The Balance of Payments

AQA A Level Economics
Revision Notes

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Components of the balance of payments

This is a record of all financial transactions made between consumers, firms and the government from one country with other countries.

It states how much is spent on imports, and what the value of exports is.

Exports are goods and services sold to foreign countries, and are positive in the balance of payments. This is because they are an **inflow** of money.

Imports are goods and services bought from foreign countries, and they are negative on the balance of payments. They are an **outflow** of money.

The balance of payments is made up of:

- **The current account:** This includes all economic transactions between countries. The main transactions are the trade in goods and services, income and current transfers.
- **The capital account and financial account:** Capital transfers involve transfers of the ownership of fixed assets. The financial account involves investment. For example, direct investment, portfolio investment and reserve assets are part of the financial account.
- **Balancing item:** The components of the Balance of Payments should balance. That is, the sum of the accounts should be zero. Where there are imbalances, a balancing item is used to cover the discrepancies.

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Current account deficits and surpluses

A current account surplus means there is a net inflow of money into the circular flow of income. The UK has a surplus with services, but a deficit with goods.

The UK has a net current account deficit. This means the UK spends more on imports from foreign countries, than they earn from exports to foreign countries. If the deficit is large and runs for a long time, there could be financial difficulties with financing the deficit.

Causes of balance of payments disequilibrium

- **Appreciation of the currency**: a stronger currency means imports are cheaper and exports are relatively more expensive, which means the current account deficit would worsen.
- **Economic growth:** when consumer incomes increase, demand increases. This could increase demand for imports. This is especially true of a country such as the UK, where consumers have a high propensity to import.
- **More competitive:** if a country becomes more internationally competitive, such as with lower inflation or if there is economic growth in export markets, exports should increase. This also occurs when a country becomes more productive, since that causes average unit costs to fall. This could cause the current account deficit to improve, or increase the current account surplus.
- **Deindustrialisation:** In the UK, the manufacturing sector has been declining since the 1970s. The goods that the UK previously made domestically now have to be imported, which worsens the deficit.
- **Membership of trade union:** The UK has traditionally had negative current transfers, since fees are paid for membership of the EU.
- **Attractiveness to foreign investors:** A capital account surplus could be caused by incoming finance from investors buying UK bonds, securities and financial derivatives. This could help fund a current account deficit.

By definition, where there is a current account surplus, there is a capital and financial account deficit. A current account deficit means there will be a capital and financial account surplus.

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By selling more exports to foreign countries, the UK will have a greater inflow of money into the circular flow of income. This will increase AD and improve the rate of economic growth.
In the UK, during periods of economic decline or recessions, the current account deficit falls. This is because consumer spending falls.
During periods of economic growth, when consumers have higher incomes and they can afford to consume more, there is a larger deficit on the current account.
If imported raw materials are expensive, there could be cost-push inflation in the UK, since firms face higher production costs.
When the pound appreciates, imports become relatively cheaper and exports become more expensive.
If the UK becomes more productive, the UK will be more internationally competitive. This causes exports to increase relative to imports.

The consequences of investment flows between countries

FDI is the flow of capital from one country to another, in order to gain a lasting interest in an enterprise in the foreign country.

FDI can help create employment, encourage the innovation of technology and help promote long term sustainable growth. It provides LEDCs with funds to invest and develop.

Portfolio investments are passive such that control over the company is not gained. The investment aims to make a financial gain. FDI, on the other hand, allows the investor to gain some control over the firm. It includes finance such as pension funds, hedge funds and stock market money flows.

The policies that might be used to correct a balance of payments deficit or surplus

Fiscal policy:

If there is a deficit on the current account, income tax could be increased. This will reduce the amount of disposable income consumers have, which will reduce the quantity of imports. However, it might also impact domestic growth, since consumers will also spend less on domestic goods.
Governments could also reduce their spending. This would reduce AD and lead to less imports. It forces domestic firms into increasing exports, which helps improve the disequilibrium.
Fiscal policy is effective in the short term, but not so much in the long term. As soon as the policy measures end, household are likely to revert their expenditure back on imports.
If taxes are imposed on trading partners, there is the risk of retaliation, which could reduce demand for exports, too.
Governments might have imperfect information about the economy, so it could lead to government failure.
If 'green taxes' are implemented, such as carbon taxes, or if there are minimum prices on pollution permits, the competitiveness of domestic firms could be compromised. This could reduce exports from domestic firms.

Monetary policy:

Expenditure-reducing and expenditure-switching

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Expenditure-reducing policies aim to reduce demand in the economy, so spending on imports fall.
Expenditure-switching policies aim to switch consumer spending towards domestic goods, and away from imports.

Reducing the growth of the supply of money in an economy can be expenditure-reducing or expenditure-switching.
If there is a current account deficit, the bank might lower interest rates to cause depreciation in the currency. This causes exports to become cheaper, but it could be inflationary for the domestic economy. Moreover, hot money might flow out of the country, since investors are not receiving a high return on their investment.
High interest rates could be expenditure-reducing, since the demand for imports falls and inflation might fall.
Changing the exchange rate could be a government expenditure-switching policy.
However, it is hard to control the supply of money in reality. Moreover, there is a significant time lag with changing the interest rate and seeing an effect.

Supply-side policies:

Supply-side policies could help increase productivity with increased spending on education and training, which could result in the country becoming more internationally competitive. This could lead to a rise in exports. However, this incurs a significant time lag, so it is not effective as an immediate measure. In the long term, this can be an effective policy.
Supply-side policies could also help make the domestic economy attractive to investors.
The domestic economy could be made more competitive through deregulation and privatisation, which will force firms to lower their average costs. However, privatisation could result in monopolies being formed, which will not increase efficiency.
If governments provide subsidies to some industries to encourage production, there could be retaliation from foreign countries that see this as an unfair protectionist policy.

The significance of deficits and surpluses for an individual economy

If imported raw materials are expensive, there could be cost-push inflation in the domestic economy, since firms face higher production costs.

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International trade has meant countries have become interdependent. Therefore, the economic conditions in one country affect another country, since the quantity they export or import will change.

A surplus or deficit on the current account could indicate an unbalanced economy, and it could mean the country is too reliant on other economies for their own growth.

It could be difficult to attract sufficient financial flows in order to finance a current account deficit. This could make it unsustainable in the long run.

The implications for the global economy of a major economy or economies with imbalances deciding to take corrective action

An imbalance suggests that the UK is reliant on the performance of other countries. If export markets, such as the EU, become weak, UK economic performance will be affected. This was seen during the 2008 financial crisis.

It could become difficult to finance the deficit in the long run. In the US, the current account deficit is financed by Chinese investors buying US securities at low interest rates. If they lose confidence in the US economy, they would stop buying US debt. The interest rates would then have to be increased to encourage investors to buy the debt. This would be damaging to US consumers who have a lot of debt, since repayments would increase, and they would have less disposable income as a result.

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In the Eurozone, current account deficits are of greater concern because the countries have a fixed exchange rate. This means they cannot devalue the currency to restore their level of international competitiveness.

Since 2006, the US deficit with China narrowed and China's surplus also fell. A surplus indicates low consumer spending and a low savings ratio, which puts China at the risk of having unsustainable economic growth. However, the government now aims to grow the economy using domestic spending, rather than exports.

China made their exports more competitive by undervaluing their currency. This makes their imports more expensive, however, so it could be inflationary and cause a boom or bust. A stronger Yuan causes lower growth, lower inflation and reduces the current account surplus. The US would prefer a stronger Yuan since it makes their domestic industries more competitive.