Fin-Ed Centre

FINANCIAL EDUCATION AND RESEARCH CENTRE

# Understanding your financial world

**Balance of payments and a country's balance sheet**

**Balance of payments (BOP)**

Accounts that record all the transactions of one country [e.g. New Zealand], with the rest of the world.

(adapted from Stewart and Rankin, 2008, p.393)

The balance of payments consists of:

- The current account

  The current account registers the receipts and payments for exports and imports of goods and services.

  The current account balance (whether we owe other countries or whether other countries owe us) is made up of the sum of:

  - Balance on goods (or merchandise trade) – the value of goods exported less the value of goods imported
  - Balance on services – the value of services sold to foreigners less the value of services bought from foreigners
  - Balance on investment income – interest and dividends received on foreign investments less interest and dividends paid to foreigners who have invested in our country
  - Balance on current transfers – money paid out or out of our country (with no return obligation I.e. no good or service is received in return) such as remittances to or from relatives living in other countries.

  When the current account balance is positive (we are owed more than we owe) we are said to have a current account surplus. Conversely, when the current account balance is negative we have a current account deficit.

Adapted from Stewart, J. and Rankin, K. (2008). *Economic concepts and applications: The contemporary New Zealand environment*, 4th ed. Pearson: Auckland, New Zealand

**Why is the balance on goods important?**

Growth of export receipts is usually regarded as a requirement for improvement in a country's economy. 'Export-led growth' is especially important for small, exporting countries like New Zealand. When net exports are negative (i.e. the value of imports is more than the value of exports, New Zealanders are collectively spending more than they earn on what they can produce.

(adapted from Stewart and Rankin, 2008, p.394)

- The capital/financial account

  The terms capital account and financial account are sometimes used interchangeably. Strictly speaking, they are separate accounts and shown separately by Statistics New Zealand but for this course you only need to know that the capital/financial account records financial flows such as borrowing from other countries (by both the Government and private sector), lending to other countries, money that foreigners invest in this country or New Zealand investment in foreign countries.

  Investments by foreigners include (whole or partial) ownership of New Zealand companies and assets, exploration for natural resources like oil and gas, and (until recently) manufacturing plants like the Tiwai Point aluminium smelter.

  New Zealand investments overseas include forestry plantations in Chile, washing machine factories and garment manufacture in Asia.

  The capital account balance is the difference between inward and outward flows of international borrowing, lending and investment.

- Overseas reserves

  Overseas reserves are the surplus of the combined balances of the current account and capital/financial account. They are held overseas by the Reserve Bank or the Government, usually in the form of gilt-edged securities like British and US Treasury Bills and foreign currency. These are known as **reserve assets**.

**The balance of payments identity is:**

Current account balance + Capital/Financial account balance + change in reserve assets

(adapted from Stewart and Rankin, 2008, p.399)

Adapted from Stewart, J. and Rankin, K. (2008). *Economic concepts and applications: The contemporary New Zealand environment*, 4th ed. Pearson: Auckland, New Zealand