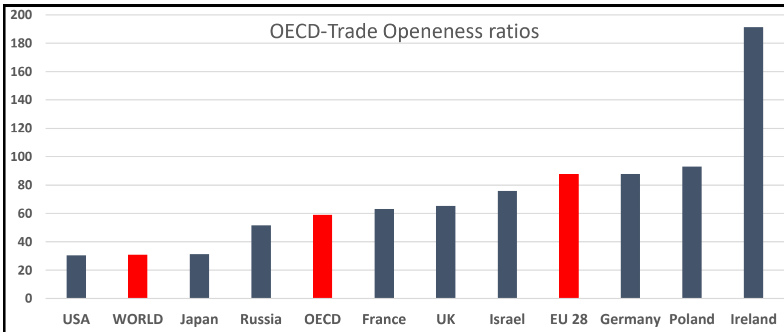
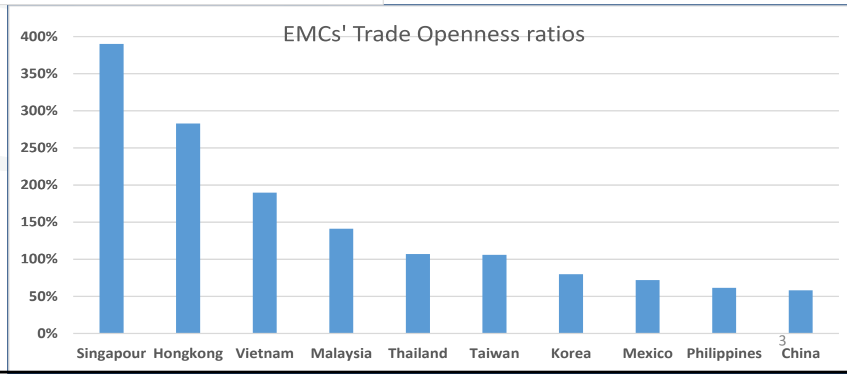


TRADE OPENNESS RATIO

(X+M/GDP%)



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	US$
EXPORTS	5000
GDP	12500
TRADE	
SERVICE REVENUES	1200
TRANSFERS	285
CURRENT ACCOUNT	
INTEREST PAYMENTS	-750
CA/GDP %	
IMPORTS	-6500
TRADE OPENNESS	

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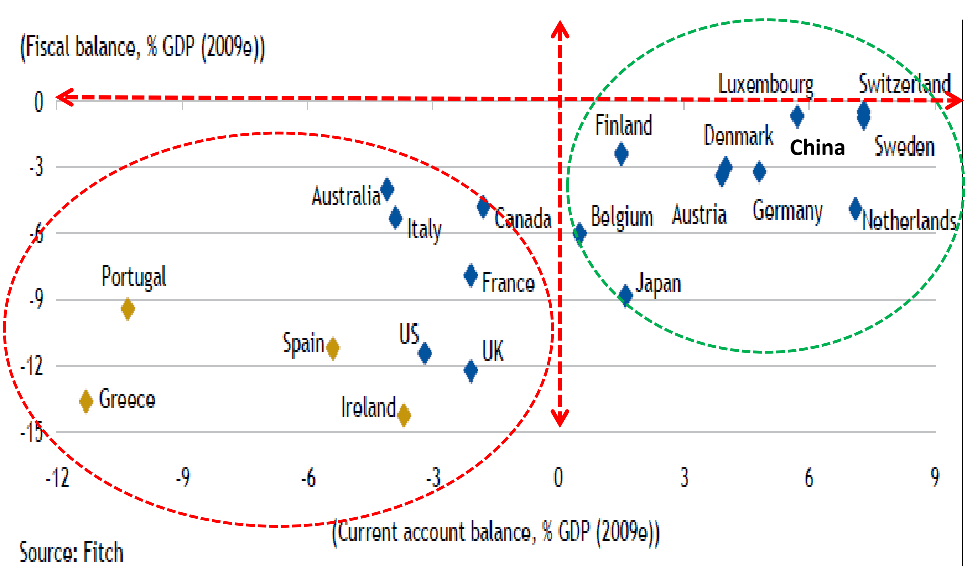
	US$
EXPORTS	5000
IMPORTS	-6500
TRADE BALANCE	-1500
SERVICE REVENUES	1200
INTEREST PAYMENTS	-750
TRANSFERS	285
CURRENT ACCOUNT	-765
GDP	12500
TRADE OPENNESS	92%
CA/GDP %	-6%

LARGE DOMESTIC PRIVATE + PUBLIC CONSUMPTION= OVERHEATING= TWIN DEFICITS

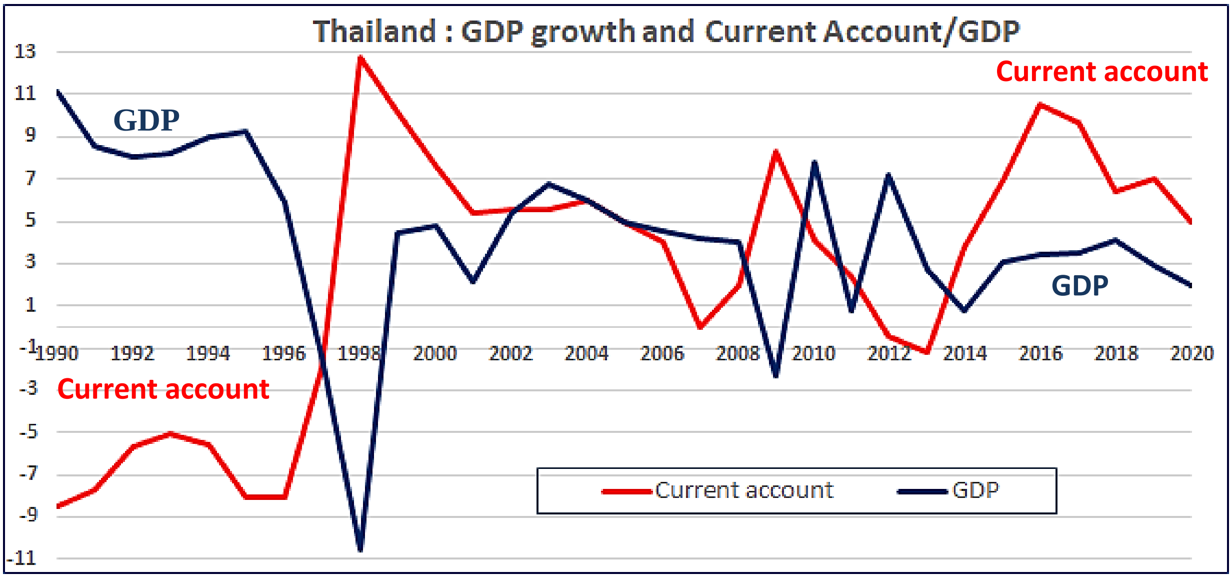


Source: Fitch

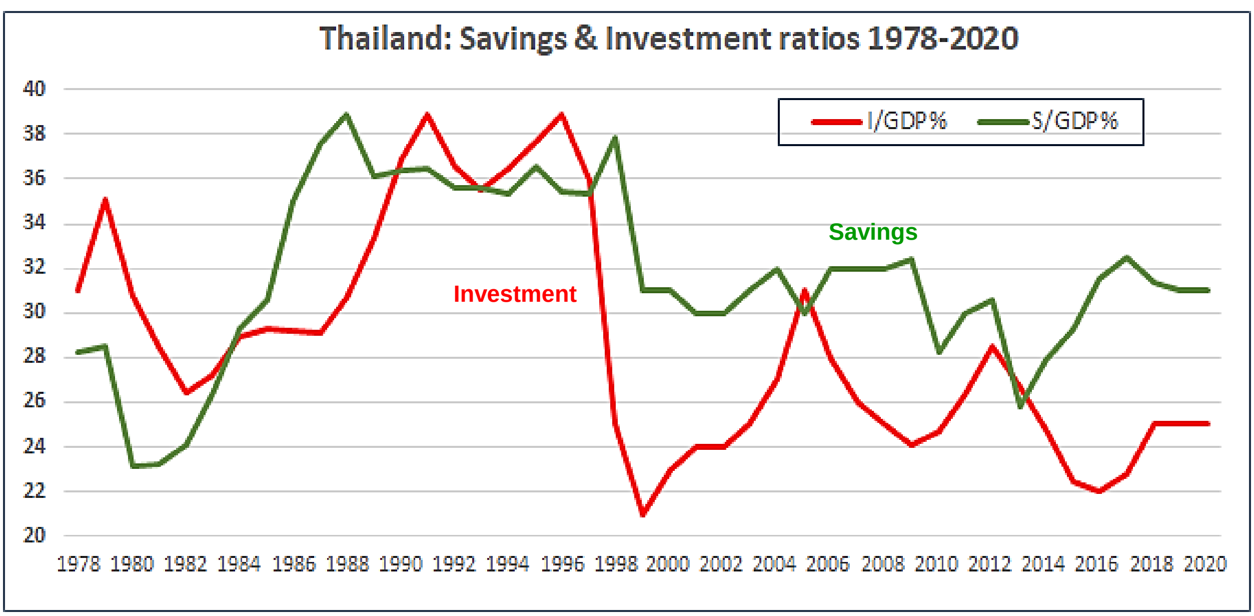
Thailand in the Global Economy

Large trade openness leads to spectacular current account and growth adjustment after 1998 & 2008 crises

Σ XGS/PIB > 120%



THE LONG-TERM DYNAMICS OF INVESTMENT AND NATIONAL SAVINGS



Source: WB and IMF 2020

POLICY TOOLS TO FIGHT A BOP DEFICIT?

- Reducing absorption and boosting income with:

1. Tight monetary policy (increase in interest rates and higher bank reserve requirements)
2. Exchange rate adjustment
3. Tight fiscal policy (taxes and spending cuts)
4. Cooling down the overheated economy by reducing private consumption and shrinking public expenditures… at the risk of killing growth?
5. Boosting competitiveness and improving productivity?

CORRECTING A TRADE DEFICIT?

- **Impact of domestic currency devaluation**
  - prices should increase for imports
    - foreign exporters may reduce price to maintain market share
  - other currencies may also weaken to stay competitive
    - no net gain from weaker domestic currency
  - international trade contracts create a lag effect
    - 18+ month lag exists in US
  - intra-company trade is resistant to currency fluctuations
    - 50% of all international trade
    - 60% of European exports are intra-European transactions

HOW TO SHRINK A TRADE DEFICIT?

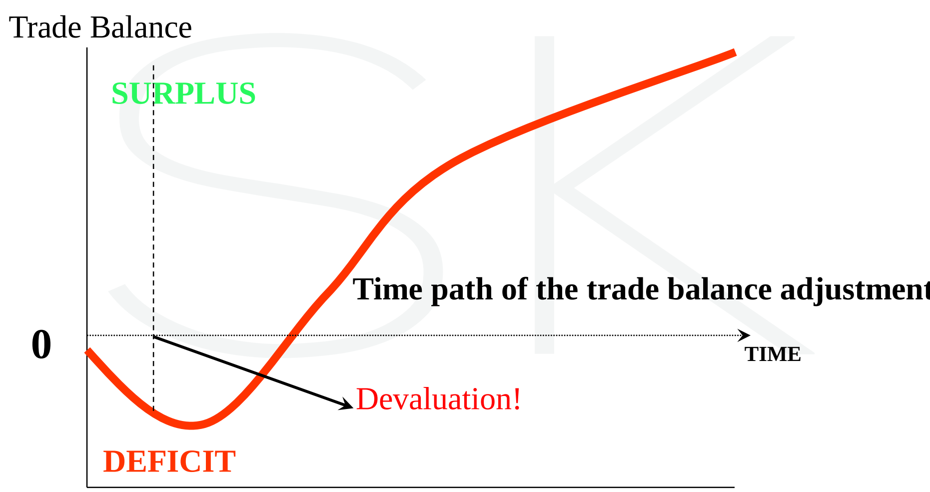
- **Boosting Exports?** depends on the price elasticity of foreign demand abroad but also on the supply elasticity of exported products at home

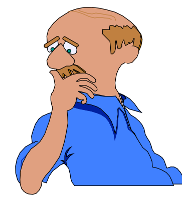
- **Reducing Imports**? depends on relative share of "incompressible" imports (foodstuffs, energy resources, capital goods, machinery, any import for re-export…), but also on the price elasticity of domestic demand

HOLA NOELLE BEAUCHEMIN!
WHAT IS CHILE'S **TRADE OPENNESS RATIO**??

X	77
M	73
GDP	277
SUM	150
RATIO	**54%**

TIME LAGS, ELASTICITIES AND THE ADJUSTMENT MECHANISM: “**J CURVE**”





DEVALUATION: THE DAY AFTER ?

KEY ROLE OF ELASTICITIES = RATIO OF TWO VARIATIONS

Supply elasticities

$$\frac{\Delta \text{ +Domestic production}}{\Delta \text{ +Foreign demand}}$$

Demand elasticities

$$\frac{\Delta \text{ - Domestic consumption}}{\Delta \text{+ Import prices}}$$

$$\frac{\Delta \text{ + Foreign demand}}{\Delta \text{ - export prices}}$$

To boost export competitiveness,

what should a country's central bank devalue?

The nominal exchange rate or

the real effective exchange rate?

2. CUTTING INFLATION AND SLOWING DOWN OVERHEATING ECONOMY WITH EXCHANGE RATE APPRECIATION?

Principle:

- 1. A currency appreciation would cut the cost of imported goods and services, as well as import commodities (gasoline, machinery, production materials), hence helping to reduce the CPI.
- 2. Lowering imported costs will make them cheaper and more competitive, forcing local producers to lower prices to maintain their market share (?)

REAL EXCHANGE RATES

- The RER is the product of the nominal exchange rate between two currencies and the ratio of prices

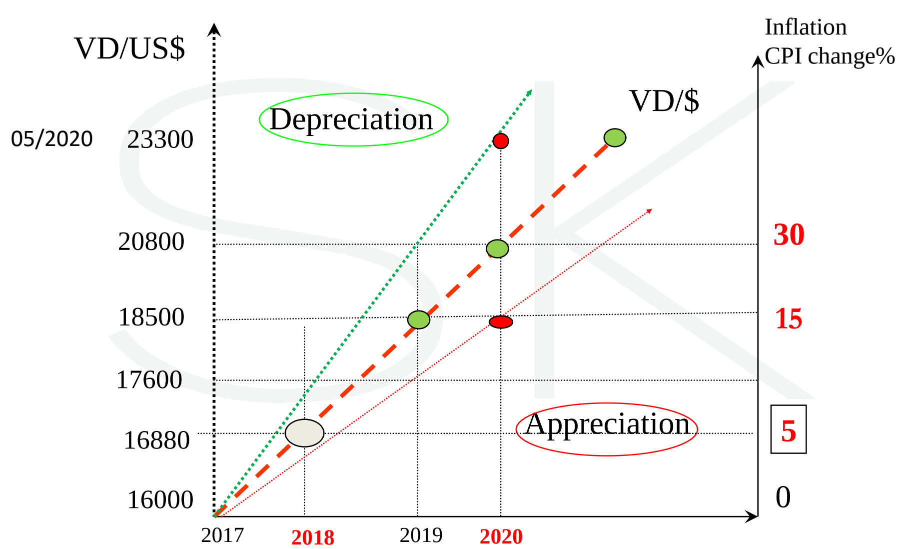
$$RER = NR \times \frac{Px}{Py}$$

If the €/$ exchange rate is 1€= 1,5 $, and if average prices for the same basket of goods are 2,5 € in the EU and 3,70$ in the US,
then the **RER = 1**

RER €/$= 1,5 * (2,5/3,7)

See: Finance & Development, September 2007, pp. 46-47.

NOMINAL AND REAL EXCHANGE RATES



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MEASURING COUNTRY COMPETITIVENESS?
NOMINAL AND REAL EFFECTIVE EXCHANGE RATES

- **Nominal EERs**= geometric weighted averages of bilateral exchange rates (weighted by trading shares)

- **Real EERs** = weighted averages of bilateral exchange rates adjusted by **relative prices.**

$$REER_{\text{country i}} = \sum_{j=1}^{N} \text{trade weight (country j)} \times \text{Real Exchange Rate (country j)}$$

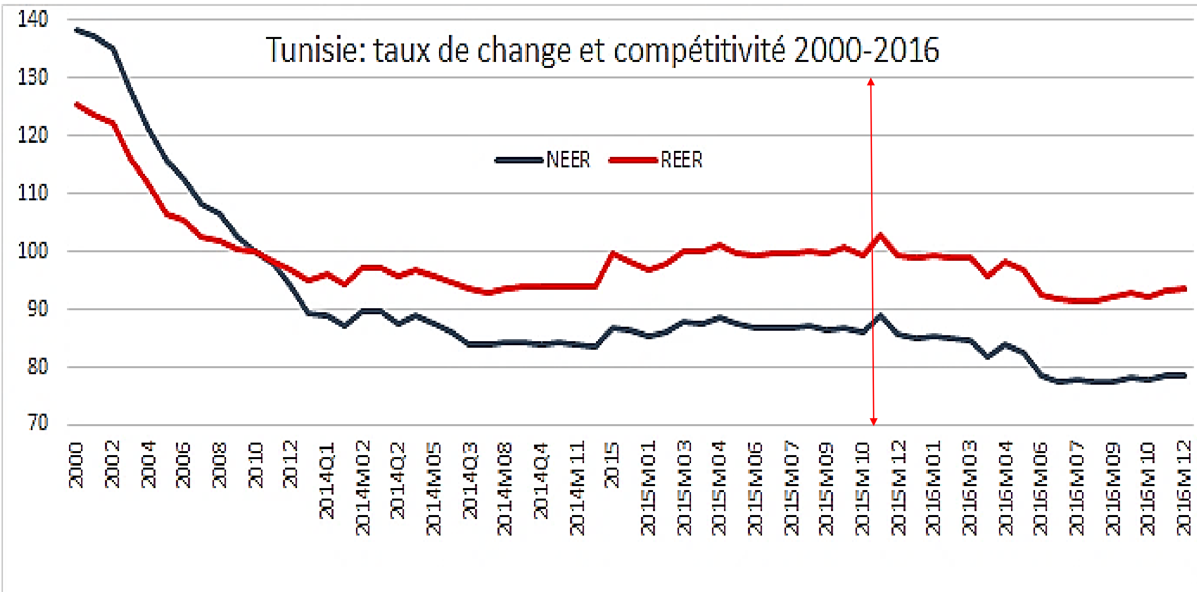
country j=1,2,...N are country i's trading partners, exchange rates in natural logarithms (geometric averages)

REAL EFFECTIVE EXCHANGE RATES

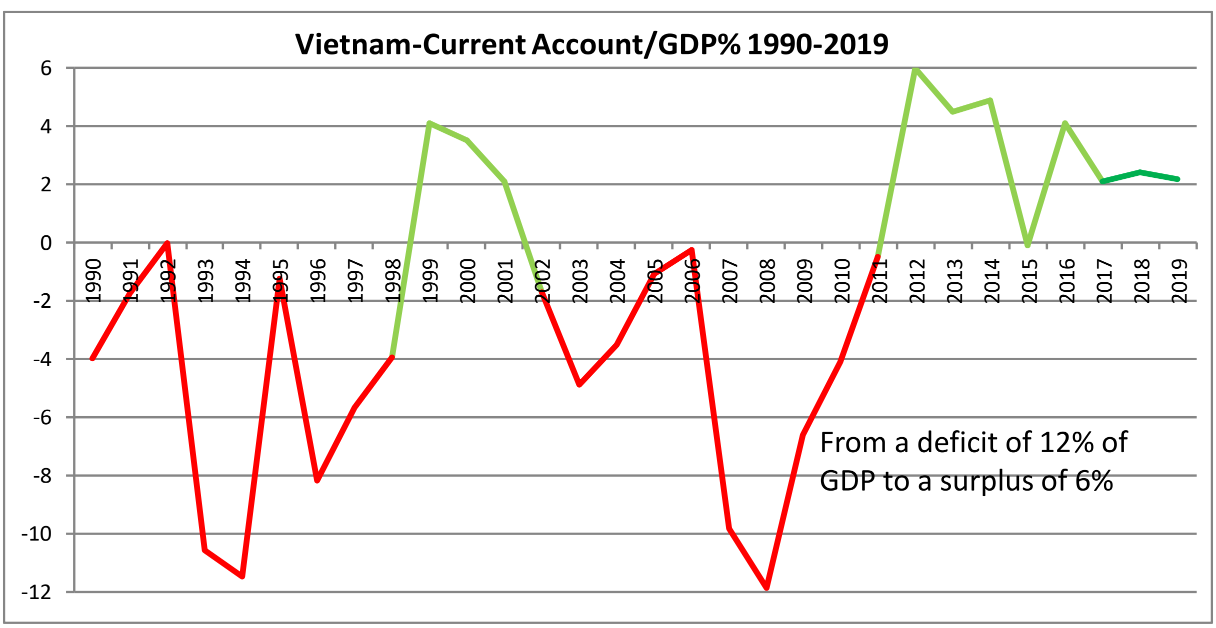
- **Real**: inflation- adjusted exchange rate
  ex.: will the devaluation fully offset inflation in country x?

- **Real Effective**: exchange rate adjusted for inflation-differential with **major trading partners**:
  a tool of exchange rate management policy (e.g. Mexico)

TUNISIA: NOMINAL AND REAL EFFECTIVE EXCHANGE RATES

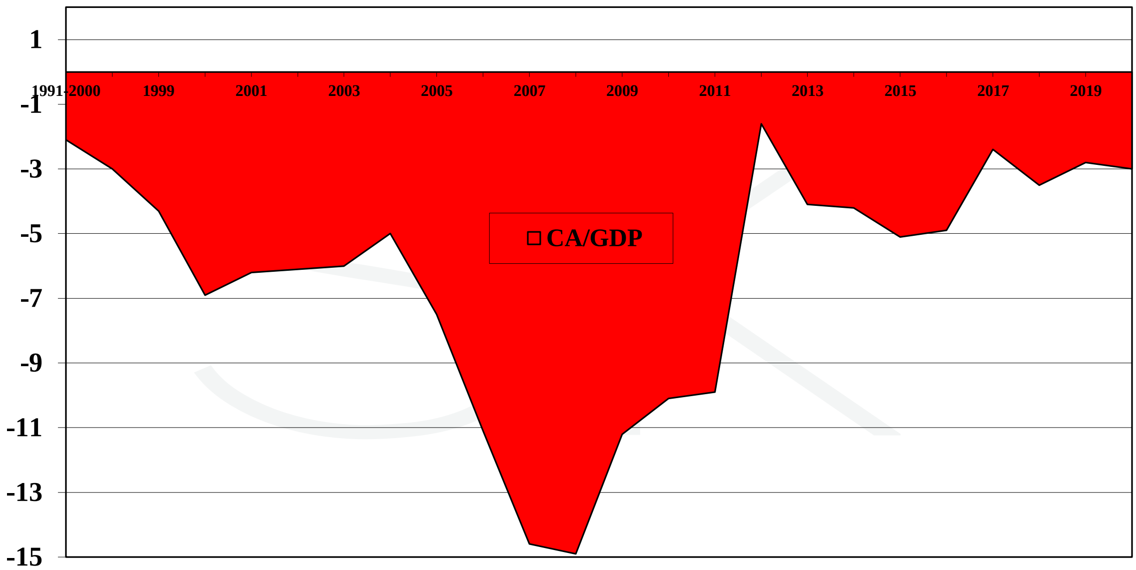


AN EXAMPLE OF SUCCESSFUL EXTERNAL ACCOUNT ADJUSTMENT



Source: IMF

GREECE: CURRENT ACCOUNT/GDP IN % 1981-2020



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Source IMF-2020

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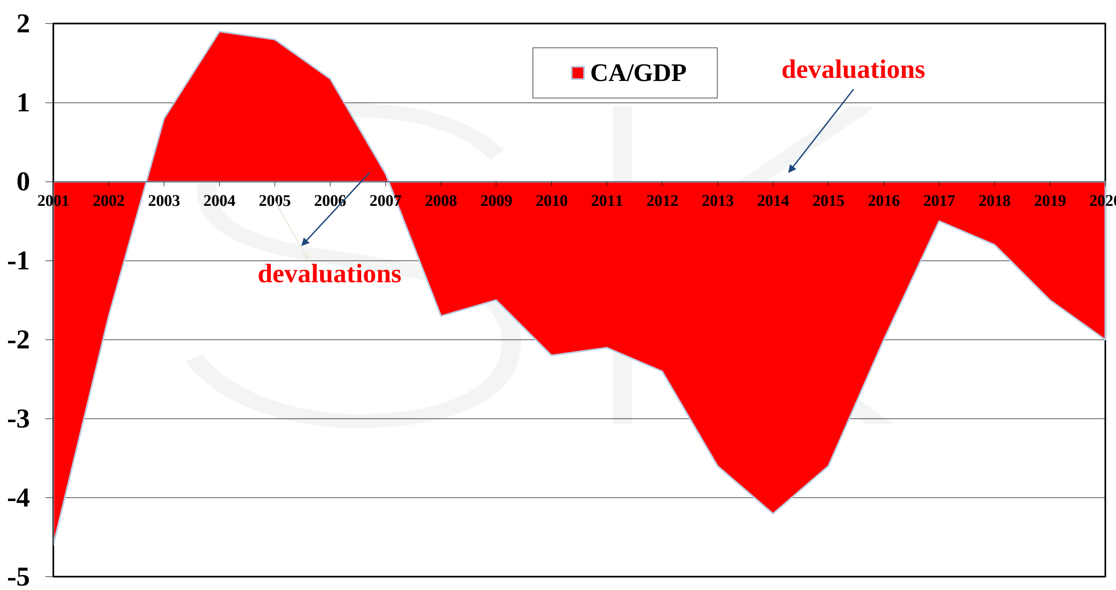
BRAZIL: CURRENT ACCOUNT/GDP IN %



IMF 2015

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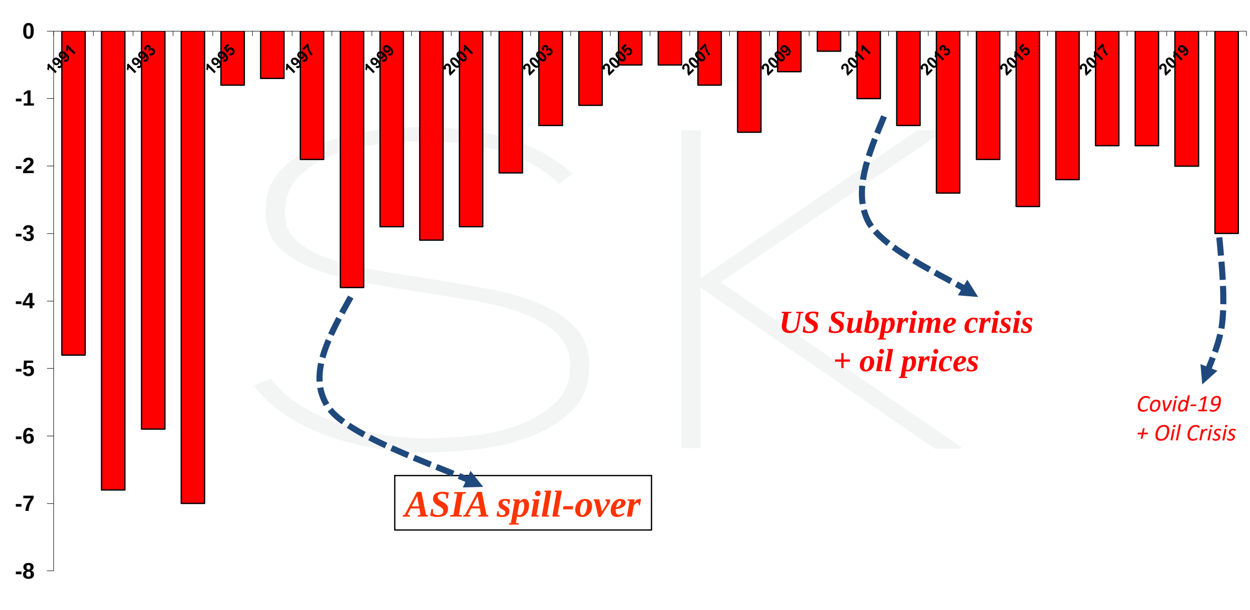
MEXICO : CURRENT ACCOUNT BALANCE/GDP RATIO % 1990-2020



Source: IMF & IIF 2020

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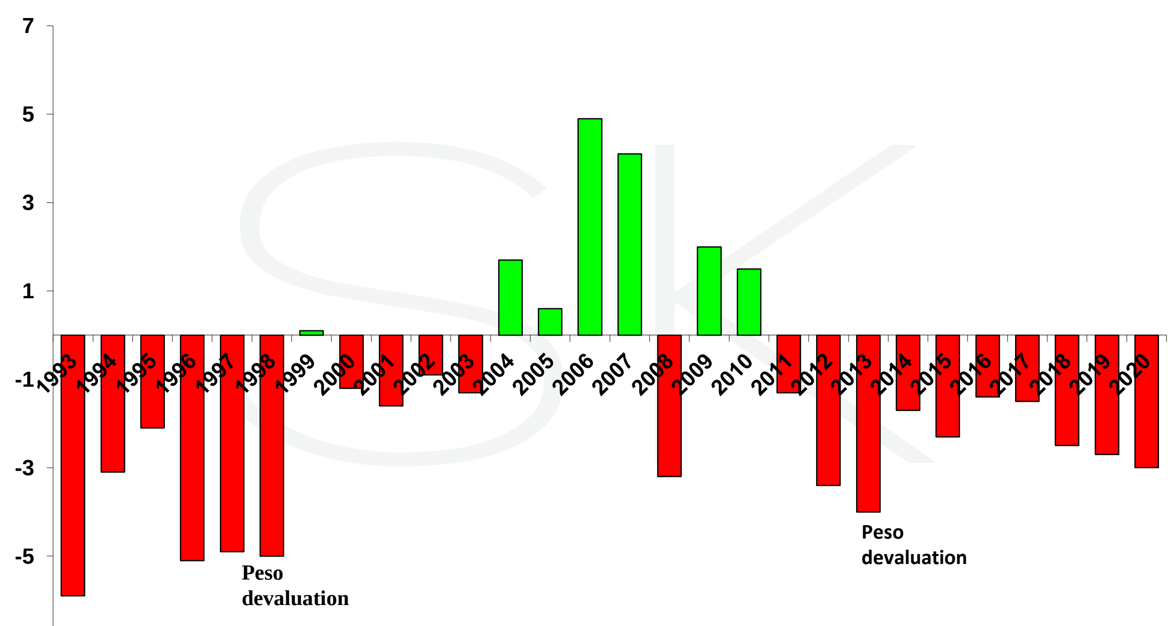
CHILE : CURRENT ACCOUNT/GDP RATIO % 1973-2020



Source: IMF 2019/CDD

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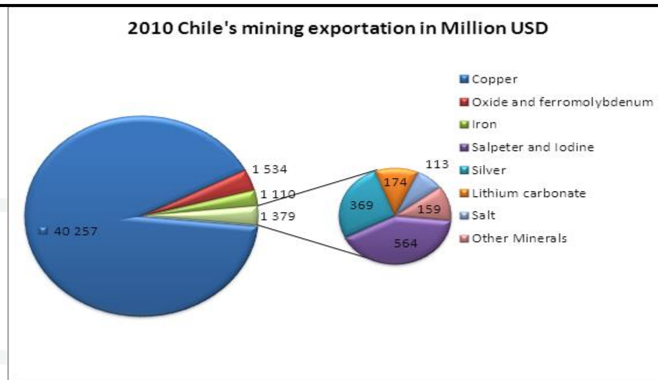
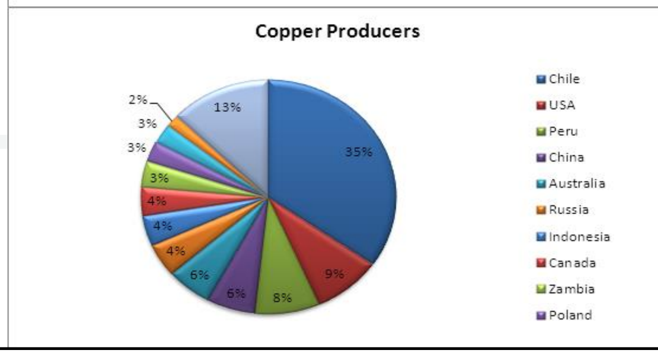
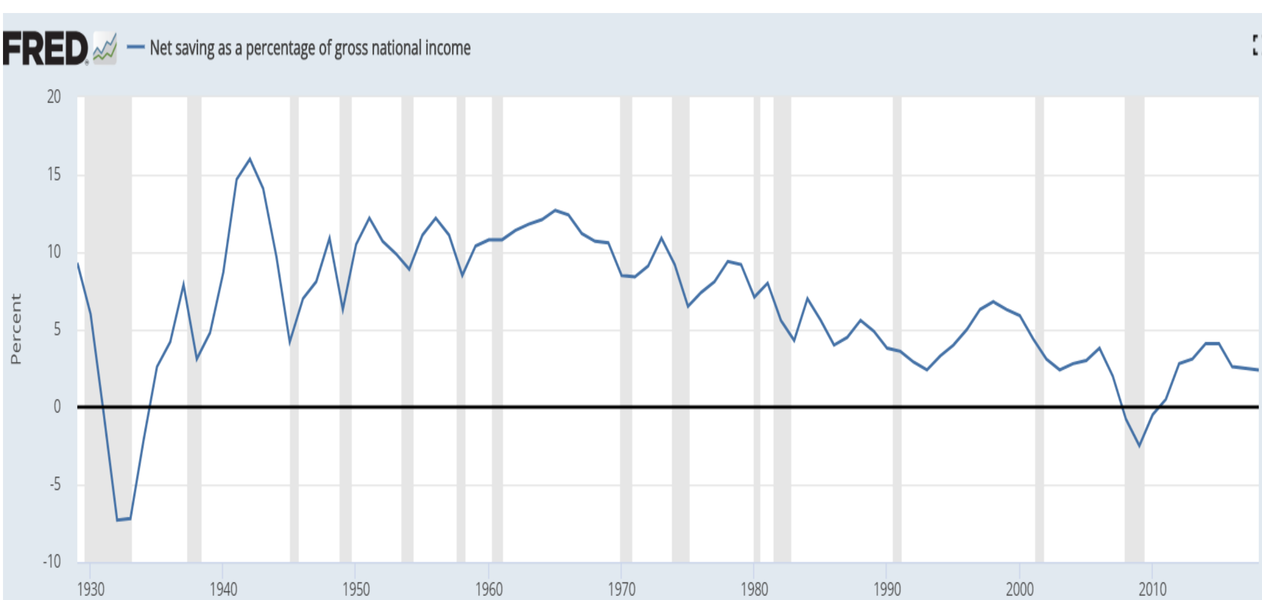
CHILE'S TRADE BALANCE: STRUCTURAL DEPENDENCE ON COMMODITIES





INVESTMENT > SAVINGS = US BOP DEFICIT 1980-2020



FRBSF March 2020

THE US CURRENT ACCOUNT DEFICIT DILEMMA

- Shrinking the deficit requires a weaker $
- Financing the deficit requires a strong $ by attracting US$2 billion/day foreign capital inflows