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Question 1

Briefly describe balance of trade, balance of payments, visible trade, invisible trade.

1.1 Balance of Trade (BOT)

1.1.1 Definition of balance of trade

The balance of trade is defined as the difference between the monetary value of exports and imports in an economy over a certain period of time. It is also referred to as "trade balance" or "international trade balance". In some circumstances, it is also called net exports, and symbolized as NX. Besides, balance of trade is the largest component of a country's balance of payments and the relationship between a nation's imports and exports. The balance of trade is also divided into a goods and a services balance. Debit items consist of imports, foreign aid, domestic spending abroad and domestic investments abroad. Credit items include exports, foreign spending in the domestic economy and foreign investments in the domestic economy.

1.1.2 Trade surplus and trade deficit

A positive balance of trade is known as a trade surplus and it is composed of exporting more than is imported. It is also called favorable balance of trade. On the other hand, a negative balance of trade is known as a trade deficit which is a trade gap. It is also known as unfavorable balance of trade. However, the balance of trade is considered as a misunderstood indicator of the economy. For instance, most of the people believe that a trade deficit is a bad thing. But, whether a trade deficit is bad thing is relative to the business cycle and economic situation. In a recession, countries tend to export more, creating jobs and demand. In a strong expansion, countries like to import more, providing price competition, which limits inflation and, without increasing prices, provides goods beyond the economy's ability to meet supply. Hence, a trade deficit is not a good thing during a recession.

1.1.3 Physical balance of trade

Monetary balance of trade is different from physical balance of trade (which is shown in amount of raw materials). Advance countries usually import a lot of primary raw materials from developing countries at low prices. Then, these materials are converted into finished products or value-added products. Although many developed countries have a balanced monetary balance of trade, its physical trade balance is negative, especially compared with developing countries, which means that in terms of materials it is imported more than exported.

1.2 Balance of payments (BOP)

1.2.1 Definition of balance of payments

Balance of payments refers to a record of all transactions made between one country and all other countries during a specified period of time. BOP compares the monetary value difference of the amount of exports and imports, including all financial exports and imports. A negative balance of payments means that more money is flowing out of the country than coming in, and vice versa. In economics, the BOP includes the trade balance, foreign investments and investments by foreigners. It measures the payments that flow between one particular country and the rest of the world over a period of time, normally one year. It is also used to summarize all international economic transactions for that country during a specific time period.

According to the IMF definition, "Balance of Payments is a statistical statement that summarizes transactions between residents and nonresidents during a period." The balance of payments comprises the current account, the capital account, and the financial account. "Together, these accounts balance in the sense that the sum of the entries is conceptually zero." The current account consists of the goods and services account, the primary income account and the secondary income account. The financial account records transactions that involve financial assets and liabilities and that take place between residents and nonresidents. The capital account in the international accounts shows capital transfers receivable and payable and the acquisition and disposal of non-produced nonfinancial assets. *[Source: IMF definition is retrieved from www.en.wikipedia.org on April 16, 2009]*

1.2.2 Components of balance of payments

The balance of payment consists of four components:

(a) Current Account

(b) Capital Account

(c) Official Financing

(d) Balancing Items

The balance of payment has two columns which are the debit and credit in the accounting statement. Debit refers to the payment made out, including imports of goods, use of foreign services, capital outflow, gifts paid abroad, net repayment to international monetary bodies, and net additions to reserves. On the other hand, credit refers to the payment received, which includes export of goods, foreigners using local services, capital inflow, gifts received abroad, net drawings from international monetary bodies, and net drawing from reserves.

All in all, the BOP is determined by the country's exports and imports of goods, services, financial capital, and financial transfers. It reflects all payments and liabilities to foreigners (debits) and all payments and obligations received from foreigners (credits). BOP is one of the significant indicators of a country's status in international trade, with net capital outflow. In addition, BOP may be used as an indicator of economic and political stability. For example, if a country has a consistently positive BOP, this could mean that there is significant foreign investment within that country. It may also mean that the country does not export much of its currency.

1.3 Visible Trade

Visible trade is defined as the exchange of physically tangible goods between countries, involving the export and import as well as re-export of goods at various stages of production. It is distinguished from invisible trade, which involves the export and import of physically intangible items such as services.

The balance of visible trade indicates the value of tangible exports and exports. Most of the advance countries import raw materials from developing countries, such as rubbers, palm oil, and so on. The advance countries export finished goods to the developing countries.

1.4 Invisible trade

The balance of invisible trade indicates the value of intangible exports and imports. Invisible trade refers to the exchange of physically intangible items between countries, where there is no exchange of physical goods. The basic categories of invisible trade consist of:

- Services which are receipts and payments arising from activities, such as customer service, shipping, consultancy firms, and so forth.
- Tourism which involves foreign tourists to one country and local citizens' travel to other countries.
- Income from foreign investment in the form of interest, profits, and dividends.
- Private or government transfers of monies from one country to another.
- Government expenditure through the maintenance of diplomatic links and trade missions, military expenditure abroad, and official aid to developing countries.
- Intellectual property and patents.

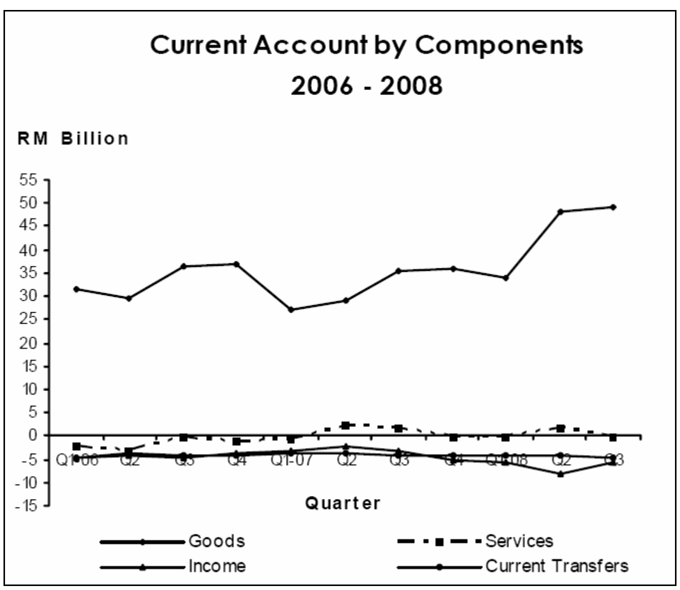
Question 2

You are required to explain the following with a suitable diagram on balance of payments for any country for any three years and interpret the figures and state the total volume of visible balance of trade, invisible balance of trade, the balance of payments and state whether there was a deficit or surplus in balance of payments?

2 BALANCE OF PAYMENTS IN MALAYSIA

2.1 CURRENT ACCOUNT BALANCE

In the third quarter of 2008, the current account surplus rose marginally by RM1.7 billion (4.5%) to RM38.7 billion from RM37.0 billion in the preceding quarter. Such a surplus was mainly due to lower net payment on income of RM5.8 billion (Q2 2008: -RM8.2 billion) and higher surplus on goods of RM49.2 billion (Q2 2008: RM48.1 billion) which offset a turnaround in services account to a deficit of RM0.2 billion (Q2 2008: +RM1.4 billion) and higher leakage on current transfers of RM4.5 billion (Q2 2008: RM4.3 billion).



Year-on-year, the surplus increased by RM9.3 billion or +31.8% to RM38.7 billion from RM29.4 billion posted in the same period of last year. The scenario was mainly attributed to the surplus in goods account amounting to RM49.2 billion, which surged by 39.5%.

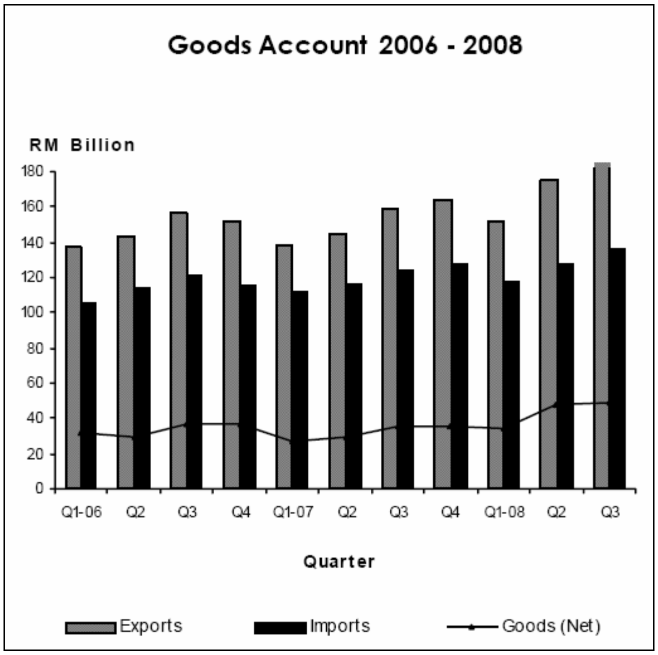
Such an improvement managed to offset higher net payments on both income of RM5.8 billion (Q3 2007: -RM3.2 billion) and current transfers of RM4.5 billion (Q3 2007: -RM4.2 billion) and a turnaround in services account to a deficit of RM0.2 billion from RM1.5 billion attained in Q3 2007.

For the first three quarters of this year, the current account surplus increased by RM25.5 billion or 34.4% to RM99.5 billion from that of RM74.1 billion posted during the same period of last year. Such an improvement was mainly due to higher surplus on goods amounting to RM131.2 billion from that of RM91.8 billion recorded in 2007, amid lower surplus on services of RM1.1 billion from that of RM2.8 billion registered last year and higher deficits on both income of RM19.7 billion (+121.7%) and current transfers of RM13.0 billion (+11.6%).

2.1.1 GOODS ACCOUNT

In the quarter under review, the surplus on goods of RM49.2 billion increased marginally by RM1.1 billion or 2.3% from RM48.1 billion registered last quarter. The increase on exports f.o.b. to RM185.4 billion was main
ly due to the increase in the palm oil & palm oil based products, crude petroleum, electrical & electronic products amounting to 7.6%, 6.1% and 5.1% respectively. Meanwhile, the increase on imports f.o.b. by 8.9% to RM136.1 billion was mainly attributed to the rise in the intermediate goods.

Year-on-year, the surplus in goods account showed an increase of 39.5% or RM13.9 billion (Q3 2007: RM35.3 billion) following the increase on exports f.o.b. at faster pace (16.8%) than that of imports f.o.b. (10.3%).

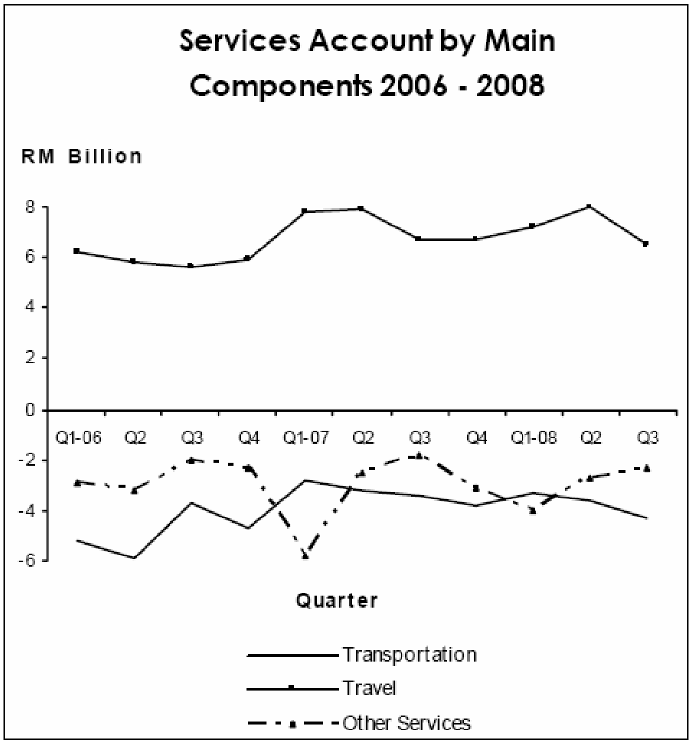


For the first three quarters of the year, the surplus in goods account rose substantially to RM131.2 billion; an increase of RM39.4 billion or 42.9% from RM91.8 billion recorded during the same period of 2007. Such an increase was mainly due to higher increase on exports f.o.b. (+15.9% or +RM70.4 billion) than that of imports f.o.b. (+8.8% or +RM31.0 billion).

2.1.2 SERVICES ACCOUNT

For the period of July – September 2008, services account experienced an outlay of RM0.2 billion from a net receipt of RM1.4 billion recorded previously. The turnaround was largely due to higher deficit on transportation amounting to RM4.3 billion (Q2 2008: -RM3.6 billion) and lower receipt on travel of RM6.5 billion (Q2 2008: +RM8.0 billion), albeit marginal improvement on deficit of other services to RM2.3 billion (-RM0.4 billion or -15.2%) from -RM2.7 billion previously.

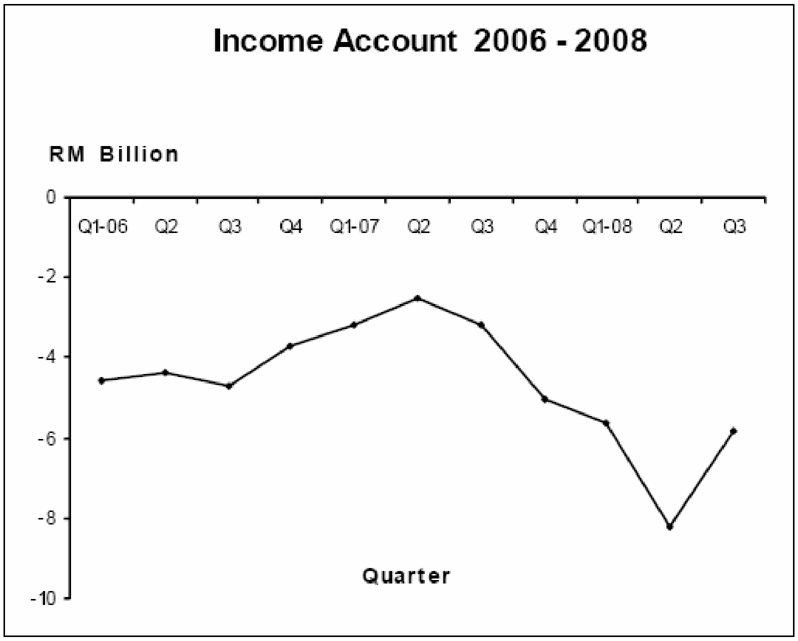
Year-on-year, the services account reversed to a net payment of RM0.2 billion from a net receipt of RM1.5 billion posted in the same period of last year. This was mainly due to higher net payment on both transportation and other services, which recorded RM4.3 billon (Q3 2007: -RM3.4 billion) and RM2.3 billion (Q3 2007: -RM1.8 billion) respectively, coupled with lower surplus on travel amounting to RM6.5 billion from RM6.7 billion in Q3 2007.



During the period of January – September, 2008, the services account continuously remained surplus albeit at lower RM1.1 billion compared to RM2.8 billion registered during the same period last year. Such a surplus was attributed to higher net payment on transportation of RM11.2 billion (+20.0%) as well as lower surplus on travel of RM21.7 billion (-3.3%). Meanwhile, net payment on other services improved to RM9.0 billion from -RM10.1 billion recorded in the corresponding period of last year.

2.2 INCOME ACCOUNT

In the third quarter of 2008, the income account experienced lower net outlay of RM5.8 billion from -RM8.2 billion previously; an improvement of RM2.4 billion or 29.5% from the previous quarter following lower deficit on investment income. Meanwhile, the deficit on compensation of employees remained unchanged at RM0.2 billion.

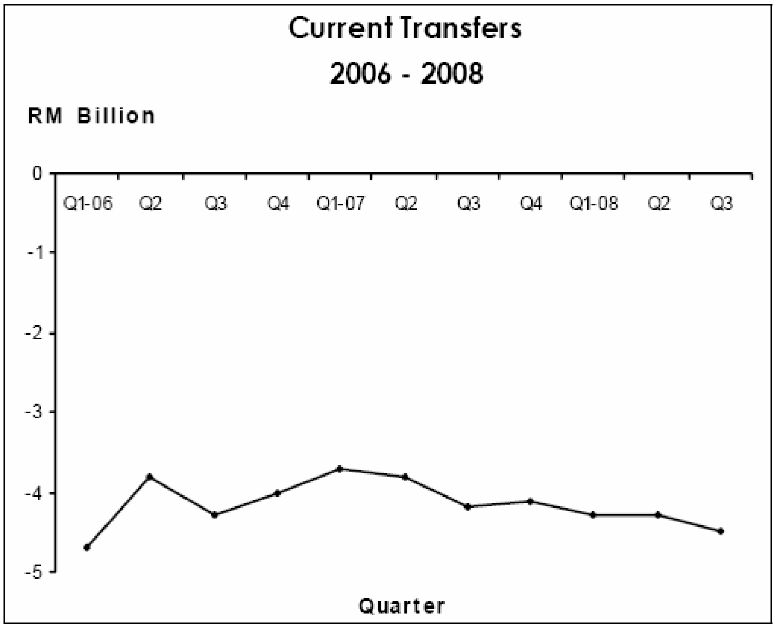


Lower deficit on investment income amounting to RM5.6 billion (Q2 2008: -RM8.1 billion) was primarily reflected in lower deficit on both incomes on direct investment of RM8.5 billion (Q2 2008: -RM9.2 billion) and portfolio investment of RM1.9 billion (Q2 2008: -RM2.4 billion). On the contrary, income on other investment had recorded higher surplus of RM1.3 billion or 37.1% to RM4.8 billion (Q2 2008: +RM3.5 billion).

Such a deficit on direct investment income was due to income outlay of foreign direct investment (FDI) of RM11.9 billion (Q2 2008: -RM15.7 billion), which offset lower income receipt of direct investment abroad (DIA) amounting to RM3.4 billion (Q2 2008: RM6.5 billion). The quarter under review saw that dividends formed the biggest share of income for direct investment abroad amounting to RM1.9 billion or 55.9%. Similarly for FDI, dividends formed the largest portion amounting to RM9.4 billion. Repatriation of profits abroad in the quarter was reflected mainly in oil and gas sector amounted to RM4.4 billion and manufacturing sector of RM2.6 billion.

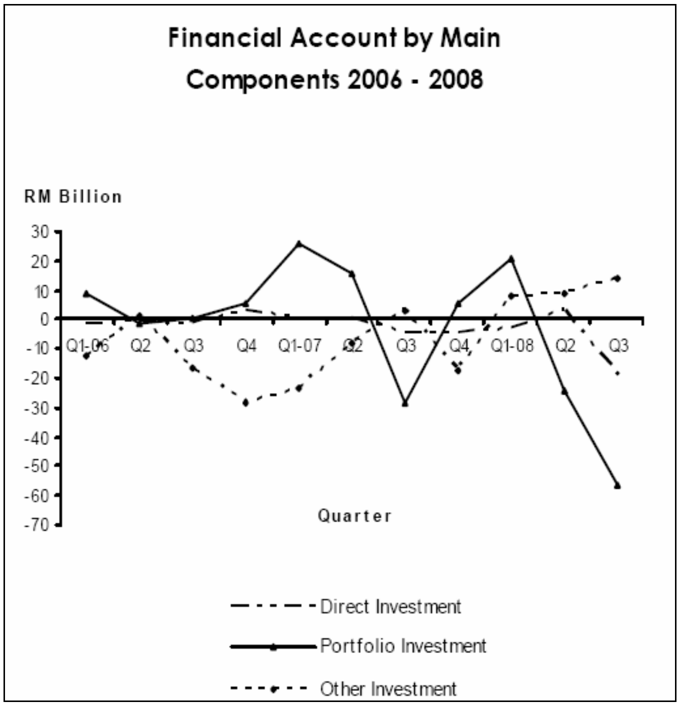
In the first three quarters of 2008, the net payment on income increased to RM19.7 billion (2007: -RM8.9 billion), following higher investment income deficit of RM19.2 billion; a significant increase by RM10.6 billion from RM8.5 billion previously.

2.3 CURRENT TRANSFERS



During Q3 2008, the net payment on current transfers widened to RM4.5 billion from that of RM4.3 billion in the previous quarter. Meanwhile, the first nine months of the year saw that the current transfers deficit rose by RM1.4 billion or 11.6% to RM13.0 billion from that of -RM11.7 billion in the same period of last year.

2.4 CAPITAL ACCOUNT



The capital account recorded higher net outflow of RM119.0 million from that of -RM37.0 million posted in last quarter. Of which, the net outflow on capital transfers accounted for RM102.0 million (Q2 2008: -RM21.0 million). Cumulatively, the capital account registered a net inflow of RM641.0 million from a net outflow of RM58.0 million experienced in the corresponding period of last year. This was mainly due to non-produced non-financial assets which registered a net inflow of amounting to RM789.0 million.

2.5 FINANCIAL ACCOUNT

In the quarter under review, the outflow in financial account which surged significantly by 400.1% or RM49.1 billion to RM61.4 billion from lower outflow of RM12.3 billion previously was mainly due to:

- Portfolio investment - substantial net outflow in both debt securities (RM41.7 billion) and equity securities (RM12.1 billion) had resulted in higher net outflow in portfolio investment amounting to RM56.2 billion (Q2 2008: -RM24.0 billion). This was in tandem with divestment activities in the local equity & debt securities markets in the quarter under review. Year-on-year, the portfolio investment was higher outflow (Q3 2007: -RM28.7 billion).

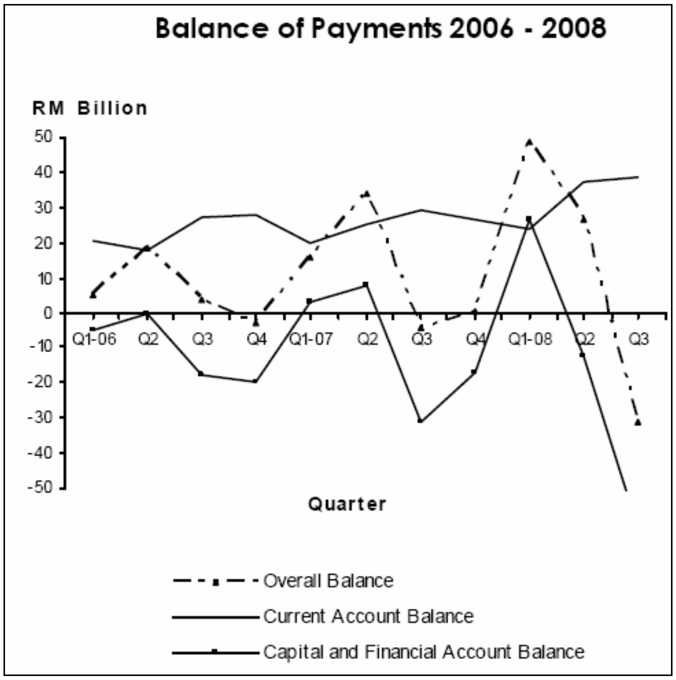
- Direct investment - a reversal to a net outflow of RM19.0 billion from a net inflow of RM2.9 billion in the previous quarter, following higher outflow in outward direct investment compared to smaller inflow in inward direct investment.

The net outflow for direct investment abroad was attributed to financial services sector (38.4%), and oil & gas sector (27.3%) as well as information & communication sector (22.7%). In the current quarter, the inward direct investment was mainly channeled to manufacturing sector albeit at lower inflow of RM1.1 billion (Q2 2008: RM5.0 billion).

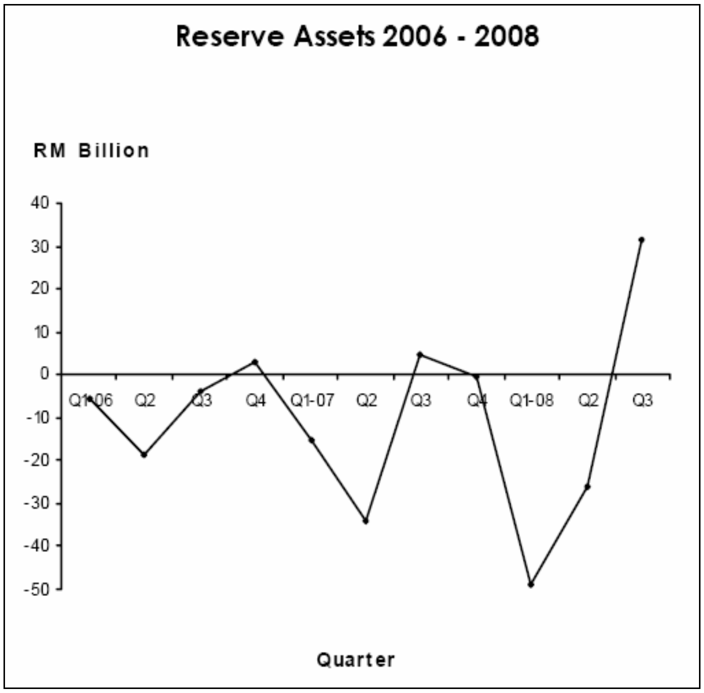
In the first three quarters of 2008, the direct investment which recorded a net outflow of RM19.0 billion from RM4.1 billion posted in the same period of last year was attributable to higher direct investment abroad by resident enterprises of 42.1% relative to smaller inflow of 11.7% in inward direct investment. However, other investment registered higher net inflow of RM13.8 billion from RM8.8 billion in Q2 2008 following substantial inflow of foreign currency/ placements / deposits recorded in the banking sector.

Year-on-year the financial account showed higher outflow of RM61.4 billion, against outflow of RM30.9 billion posted in the corresponding period of last year; an increase of RM30.5 billion or 98.7%.

2.6 OVERALL BALANCE



In Q3 2008, Malaysia's overall balance of payments recorded a deficit of RM31.5 billion; a turnover from a surplus of RM26.2 billion recorded during Q2 2008. The current account balance continuously remained positive with a surplus of RM 38.7 billion; an increase of RM1.7 billion or 4.5%. Meanwhile capital & financial account experienced significant outflow of RM61.5 billion; an increase of RM49.2 billion or 399.6% against previous quarter. Consequently, this had resulted in errors & omissions of –RM8.8 billion. At the same time, the international reserves held by Bank Negara Malaysia decreased by RM31.5 billion relative to an increase of RM26.2 billion posted in the second quarter, 2008.



For the period of January – September, 2008, the surplus in overall balance receded by 3.0% or RM1.4 billion to RM43.6 billion compared to RM45.0 billion during the same period of 2007. Meanwhile, the net increase in external reserves amounting to RM43.6 billion however was lower than that of RM45.0 billion posted during the January – September period of 2007.

JADUAL 1 MALAYSIA - IMBANGAN PEMBAYARAN SUKU TAHUNAN (BERSIH), 2006 - 2008
TABLE 1 MALAYSIA QUARTERLY BALANCE OF PAYMENTS (NET), 2006 2008

	Perkara/*Item*	Tahun/ *Year* 2006	2007	2006 (Jan - Sept)	2007 (Jan - Sept)	2008 (Jan - Sept)
A.	Barangan dan Perkhidmatan/*Goods and Services*	127627	130,047	82,132	94.618	132,242
	1. Barangan/*Goods*	134558	127,670	87,786	91.709	131,176
	2. Perkhidmatan/*Services*	-6931	2,373	-5,654	2.809	1,066
	2.1 Pengangkutan/*Transportation*	-19620	-13,173	-4,896	-9.349	-11,215
	2.2 Perjalanan/*Travel*	23501	29,113	7,628	22.453	21,703
	2.3 Perkhidmatan lain/*Other Services*	10378	18,178	8,098	10.085	9,346
	2.4 Urus Niaga Kerajaan Yang Tidak Dicatat Di tempat Lain/ *Government Transactions n.i.e*	-453	-390	-287	-190	-375
B.	Pendapatan/*Income*	-17271	-13,893	-3,604	-8.874	-19,675
	1. Pampasan Pekerja/*Compensation of employees*	-283	-600	-166	-343	-520
	2. Pendapatan Pelaburan/*Investment income*	-16988	-13,294	-3,439	-8.532	-19,155
C.	Pindahan Semasa/*Current Transfers*	-16852	-15,743	-2,841	-11.675	-13,329
D.	**Imbangan Akaun Semasa/*Balance on Current Account* (A+B+C)**	**93504**	**100,410**	**+5,687**	**74,069**	**99,537**
E.	Akaun Modal/*Capital Account*	0	-95	0	-58	641
	1 Pindahan Modal/*Capital Transfers*	0	-71	0	-47	-148
	2. Aset Bukan Kewangan Bukan Pengeluaran/ *Non-produced Non-financial Assets*	0	-24	0	-11	789
F.	Akaun Kewangan/*Financial Account*	-43400	-37,710	-35,470	-20.447	-47,976
	1 Pelaburan Langsung/*Direct Investment*	99	-9,142	-2,725	-4.120	-19,080
	2. Pelaburan Portfolio/*Portfolio Investment*	12911	18,355	7,480	12.775	-59,130
	3. Pelaburan Lain/*Other Investment*	-56422	-46,920	-50,216	-29.102	30,194
G.	Kesilapan & Ketinggalan/*Errors & Omissions*	-24857	-17,309	-4.357	-8.566	-8.571
H.	**Imbangan Keseluruhan/*Overall Balance* (D+E+F+G)**	**25158**	**45,296**	**27,830**	**44.999**	**43,632**
I.	Aset Rizab/*Reserve Assets*	-25158	-45,296	-27,830	-44.999	-43,632
	1. Sumber IMF/*IMF Resources*	0	0	0	0	0
	2. Perubahan Bersih dalam Rizab Luar Negeri Bank Negara Malaysia [Bertambah (-) / Berkurangan (+)]/ *Net Change in Bank Negara Malaysia's External Reserves [Increase (-) / Decrease (+)]*	-25158	-45,296	-27,830	-44.999	-43,632

The Quarterly Balance of Payment (RM mil) in Year 2006-2008, taken from the *Department of Statistic, Malaysia.*

Question 3

Briefly describe the implication of balance of payments on the exchange rates of currency of a country?

3.1 Balance of Payment

Balance of payment referred as record of transactions happen between countries. When a balance of payment is negative, it is a situation where the home country is facing more money out flow compare to in flow. This occurs mainly because the home country is buying more from other country and they required to pay the amount. On the other hand, when balance of payment is positive, it means the home country is now transacting and receiving money in flow compare the out flow. This happens because the home country is selling more goods or services to other countries and in return receiving the money as payment.

3.2 Exchange Rate

Exchange rate is the determination rate to compare how much a currency is weighted with another currency. For instance, if 1 Ringgit Malaysia is weighted equal to 0.25 US dollars, then the same weight will apply for US dollar when it is weighted with Ringgit Malaysia whereas 1 US Dollar is weighted equal to 4 Ringgit Malaysia. The exchange rate is the ratio between them which is 1:4. This ratio is would be fixed or fluctuation based on how the currency is placed in the market.

There is two way of placing the currency in the money market which are fixed exchange rate and floating exchange rate. Fixed exchange happens when the home currency fixes their exchange rate by weighting permanently over certain currency. The best example would be Malaysia itself whereas we did fixed our exchange rate at ratio of 1 US Dollar equal to 3.8 Ringgit Malaysia. On the other hand, floating exchange rate would cost the currency to fluctuation up and down following demand and supply elastic. Malaysia had placed the Ringgit currency back to floating last year. As result of this, today Malaysia currency is weighted nearly 3.6 Ringgit Malaysia equal to 1 US Dollar.

Floating of currency is explained as simple as the demand and supply elastic. When many people are buying Ringgit Malaysia currency, this shows the demand is high. Notable here that Malaysia would not print any extra currency and therefore the supply remains the same. Demand and supply elastic mention that the price would go up if demand goes up while supply is constant. This is what will happen to the floated exchange rate, increase in currency price means it is valued more and appreciates. When a currency appreciates, the rate will go stronger to compete with other currency. That is from 3.4 MYR = 1.0 USD, it would be 3.0 MYR = 1.0 USD. The Ringgit currency goes stronger against the US Dollars. As result of this, the Ringgit currency would have power to buy more compared to the previous situation.

3.3 International Trading

International trading is the name for countries world wide transact good and services between them. A cost would be applied for the transacted goods or services and the parties are entitled to receive the cost or pay the cost. Transactions are simplified in two manners which are imports and exports. Transaction always happens in the seller country’s currency. For instances, we assume Malaysia is the home country and now Malaysia want to buy BMW car from Japan. In this case, Malaysia is importing, we receiving the goods while Japan is the exporting country because they send the goods. The seller here is Japan, and therefore the transaction must occur in their currency which is Yen. The exchange rate is 1 Ringgit Malaysia = 28 Yen. If the BMW cars cost 28 Million Yen, Malaysia would pay 10 Million Ringgit to buy their 28 Million Yen and would be paid to the seller.

On the export scenario, if Malaysia is exporting Proton cars worth of 10 Million Ringgit. The Japanese buyer needs to buy Ringgit currency with 28 Million Yen and pay the Malaysia merchant. When currency is being bought for trading, it would appreciate the currency making it more competitive.

3.4 Implication of Balance of Payment on Exchange Rate

Bringing in the theories and logics of balance of payment, exchange rate and trading together, we can not denied the influence and implication of each of them on each other. Generally, when countries trade, the payment must would be paid in the home country's currency which is the exporting country. This forces the traders to involve in exchange of currency influenced by the exchange rate. For instance, if United States is buying good from Malaysia, Malaysia is the exporter and this would cause US to buy Malaysia Ringgit currency and pay the merchant.

Balance of payment would be positive and higher if the country exporting higher than its imports. When this high export occurs, this ensures the country's currency is being bought or exchanged in high quantity. Taking the above example, Malaysia's currency would be bought by other countries and in result, the money demand would be higher and appreciation of currency would happen. Appreciation of currency would make it stronger against other country and lower the exchange rate would be with other stronger currency.

If Malaysia currency gets stronger against other currency, for example US dollars, this would result Malaysia to be capable of buying more goods for the same price. Illustration is, Malaysia exchange rate with US dollar is 3.4 Ringgit for 1 US Dollar. If a US car priced for 100,000 US Dollars, Malaysia would buy it for RM 340,000. But when our exports, balance of payment is high and our currency is get slightly stronger to exchange at 3.0 Ringgit for 1 US Dollar, Malaysia would buy the same US car for only RM300,000. This means although we have RM 340,000, we just require RM300,000 for the car. And for the balance money of RM 40,000 we could buy something else. We have stronger purchasing power for the same amount of Ringgit compared to previous state.

3.5 Conclusion

International trade between countries would influence directly on the balance of payment of the country. At the same time, higher exports will result to higher and positive balance of payment. Higher exports would cause the currency to be traded in high quantity. High currency trading would result to higher demand of the currency and therefore floating exchange rate would get stronger. Stronger exchange rate would appreciate the currency. Appreciated currency would make the country and its resident to buy more foreign good cheaper. Importing foreign goods at cheaper price would increase the standard of living in the country and the wealth shared. Therefore countries keep their balance of payment more in favor to enhance their currency strength against other currency for trading purposes.

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