SL IB Economics

Your notes

4.6 Balance of Payments

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An Introduction to the Balance of Payments

- The **Balance of Payments (BoP)** for a country is a record of all the financial transactions that occur between it and the rest of the world

- The **BoP** has two main sections:
  - **The current account:** all transactions related to goods/services along with payments related to the transfer of income
  - **The financial and capital account:** all transactions related to savings, investment and currency stabilisation

- Money flowing into an account is **recorded** in the relevant account **as a credit (+)** and money flowing out **as a debit (-)**
  - If more money flows into an account than out of it, there is a **surplus** in the account
  - If more money flows out of an account than into it, there is a **deficit** in the account

The Current Account

- The Current Account is often considered to be the **most important account** in the BoP
- This account records the **net income** that an economy **gains from international transactions**

An Example of the UK Current Account Balance for 2017

Component	2017
Balance of trade in goods (exports - imports)	£-32.9bn
Balance of trade in services (exports - imports)	£27.9bn
Sub-total trade in goods/services	**£-5bn**
Net income (interest, profits and dividends)	£-2.1bn
Current transfers	£-3.6bn
Total Current Account Balance	**£-10.7bn**
Current Account as a % of GDP	3.7%

- **Goods** are also referred to as **visible** exports/imports
- **Services** are also referred to as **invisible** exports/imports
- **Net income** consists of income transfers by citizens and corporations
  - Credits are **received from UK citizens** who are abroad and send remittances home
  - Debits are **sent by foreigners** working in the UK **back to their countries**
- **Current transfers** are typically payments at **government level** between countries e.g. contributions to the World Bank

The Capital Account

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- The **Capital Account** records **small capital flows** between countries and is relatively inconsequential
- The capital account is made up of two sections:

1. **Capital transfers**
   Smaller flows of money between countries
   E.g. **Debt forgiveness** payments by the government toward developing countries
   E.g. **Capital transfers** by **migrants** as they emigrate and immigrate

2. **Transactions in non-produced, non-financial assets**
   Small payments are usually associated with royalties or copyright e.g. royalty payments by record labels to foreign artists

The Financial Account

- The **Financial Account** records the flow of all transactions associated with changes of ownership of the country's foreign financial assets and liabilities

- It includes the following sub-sections

1. **Foreign Direct Investment (FDI)**
   Flows of money to purchase a controlling interest (10% or more) in a foreign firm. Money flowing in is recorded as a credit (+) and money flowing out is a debit (-)

2. **Portfolio Investment**
   Flows of money to purchase foreign company **shares and debt securities** (government and corporate bonds). Money flowing in is recorded as a credit (+) and money flowing out is a debit (-)

3. **Official Borrowing**
   Government borrowing from other countries or institutions outside of their own economy e.g. loans from the International Monetary Fund (IMF) or foreign banks. When the money is received, it is recorded as a credit (+) and when the money (or interest payments) are repaid, it is recorded as a debit (-)

4. **Reserve Assets**
   These are assets controlled by the Central Bank and available for use in achieving the goals of monetary policy. They include gold, foreign currency positions at the International Monetary Fund (IMF) and foreign exchange held by the Central Bank (USD, Euros etc.)

Interdependence Between the Accounts

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- It is called the BoP as the **current account should balance with the capital and financial account** and be equal to zero
  - If the current account balance is **positive**, then the capital/financial account balance is **negative** (and vice versa)
  - In reality, it never balances perfectly and the difference is called 'net error and omissions'

- If there is a **current account deficit**, there must be a **surplus** in the **capital and financial account**
  - The excess **spending on imports** (current account deficit) has to be financed from money flowing into the country from the **sale of assets** (financial account surplus)

- If there is a **current account surplus**, there must be a **deficit** in the **capital and financial account**
  - The excess **income from exports** (current account surplus) is financing the **purchase of assets** (financial account deficit) in other countries

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Balance of Payments Calculations

Worked example

The following table provides selected data from the balance of payments for a country in the European Union for the 2018

Data	€ (million)
Net capital transfers	–278
Net current transfers	–179
Net direct investment	351
Exports of services	419
Imports of goods	839
Net investment income	154
Import of services	445
Exports of goods	872

Calculate the current account balance of this country in 2018 [2]

Step 1: Recall the formula for calculating the current account balance
Net trade in goods + net trade in services + net income + net current transfers

The items *'Net capital transfers'* and *'Net investment income'* are not included in current account calculations and should be ignored

Step 2: Substitute the appropriate values

Net trade in goods = (872–839) = 33

Net trade in services = (419–445) = -26

Net income transfers = 154

Net current transfers = -179

Step 3: Complete the calculation

33 - 26 + 154 -179 = -18

(1 mark for the correct working)

Step 4: Check the units and ensure your answer uses the correct units

€-18 m

(2 marks for the correct answer or 1 mark for any correct working)

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