The Balance of Payments

The BOP provides a record of a country's trade with other countries, and shows its imports and exports. A **current account deficit** is when more money is leaving the country than entering it, as a result of sales of its exports, income and transfers from abroad being less than imports and income and current transfers going abroad.

The most useful part of the BOP shows the trade in goods and services. A deficit in the trade in goods and services means that more has been spent on imports than has been earned from exports, and may mean poor economic performance. The country's goods and services may be uncompetitive in terms of price or quality, or the country may be producing goods that there is a low demand for.

In the past, governments placed a lot of emphasis on achieving a satisfactory BOP position. Nowadays, they may be less concerned in the short term if import expenditure exceeds export revenue if this deficit is likely to be self-correcting. For example, a country may import a lot of raw materials, but may turn these into finished products for export. A current account deficit may also be offset by a net inflow of investment into the country. In the longer term though, the government will want to see an increase in the international competitiveness of the country, in order to keep AD and output high.

The main elements of the BOP are:

1.**The current account**. This is the part which people are more familiar with, and measures trade in goods and services (the **net trade balance**), income and transfers. Trade in goods measures the earnings from exports and the expenditure from imports of goods, and is referred to as the **visible balance**. Trade in services is called the **invisible balance**, as services are intangible. The UK tends to have a surplus in the invisible balance and a deficit in the visible balance. The income part of the current account is mainly investment income. The UK normally has a surplus on this, meaning that its residents earn more in terms of profit, interest and dividends on their investments abroad than foreigners do on their investments in the UK. Transfers cover the transfer of money made and received by the government and individuals. For example, government payments to and from the EU, and money sent out of the UK by foreigners working in the UK to relatives abroad.

2. **The capital and financial accounts** show the movement of direct investment – for example, the setting up of businesses, and portfolio investment, e.g. the purchase of shares and bank loans between the country and abroad

3. **Net errors and omissions**. This is added to make sure that the BOP does balance, as some mistakes will inevitably be made and some things missed out.

The balance of payments sums to zero overall, and a current account deficit or surplus will be matched by compensating flows on the capital and/or financial accounts.

The Causes of a Deficit in the net trade balance

A deficit on the net trade balance occurs when the country's expenditure abroad exceeds its revenue from abroad. This could be because the inhabitants have spent more on goods and services from abroad than people overseas have spent on the country's products, or because there has been a net outflow of investment income.

A negative trade balance can lead to a deficit in the current account, depending on what is happening to income and transfers.

Causes of a deficit include:

- Changes in real income at home. When incomes rise in a country, there tends to be more demand for imports. Also, if incomes are falling, then demand for the country's exports is likely to rise. Therefore, economic growth can cause a current account deficit. A deficit caused by changes in income is called a **cyclical deficit**
    - changes in real income abroad. If other countries have a fall in income, then these countries will import less from the UK. This can lead to a current account deficit.
- Changes in the exchange rate. A rise in the value of the £ may result in a deficit, as it will raise export prices and lower import prices, so exports will fall and imports will rise
- Structural problems. This is the most serious cause of a deficit, as it may persist. A structural problem means that the country is charging too much (this could be due to low productivity or high factor costs, for example), has produced low quality products, or is not producing what people want.
- An outflow of investment income will occur if the investments that foreign residents have made in the country earn more than investments the country's inhabitants have made in other countries. Whether this happens will be influenced by factors including the relative amount of investments made and the level of profit, interest and dividends made on the investments
- Protectionist policies, e.g. other countries putting tariffs on exports from that country

- Changes in industrial structure. A country which has industrialised will manufacture a lot of goods. This will allow them to export more, and mean that they will import less. When countries deindustrialise, they may produce fewer goods for export

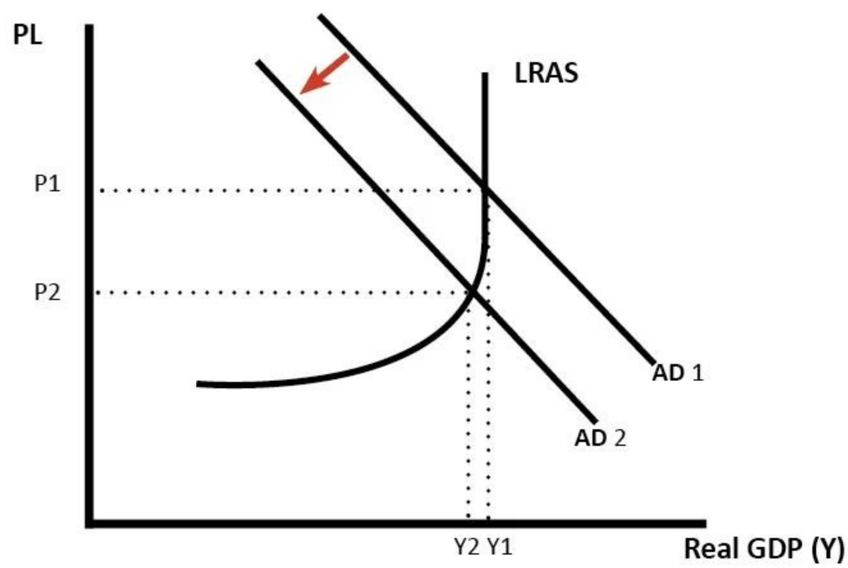
- Changes in comparative advantage. You will cover comparative advantage more next year. However, countries have a comparative advantage when they can produce a good at a lower opportunity cost than another country. if a country has a comparative advantage in a good, but another country then becomes a more efficient producer, then their exports may fall

The converse will cause a surplus. A surplus may arise from the strength of the economy, a change in the exchange rates or because the country is a net earner of investment income. The country is likely to have a surplus if its products are of high quality, are produced at a low cost, and are what consumers are demanding. It could also be caused by a fall in the exchange rate.

However, a surplus can also be caused by a recession! This is because, as incomes fall, people in that country will buy fewer imports. Also, due to decreasing demand in domestic markets, firms will try even harder to sell abroad.

The consequences of current account imbalances

A current account deficit means that a country is consuming more than it produces. The income from this extra consumption is going to people abroad. If a deficit increases, then AD will be decreased, as the diagram below shows. This is because exports – imports are a part of the balance of payments.



This will lower the economy's output, be likely to raise unemployment, and may put downward pressure on the price level. A rise in the deficit is also likely to lead to a fall in the value of the currency and increase the debt of the country. However, the country's inhabitants will be able to enjoy more goods and services than their country is producing, although this is adding to the demand, output and employment in the other country rather than their own.

A surplus means that a country is consuming less than it is producing and is having a net inflow of money and income. This increase in money supply will mean that banks have more money, which can increase bank lending. Net exports will be increasing. This will raise AD and be likely to increase the exchange rate.

How significant a current account deficit is depends on:

- Its size relative to the size of real GDP

- Its duration. If the deficit is quickly followed by a surplus, then this surplus can be used to offset the deficit, and this also indicates that there are no major weaknesses in the economy

- Its cause. A deficit may indicate a growing and healthy economy, or one with structural problems. If output is increasing, then more foreign raw materials may be bought for a time, and the higher income may also result in more imports of finished goods. On the other hand, an economy with a high inflation rate and low productivity may also have a deficit, but this is more serious. There may be weaknesses in the country meaning that foreign goods are more attractive than British ones (e.g. due to quality or price).With a floating exchange rate, a structural deficit would result in a fall in the value of the currency, which could in theory mean that UK goods become more attractive to other countries again as they will be cheaper. However, if the goods are still not seen to be attractive, the deficit will still occur and the country's output and employment are likely to be below their potential levels.

- What is happening in the capital and financial account parts of the BOP. If there is a current account deficit, but the country is attracting Foreign Direct Investment (FDI) and has a net inflow of portfolio investment, then the value of the £ and the strength of the economy will still be stable despite the current account deficit.

The Balance of Payments Questions

1. What does the balance of payments show?

2. Explain the 3 parts of the balance of payments

3. What is the difference between a current account deficit and a current account surplus

4. Analyse the effect that a recession in the UK would have on the UK current account (4)

5. Analyse the effect that a recession in the US would have on the UK current account (4)

6. Analyse the effect that a fall in the value of the £ would have on the UK current account (4)

7. Explain what is meant by a “structural problem” which can lead to a current account deficit

8. Analyse why a current account deficit may be undesirable for an economy (6)

9. Analyse two reasons why a current account deficit may not always be a huge problem for an economy (8)