

# **Balance of Payments Constraint — Trade and Finance**

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**Abstract:** This paper summarizes conceptual aspects of two contemporary global phenomena: "economic growth external constraint" or "balance of payments constraint (BPC)" and "financial flows", both of them especially studied as structural features of Argentina economy. Our general hypothesis is that external constrain, in its commercial (exports and imports relative income-elasticity) or financial (unsustainable debt, interest payments) versions, means a significant difficulty for some countries' growth. Besides, financial outflows (purchase of foreign assets by residents, capital flight), offer various additional complexities. Both performs simultaneously as cause and consequence of growth, as circular cumulative causation (CCC).

Key words: balance of payments constraint; financial cross-borders flows; capital flight; circular cumulative causation

JEL codes: E61, F32, O16

### **1. Introduction**

Real and financial BPCs correspond to international financial and monetary system different phases. Currently, the predominance of financial flows and excess financial elasticity installs a scenario of lengthy and sharper cyclical global crises. This fact explains partially increases in foreign assets resident's holdings in majority of countries, so in Argentina ("capital flight").

Throughout the work we submit some conceptual frameworks, among them:

- BPC first formulation attempts formalized by argentine authors.
- Original BPC Thirlwall model (1979).
- Extensions of the model including their latest versions.

In section 1 the paper explores first and traditional BPC linked to current account. Financial openness is addressed in section 2 while in section 3 the paper tackles some macroeconomic identities to include capital flows. Foreign assets purchases by residents is commented in section 4 with some references to Argentina. Conclusions are developed in section 5.

## 2. Traditional Constraint — Current Account

Literature about economic growth Balance of Payment's Constraint (BPC) recognizes background in the writings of Roy Harrod (1933) and Nicholas Kaldor (1973).

A group or Argentinean economists, exploring difficulties for Latin America's development, settled pioneers

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contributions: Raúl Prebisch (1949, 1988), Oscar Braun (1968), Carlos Díaz-Alejandro (1963), Aldo Ferrer (1963) and Marcelo Diamand (1972, 1973).

In 1979 appears Professor Anthony Thirlwall seminal work, the first of a significant series (McCombie & Thirlwall, 1997; Thirlwall, 1997, 2012, 2014; Gouvea & Lima, 2010). In a Keynesian approach with demand driven economic growth, using simple analytical terms, it raises that, unless a country could borrow indefinitely from abroad, its long-term growth rate will be limited by its external performance; more precisely by income-elasticity of imports and the pace of expansion of exports. Therefore external trade deficit at current account became a third kind of economic growth constraint itself, in addition to effective demand insufficiency and lack of resources (supply).

In following paragraphs we'll briefly describe this current account deficit, reflection of structural constraints, based on the system of equations extracted from Porcile et al. (2003).

From traditional macroeconomic models, in an economy without government, macroeconomic balance stems from income (Y) equalization with consumer spending (C) plus investment (I) and net exports (X - M).

(1) Y = C + I + (X - M)

From this equality, external trade deficit (M exceeding X) equals the surplus spending added (C + I) on domestic income (Y).

(2) -(X + M) = C + I - Y

Introducing (Y) distribution in a kaleckian framework, profits (P) income share is (b) and (W) is wages bill. Consequently, from the point of view of its distribution, income (Y) is identical to wages (W) plus benefits.

- (3) Y = W + P
- (4) P = b Y
- (5) W = (1-b) Y

Additional assumption, marginal propensity to save of workers = 0 means, in Kalecki's words, that workers do not save, they "spend what they earn". Workers consumption (Cw) equals total wage bill (W) and capitalist consumption (Cp) is (1 - s) of total profits will, being (s) the marginal propensity to save. Therefore, capitalist consumption will depend on this coefficient (s) and profit share (b).

- $(6) \qquad C = Cw + Cp$
- (7) Cp = (1-s) P = (1-s) b Y = b Y s b Y
- (8) C = Y b Y + b Y s b Y = Y s b Y = Y (1 s b)

Current account balance can be explained by the evolution of real variables: income (Y) distribution and propensity to save of benefits. Therefore, trade deficit represents the excess of what capitalists invest over their savings from benefits. On the contrary, trade surplus would be equivalent to an excess of the saved percentage of profits.

- $(9) \qquad -X+M=Y-s \ b \ Y+I-Y$
- (10) -X + M = I s b Y

In a closed economy there will be no deficit and, with positives savings, investment rate (which in turn determines growth) will be lower than profit rate. But in an open economy, the deficit make feasible a growth rate higher than profit rate. Opening the economy allows the country's growth rate to increase so current account deficit is capital imports need to expand the economy at a rate higher than which would correspond to a closed one, given the capitalists profits share and marginal propensity to save.

Rounding it off, in this approach balance of payment's financial flows have compensatory character,

representing foreign debt of domestic firms financing capital goods beyond domestic benefits and consumption possibility.

#### 3. Financial Constraint - Capital Account

Since 1980s decade economic literature had been providing models expanding and adjusting Thirlwall seminal version, as well as empirical tests: Thirlwall & Dixon (1979); Krugman (1979); Thirlwall & Hussain (1982). This latter model is specifically elaborated to investigate, on empirical observations, a group of countries with lowers growth rates than predicted BPC ones. In addition to exports, the growth rate can also be increased by capital inflows, which "loosen" external trade constraint. But as in empirical tests carried out by Thirlwall, even with positive net financial flows, generally the observed growth was lower than expected rate.

Elliot & Rohdd (1999) includes payments of external debt services in the model. In short term capital flows "loosen" external constraint but, they can lead to the accumulation of debt and interest liabilities over time. In fact, before the reforms carried forward by many countries in the 1990s decade, external debt-financed consumption was a common economic figure. The conclusion is that economic growth is not only restricted by exports and capital flows, but also adversely affected by debt service payments, that removes essential resources.

Series of papers as McCombie & Thirlwall (1997), Moreno-Brid (1998, 2003), Barbosa-Filho (2006, 2012) included a new international financial markets liquidity constraint: international currency issued by the hegemonic country. Productive performance of countries, and consequently his current account, tend to adapt to external financing availability. Therefore, growth rate and also exchange rate are restricted variables, which must conform international financial conditions and in turn determine final external balance regardless trade flows.

In Porcile, Curado & Bahry (2003) financial sector restrains underdeveloped economies growth. Capital flows to Latin America in the 1990s defused financial constraint and elevated growth rates beyond balance of payments limits. However, this expansion increased foreign debt stock and raised risk of default, speculative attacks, exchange rate crises and finally effective default. Monetary policies could not avoid it by increasing interest rates.

Minsky literature (1992) complete the analysis including "financial fragility" (Foley, 2003). Depending on expected (income/debt) ratio, Minsky distinguishes three kinds of financial units: edge (income covers depreciation and debt services), speculative (income pays only debt services) and Ponzi if expected incomes are even insufficient for interest payments. Internal mechanisms based on returns of investment's expectations and its relationship with interest rates are fundamental in driving financial units to a Ponzi situation. Initial stability with lowers short-term interest rates and expected returns of investments in capital, draws an optimistic environment that stimulate indebtedness and leads to a preponderance of speculative or Ponzi units. In Foley's view, monetary policy aimed at raising the interest rate above this equilibrium level, drives a speculative system to recurrent crisis.

Barbosa Filho (2006) links differential in growth rates and interest rate. When the former is positive Central Bank would raise interest rate weakening the economy financial position and thus encouraging Ponzi behaviors. Therefore, open economies are likely to suffer recurrent financial crises, because the entrance of foreign capital modifies the behavior of the interest rate, enlarging indebtedness ratio of the economic system. Barbosa Filho's model includes, among other variables, (risk on debt premium, usually called country risk premium), three coefficients which are calculated as ratios on income: benefits and net dividends payments to foreigners, net

capital inflows to the country in the form of bonds with interest purchases by non-residents and net FDI (Foreign Direct Investment) inflows.

#### 4. Financial flows, National Accounts and Balance of Payments

Borio (2014) distinguishes two prevailing views in the analysis of international financial imbalances and consequent crisis. The first, influential in political circles, points to current account and attributes 2007-2008 crisis to a "savings glut" in emerging market economies, financing trade deficit of advanced industrial economies. Analysts cares about the impossibility of reverse current account imbalances and the asymmetry between debtor and creditors countries. Debtors are compelled to adjust their economies while creditors accumulate surpluses in the form of reserves and would drives to a deflation or global downturn. This view resembles Keynes in a 1941 memo entitled "Post war Currency Policy".

The second approach focuses an alleged lack of safe assets, which significantly stimulates a strong precautionary demand for currency reserves, with equal potential danger of a recession. It also ends up highlighting the role of the current account, although recommends tax adjustment so that the State can issue safe assets in sufficient quantities.

Both diagnoses agree in that dollar as international currency makes worse the situation.

Borio and Disyatat (2011) advocates a third alternative vision, giving capital account (actually financial account, by IMF methods) a prominent role. Financial flows can't be interpreted uniquely as compensatory counterpart of the current account deficit. "Savings gluts" interpretation incorrectly identifies ex-post saving with the availability of ex - ante funding, both in any country and in the global system.

In national account recording income use/disposal, saving is not consumed income. Ex-post saving must be identical to ex-post investment. Considering investment as non-planned variation of inventories is a simple way to illustrate this identity (Bhaduri, 1990). But in a monetary economy, with financial institutions creating debt money, previous savings aren't necessaries to finance investment. The production of goods of capital, as an ex-ante expenditure decision, require prior funding availability.

It is possible that, at a given period, product is totally consumed. Consequently saving is null and also investment, because there will be no unwanted stock of produced. However, such production process had to be planned and materialize given previous existence of financing (credits and loans, assets and liabilities). This funding sources are necessary to remunerate production's factors and even to facilitate consumption, before that purchases and sales can mobilize means of payment (Disyatat, 2010).

Therefore, changes on debits and credits, financial assets and liabilities at any period, are unrelated to saving (and investment) ex - post defined in the national accounts. Increased saving can be null in a period and, however, assets and liabilities change. These changes, by definition, have turned net zero for the system: debt issued by a sector (passive) stands as a holding (credit) on the other. Normally these operations exceed in value on saving and investment of any period. In addition, the stock of credit to the private sector historically tends to grow faster than product in a process called "financial deepening" (Goldsmith, 1969).

This difficulty in distinguishing clearly between saving and investment is due to two "inappropriate" economic analysis. One is projecting conclusions valid only for a single agent automatically to the whole economic: fallacy of composition. A single agent earns an additional income and decide to save it (accumulated) buying a real asset (a building for example) or a financial asset (shares or debt securities). But these saving and

accumulated assets, are another/s individual/s dissaving, reduction of active or passive. Purchase and sale of assets existing, (financial or real) aren't directly associated with the generation of income (product) and national accounts. They have their own dynamic, different from production dynamics. Financial assets (stocks and securities) prices are determined in securities markets and not by saving/investment decisions inside the production chain.

The second "mistake" arises from the use of generalized analytic structures, limited to "real" economy, ignoring monetary phenomena (Schumpeter, 1954). This implies assuming real investment financed only with savings: surplus units transferred it to deficit investing ones, so production and investment demands previous resources. Banks and financial intermediaries assign but don't create any kind of money.

In open economies under current international financial system, this matching saving – financing drives to confuse balance of payments analysis. Financial flows have a much more substantial meaning than mere compensation of current account deficit and net amounts only capture a small fraction of global financial flows.

Transactions involving only financial assets trade and not related to current account movements explain the main volume of cross-border financial activity. In fact, an economy with balanced current account may be involved in financial intermediation on a large scale (take foreign credits and loans abroad). Although capital flows, (computing net balance of all income and expenditures), are identical to current account balance plus net reserves variation, they have independent dynamics from commercial operations and payments to production factors.

Following Borio (2011), balance of payment's identity can be written:

Net change in current account = increase/decrease in resident's external assets (gross outflow or inflow) – increase/decrease in no-resident's debt (gross outflow or inflow) = net capital outflow or inflow = saving – investment.

This way, current account balance equals net resources flow between any country (defined using residence concept) and the rest of the world; in other words "net capital flow".

Trade surplus would reflect an accumulation of currencies, stocks or securities by residents, i.e. a net increase in their rights over non-residents from the rest of the world and therefore imply an excess of savings over investment in the country. At the same time, net capital flow is identically equal to net purchases of foreign assets by residents minus net purchase of domestic assets by non-residents.

As previously stated, gross flows do not necessarily relate to net flows and hence to the current account. Even assuming a trade-closed economy, net balance from financial operations is the final result of multiple transactions involving entrance and outflows of foreign exchange, and is therefore lower than its total amounts. At the same time, gross flows also show net operations that are compensated, capturing only a small fraction of transactions between residents and non-residents.

Net flow (1) = gross outflow (foreign assets resident's purchases) - gross inflow (foreign assets resident's sales) = net inflow or outflow for acquisitions and sells of foreign assets.

Net flow (2) = gross inflow (external debt increase/residents liabilities increasebonds issuing) – gross outflow (external debt decrease/ residents liabilities decrease/rescue of bonds). = net inflow or outflow (increase and decrease of external liabilities).

Net Capital inflow or outflow = Net Flow (1) + Net Flow (2)

#### 5. Foreign Assets and Currency Flight

Cross-border financial flows, prominent in nowadays global finances, are analyzed in Argentina by "Economics and Finance for Argentina Development Center" (CEFID-Ar) researchers and "External Debt and Capital Flight Program" (FLACSO Buenos Aires) (Gaggero J., Casparrino & Libman, 2007; Gaggero J., Kupelian & Zelada, 2010; Gaggero J., Rua & Gaggero A., 2013; Grondona & Gaggero J., 2014; Rúa & Gaggero J., 2014; Gaggero J., Grondona & Burgos, 2015; Gaggero A., 2015; Basualdo, Manzanelli, Barrera, Wainer, & Bona, 2015).

Capital outflows between 2006 and 2015, a period of notorious economic growth, prompted analysts to focusing financial outflows by residents: purchases of external assets, money-laundering, under-invoicing of exports and over-invoicing of imports, profit remittance. Besides, given actual structure of foreign trade, it is difficult to distinguish commercial from financial operations, because primary/agricultural commodities also are financial assets traded in futures markets. Financial outflows were largely composed of currencies from external trade surplus, which wasn't accumulated domestically but increased non-financial private resident's external assets. From 2007 to 2009, along the international crisis, CEFID-Ar estimated that this mechanism soak up 80% of external assets from external trade. In an obvious vicious circle, currency flight has a negative impact on internal investment worsening future growth constraints.

Economic Commission for Latin America and Caribe (ECLAC-CEPAL, 2014) addressed the impact of the financial crisis in Latin America (Jimenez & Fanelli, 2009; Velloso, 2016). In "all channels by which Latin America is connected with the international economy" papers include capital flows "sudden stops". In times of crisis "net out" or capital flight affect almost whole "south" of the world.

At international scope, the financial system shows a clear trend: remarkable growth in external assets positions of non-residents. Associated to liberalization and deregulation, that increased cross-border financial flows affects all economies (Sinn, 1990; Rider, 1994; Lane & Milesi - Ferretti, 2001).

Net transfers of resources from poor and "intermediate development" countries to developed ones, show an especially clear trend of sustained growth. The statistics of CIDSE (International Cooperation for Development and Solidarity, an organization of Catholic agencies) points out a number: 46.000 million dollars in 1995 which amounted to 660.000 million in 2006, the year prior to the start of the crisis (CIDSE, 2006). According to these data, on a hypothesis described as very conservative, CEFID-AR assume that the annual value of these transfers has exceeded the trillion dollars during the crisis years.

Clearly we need to further deepen theoretical research and empirical tests about capital flight in its diverse and multiple forms, especially foreign asset's purchase by residents, a fundamental feature in current international financial system. In that sense is worthy quoting two models. One is Barbosa Filho (2006) already analyzed and other more recent developed by Andrés Asiain (2011).

The first includes, among other variables, net capital inflows to the country by interest-bond purchases from non-resident and also net capital inflows as FDI (Foreign Direct Investment) both normalized by income. Debt constraints trade balance and the model determines a (currency) liquidity index needed to face it. Assuming that the country benefits with a net inflow of foreign capital through the sale of bonds, the consequent increase in the perception of a likely risk of currency crisis forces the country to increase their net exports. If the net flow of capital is negative (capital flight), as a result of the increase in purchases of foreign assets by residents, consequent pressure on commercial sector will be higher.

Andrés Asiain (2011), following Marcelo Diamand's seminal work, proposes an open economy model, with a

primary export sector and an industrial sector. While the production of the primary sector is determined from the supply side (by limiting it to the availability of land) given the possibility of exporting all production not consumed internally, industry had to resolves its production level considering and facing effective demand for industrial goods. In general terms, this description fits with what Diamand branded as Unbalanced Production Structures (UPS-EPD). However, both sectors carried out a similar behavior: spend their profits (after productive investments requiring capital goods imports) in real estate investments at domestic economy or in acquisition of external assets. On the basis of comments made in the preceding paragraphs, this is the key aspect to observe the implications on the whole system of these foreign asset's purchase.

On these assumptions the model analyzes traditional economic policy impact over the two sectors, balance of payments and the whole economy. A devaluation would have expansionary effects. An increase in the benefits of the primary sector could enlarge real estate investments in the domestic economy. Substitution of expensive imported consumption goods rises domestic demand. Possibly there would be an increase in industrial export's volumes. But on the other hand, contractive effects could be greater, as a consequence of the reduction in the purchasing power of wages (the devaluation implies rising prices of wage-goods, especially food) and the possible decrease in investments by the price increase of imported capital goods.

From a kaleckian framework considering saving's particular behavior of different social groups, devaluation implies a redistribution of income from workers to employers and landlords. Setting some kind of "export taxes" would be an economic policy tool to put pressure in the opposite direction. These distributional effects are not normally considered by traditional aggregative models.

Impact on external accounts is also ambiguous. Replacement and reduction of imports of consumer goods and possible greater industrial exports volume would enlarge internal effective demand, product and national income, although industrial non-traditional exports prices would be lower by the devaluation. Reduced value in currency of industrial sector benefits and its remittance of profits would have a positive impact. Enlarged remittance of higher export's profits would go in the opposite direction.

It's clear then, that switching capital's outflows exerts new pressure on any country, consolidating a new variant of external constraint. Consequences on balance of payments must be object of careful analysis. They can't be seen merely as an exogenous flow of foreign currency to the rest of the world. Its relationship with domestic productive activity makes its reaches deeper. Inside this scheme, both the improvement of international prices, devaluation, as any other economic policy changing income's distribution to higher profits, will result in higher outflows of currency by external financial asset's acquisition.

As already mentioned, traditional policy's effects, aimed at improving the country's external position, could be smaller than government's expectative and will depend on sector's propensity to increase their production of tradable goods and replace imports, either from the contraction of the product as a consequence of the fall in real wages.

### 6. Concluding Remarks

Earlier versions of BPC, extensively discussed during 1960s and 1970s, focused a new constraint to developing economies growing possibilities, different from traditional ones: Balance of Payment Constraint (BPC). The analysis interpreted that domestic capital resources were not sufficient and appeared as a current account deficit, reflecting external capital's needs to stimulate income growth. Sources of economies growing

difficulties were "real" ones.

During the 1980s, valuable "enlargements" of the original model incorporated a "financial sector", thus including "constraint of constraint", because capital flow came from the issuance of debt, a continuously increasing stock. Indebtedness put forward bigger troubles to countries. Initially foreign capital inflows loosen BPC, improve account's performance and made real growth possible for the economy. But finally result in new restrictions, now financial ones.

In parallel with the processes that characterized a radical change of the international financial system, models reflected states and private indebtedness in underdeveloped countries, which had a noticeable growth until the mid-1990s.

New models and empirical tests, multiplied during 2007-2009 crisis, necessarily deal with an accelerating trend: financial globalization enlargement and deepen. Researchers had to consider actual context, especially dollar as international currency and financial cross-border remarkable flows growth, in turn resulting from purchases of foreign assets by residents widening.

Following Borio et al. (2014) consolidation of these trends demands a change at core of BPC analysis: from the current account to balance of payment's financial account, in a reversal of first model's causality: now it has to go from financial account to current account and especially to trade balance.

But changes have to be more essential. According to the international stage sketched above and its impact at external links of nations, balance of payments is insufficient as a reference for empirical studies. These should include net international investment position and requires observing carefully foreign currency gross flows resulting of purchases and sales of foreign assets. And even balance sheets of companies and banks. So the notion of external constraint expands significantly.

Formal growth models consider growth rate as an endogenous variable that had to fit with balance of payments current account. But beyond all that, growth rate happens to be also determined by movements in purchases/sales of foreign assets and other capital flows alternatives, which are in turn a consequence of growth process itself since they arise from domestic savings. In Myrdal's words (1957) we are facing a "cumulative causation process (CCC)" (O'Hara, 2008). This link growth — external sector have becomes more complex, raising the need to replace equilibrium models by these cumulative causation ones.

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