Balance of Payment and Economic Development - Lessons to Learn

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### I. Balance and payment and growth

*Short reminder of national accounting and economic models*

<table>
<thead>
<tr>
<th>Net capital flows zero</th>
<th>→ current account balance zero</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net capital imports</td>
<td>→ current account deficit</td>
</tr>
<tr>
<td>Net capital exports</td>
<td>→ current account surplus</td>
</tr>
</tbody>
</table>

#### Theoretical ideas and the current account

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<tr>
<th>Net capital flows zero</th>
<th>→ current account balance zero</th>
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<tbody>
<tr>
<td></td>
<td><em>David Ricardo with the exchange rate as perfect protection</em></td>
</tr>
<tr>
<td>Net capital imports</td>
<td>→ current account deficit</td>
</tr>
<tr>
<td></td>
<td><em>Neoclassical saving gap model (for example World Bank)</em></td>
</tr>
<tr>
<td>Net capital exports</td>
<td>→ current account surplus</td>
</tr>
<tr>
<td></td>
<td><em>Keynesian export-led development (demand drives output)</em></td>
</tr>
</tbody>
</table>
The Keynesian development model and the balance of payment

Output $\leftarrow$ AD = I + C + G + Ex-Im

AD: aggregate demand, I: investment demand, C: consumption demand, G: government demand, Ex: Exports, Im: Imports

The model assumes unused capacities and unemployment (the usual situation in a developing country)

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Capital import scenarios, examples

A: Foreign direct investment (FDI) as green field investment creates a current account deficit and increases domestic investment

Output $\leftarrow$ AD = I + C + G + Ex-Im

\[
\begin{array}{ccc}
(0) & (+) & (-) \\
\end{array}
\]

B: FDI as mergers & acquisitions creates a current account deficit

Output $\leftarrow$ AD = I + C + G + Ex-Im

\[
\begin{array}{ccc}
(-) & (0) & (-) \\
\end{array}
\]
C: Domestic firms take foreign credits which they could not get in the domestic financial market and invest
Output ← \( AD = I + C + G + Ex-Im \)
- \( (0) \)  \( (+) \)  \( (-) \)

D: Foreign portfolio investment in the secondary market
Output ← \( AD = I + C + G + Ex-Im \)
- \( (-) \)  \( (0) \)  \( (-) \)

Scenario of full capacity utilisation
(Higher production is not possible because of full capacity utilisation)
- Net capital imports also do not increase GDP growth in the present situation, but it increases capacities in the next situation

- However, current account deficits also can be used for
  - private consumption
  - government consumption
  - wasteful FDI investment (real estate bubble, government useless status projects, etc.)
Export-led growth model

Net capital export leads to current account balance surpluses

Output ← AD = I + C + G + Ex-Im

(+) (+)

Capital exports *can be strategically created* via central bank intervention in the foreign exchange market or development aid by developed countries.

Show cases for this model are China, Germany or Japan.

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II. Balance of payment and productivity

A. Ricardo-List trade based development model:

Sell low tech products in the world market and import high tech investment goods

Use tariffs and industrial policy to stimulate domestic productivity and innovation

Conclusion

Exchange rate as a global protection and

Tariffs and industrial policy as a selective protection/support
Capital inflows and productivity

FDI can bring new technology, organisation skills, etc.

But not all FDI is useful, not useful is for example too much FDI in real estate, domestic financial system, retail market, natural resource exploitation, etc.

Portfolio investment - no new technology, etc.
Foreign credits - no new technology, etc.

III. Balance of payment and economic fragility

• Original sin (Barry Eichengreen) and foreign debt in foreign currency

• Currency mismatch and economic fragility (real foreign debt effect in case of devaluation)

• Danger of boom-bust-cycles and twin crises

There is no positive relation between capital account liberalisation and economic development
IV. Theoretical lessons

• Full capital account deregulation in almost all cases does not increase growth substantially but increases volatility and fragility of the economy
• Selective FDI has positive productivity effects, but not all FDI has positive effects and FDI usually is only a small demand driver
• A country should prevent currency mismatch (control foreign credit inflows and portfolio debt security, strict banking supervision, no foreign loans to private households and no foreign loans to firms without foreign exchange revenues)
• A country should prevent an external boom-bust cycles which usually is interrelated with domestic bubbles
• A country should prevent medium-term current account deficits and strive for a balanced current account
• Industrial policy combined with tariffs are important for developing domestic competitive industries
• The exchange rate should be used as a global protection and tariffs and industrial policy as selective protection/support
• The country should be able to depreciate to increase price competitiveness (no currency mismatch, no inflation path through)

V. Lessons for Vietnam

• The current account deficit and especially the trade deficit in Vietnam are too high

• A balanced current account would stimulate GDP growth in Vietnam

• Vietnam should try to reduce the current account deficit with a combination of
  – exchange rate policy
  – Interventions of the central bank in the foreign exchange market (FDI inflow and balanced current account are then possible)
  – industrial policy and productivity development
  – trade restriction in different way

• The structure of FDI inflows in Vietnam is not optimal

• Vietnam should prevent currency mismatch
  – via capital import controls
  – strict financial market supervision including the prohibition of foreign credit of the private household sector and firms without foreign currency revenues.
  – foreign debt of public households should be low
Current accounts in per cent of GDP

Balance of Payment, Vietnam in 2010

<table>
<thead>
<tr>
<th>Component</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current Account</td>
<td>-3.511</td>
</tr>
<tr>
<td>Trade Balance</td>
<td>-5.147</td>
</tr>
<tr>
<td>Non factor services</td>
<td>-2.461</td>
</tr>
<tr>
<td>Transfer (net)</td>
<td>8.661</td>
</tr>
<tr>
<td>Investment Income (net)</td>
<td>-4.564</td>
</tr>
<tr>
<td>Financial and Capital Account</td>
<td>5.542</td>
</tr>
<tr>
<td>Foreign Direct Investment</td>
<td>7.100</td>
</tr>
<tr>
<td>Medium and long term loans</td>
<td>2.751</td>
</tr>
<tr>
<td>Short term loans</td>
<td>1.043</td>
</tr>
<tr>
<td>Portfolio</td>
<td>2.370</td>
</tr>
<tr>
<td>Money and deposits</td>
<td>-7.722</td>
</tr>
<tr>
<td>Errors and Omissions (unregistered capital outflows?)</td>
<td>-3.796</td>
</tr>
<tr>
<td>Central Bank Intervention (reduction in reserves)</td>
<td>+1.765</td>
</tr>
<tr>
<td>Sum</td>
<td>0</td>
</tr>
</tbody>
</table>

Quelle: IWF WEO database Apr 2011
Selected Literature


Structure of (licensed) FDI inflows in Vietnam until 2009, right column in per cent of total FDI

<table>
<thead>
<tr>
<th>Zielsektoren lizenziert</th>
<th>Volumen lizenziierter Projekte (Mill. USD)</th>
<th>Relativer Anteil am Gesamtvolumen</th>
</tr>
</thead>
<tbody>
<tr>
<td>Agriculture and forestry</td>
<td>3.838</td>
<td>1.97%</td>
</tr>
<tr>
<td>Fishery</td>
<td>541</td>
<td>0.28%</td>
</tr>
<tr>
<td>Mining and quarrying</td>
<td>10.980</td>
<td>5.65%</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>88.580</td>
<td>45.56%</td>
</tr>
<tr>
<td>Electricity, gas and water supply</td>
<td>2.231</td>
<td>1.15%</td>
</tr>
<tr>
<td>Construction</td>
<td>7.964</td>
<td>4.10%</td>
</tr>
<tr>
<td>Trade, Repair Services</td>
<td>1.042</td>
<td>0.54%</td>
</tr>
<tr>
<td>Hotels and restaurants</td>
<td>18.403</td>
<td>9.88%</td>
</tr>
<tr>
<td>Transport, storage, communication</td>
<td>8.435</td>
<td>4.34%</td>
</tr>
<tr>
<td>Financial intermediation</td>
<td>1.104</td>
<td>0.57%</td>
</tr>
<tr>
<td>Real Estate, Renting Business</td>
<td>45.506</td>
<td>23.40%</td>
</tr>
<tr>
<td>Education and training</td>
<td>2.26</td>
<td>0.14%</td>
</tr>
<tr>
<td>Health and social work</td>
<td>1.033</td>
<td>0.53%</td>
</tr>
<tr>
<td>Recreational, cultural and sporting</td>
<td>2.638</td>
<td>1.46%</td>
</tr>
<tr>
<td>Community, social services</td>
<td>658</td>
<td>0.34%</td>
</tr>
</tbody>
</table>

Quelle: General Statistics Office of Vietnam, IMF Staff Reports