

 **HL IB Economics**

## 4.6 Balance of Payments

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## 4.6.1 Components of The Balance Of Payments

### 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
<b>Sub-total trade in goods/services</b>	<b>£-5bn</b>
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

- 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

- 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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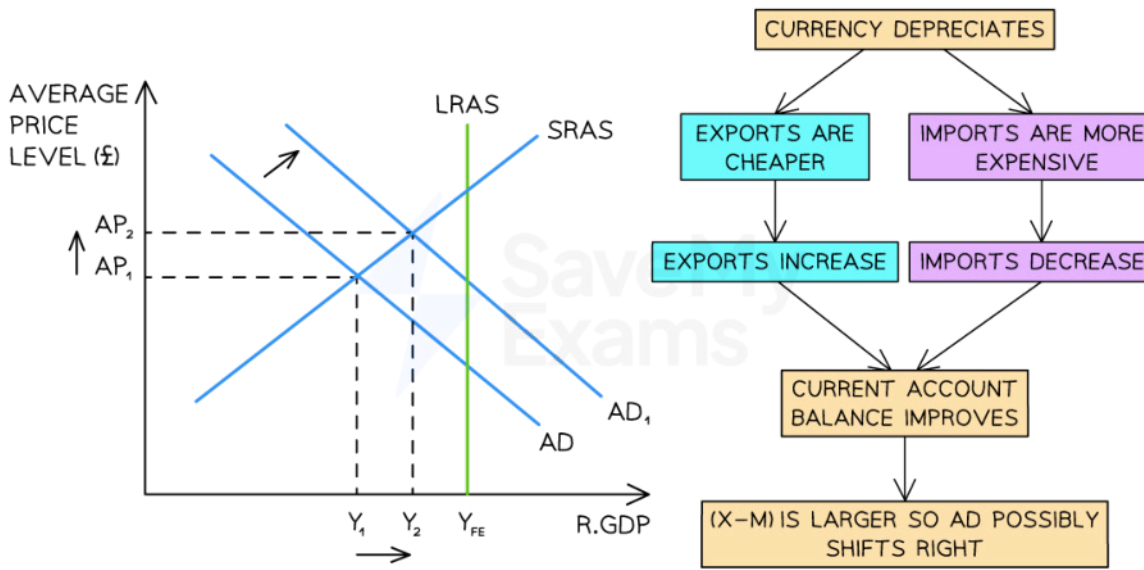
## 4.6.2 Exchange Rates & the Balance Of Payments

# The Relationship Between the Current Account & the Exchange Rate

- The relationship between the **current account** and the **exchange rate** is dynamic
  - Factors such as **trade policies**, capital flows, **global economic conditions** and investor sentiment can influence both the current account and the exchange rate
- The current account and the exchange rate are **closely linked** in international trade
  - The current account **records the value of a country's trade** in goods/services and transfers with the rest of the world
  - The exchange rate determines the **price of a country's currency** in relation to other currencies
- **A stronger exchange rate** makes imports cheaper and exports more expensive
  - When a country's currency appreciates, its exports become relatively more expensive for foreign buyers, potentially leading to a decrease in export volumes
  - Conversely, imports become relatively cheaper for domestic consumers, which may lead to an increase in import volumes
- **A weaker exchange rate** makes imports more expensive and exports cheaper
  - When a country's currency depreciates, its exports become relatively cheaper for foreign buyers, potentially leading to an increase in export volumes.
  - At the same time, imports become relatively more expensive for domestic consumers, which may result in a decrease in import volumes



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### EXAMINER TIP

The impact of a depreciation on the current account is dependent on the price elasticity of demand for the exports and imports (Marshall Lerner condition). See the next page of revision notes for further explanation of this

## Relationship Between the Financial Account & the Exchange Rate

- The financial account measures the inflows and outflows of financial assets, including **foreign direct investment** and **portfolio investment**
- **Changes in the financial account can impact the exchange rate**
  - When there is an inflow of foreign investment into a country, it **increases the demand for the country's currency**, potentially leading to an **appreciation of the exchange rate**
  - Conversely, when there is an outflow of domestic investment to other countries, it **increases the supply of the country's currency** in the foreign exchange market, **potentially leading to a depreciation of the exchange rate**
- The exchange rate influences the attractiveness of a country for foreign investment

- A **stronger exchange rate** makes foreign investments more expensive in terms of the investor's home currency, **potentially reducing the appeal** of investing in that country.
- A **weaker exchange rate** can make a country's assets more affordable for foreign investors, potentially **increasing the attractiveness** of investing in that country



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### 4.6.3 Persistent Current Account Deficits

## Implications of a Persistent Current Account Deficit

- A persistent current account deficit refers to a situation where a country **consistently spends more on imports than it earns from exports**

#### The Impact of Persistent Current Account Deficits

Factor	Implications of a Persistent Current Account Deficit
<b>Depreciating Exchange Rates</b>	<ul style="list-style-type: none"> <li>▪ A persistent current account deficit can put <b>downward pressure (depreciate)</b> on a country's currency as the economy is constantly supplying its currency onto world markets</li> </ul>
<b>Increasing Interest Rates</b>	<ul style="list-style-type: none"> <li>▪ With downward pressure on the currency, the Central Bank may raise interest rates in order <b>to attract foreign/portfolio investment</b> <ul style="list-style-type: none"> <li>▪ The raised rates will encourage demand for the currency which will help it to stop depreciating</li> </ul> </li> </ul>
<b>Increasing Foreign Ownership of Domestic Assets</b>	<ul style="list-style-type: none"> <li>▪ A persistent current account deficit may <b>result in increased foreign ownership</b> of domestic assets <ul style="list-style-type: none"> <li>▪ It can be driven by <b>the need to finance the deficit</b> through foreign capital inflows, potentially leading to a larger share of ownership by foreign entities</li> </ul> </li> </ul>
<b>Increasing National Debt</b>	<ul style="list-style-type: none"> <li>▪ A chronic current account deficit can contribute to the accumulation of external debt as financing is required to fund the deficit</li> </ul>
<b>Worsening International Credit Ratings</b>	<ul style="list-style-type: none"> <li>▪ If the deficit is viewed as unsustainable or indicates weak economic fundamentals, <b>credit rating agencies</b> may downgrade the country's creditworthiness, potentially raising borrowing costs <ul style="list-style-type: none"> <li>▪ Investors can lose confidence in a country's ability to repay any future borrowing</li> </ul> </li> </ul>





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<p><b>Demand Management Conflicts</b></p>	<ul style="list-style-type: none"> <li>A persistent current account deficit may necessitate adjustments in demand management policies and in the process <b>create trade offs</b> <ul style="list-style-type: none"> <li>E.g. It may require measures to curb domestic consumption or stimulate exports to reduce the deficit and rebalance the economy</li> </ul> </li> </ul>
<p><b>Impact on Long term Economic Growth</b></p>	<ul style="list-style-type: none"> <li>A chronic current account deficit can have implications for economic growth                     <ul style="list-style-type: none"> <li>It may signal an imbalance in the economy, <b>relying on external financing</b> rather than <b>domestic productivity and competitiveness</b></li> </ul> </li> </ul>

### EXAMINER TIP



Remember that a current account deficit is different to a budget deficit. A budget deficit refers to the situation in which government spending is higher than government revenue

## Correcting a Persistent Current Account Deficit

- The Government has several options available to them in order to tackle a **current account deficit**
  - They could do nothing, leaving it to market forces in the foreign exchange market to self-correct the deficit
  - They could use **expenditure switching policies**
  - They could use **expenditure reducing policies**
  - They could use **supply-side policies**
- The choice of any policy - or any combination of policies generates both costs and benefits

### Costs & Benefits of Policies used to Tackle Current Account Deficits

Policy Option	Benefits	Costs
<p><b>Do nothing</b></p>	<ul style="list-style-type: none"> <li>Floating exchange rates act as a <b>self-correcting mechanism</b>. Over time a higher level of imports will end up depreciating the currency causing imports to decrease (they are now</li> </ul>	<ul style="list-style-type: none"> <li>There may be other <b>external factors</b> that prevent the currency from depreciating. It may take <b>a long time</b> for self-correction to happen and many domestic industries may go out</li> </ul>



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	more expensive) and exports to increase (they are now cheaper). This improves the deficit	of business in the interim. The longer it takes to <b>self-correct</b> , the more firms will delay investment in the economy
<b>Expenditure Switching</b>	<ul style="list-style-type: none"> <li>This is often successful in changing the <b>buying habits</b> of consumers, <b>switching consumption on imports to consumption on domestically produced</b> goods/services. This helps improve a deficit</li> </ul>	<ul style="list-style-type: none"> <li>Any protectionist policy often leads to <b>retaliation</b> by trading partners. This may consist of <b>reverse tariffs/quotas</b> which will decrease the level of exports. This may offset any improvement to the deficit caused by the policy</li> </ul>
<b>Expenditure Reducing</b>	<ul style="list-style-type: none"> <li>Deflationary fiscal policy invariably reduces <b>discretionary income</b> which leads to a <b>fall in the demand for imported goods</b> &amp; improves a deficit</li> </ul>	<ul style="list-style-type: none"> <li><b>Deflationary fiscal policy</b> also dampens domestic demand which can cause output to fall. When output falls, GDP growth slows &amp; unemployment may increase</li> </ul>
<b>Supply-side</b>	<ul style="list-style-type: none"> <li>Improves the quality of products and lowers the costs of production. Both of these factors help the level of exports to increase thus reducing the deficit</li> </ul>	<ul style="list-style-type: none"> <li>These policies tend to be long term policies so the benefits may not be seen for some time. They usually involve government spending in the form of subsidies and this always carries an <b>opportunity cost</b></li> </ul>



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## 4.6.4 Marshall-Lerner & J-Curve

### The Marshall-Lerner Condition

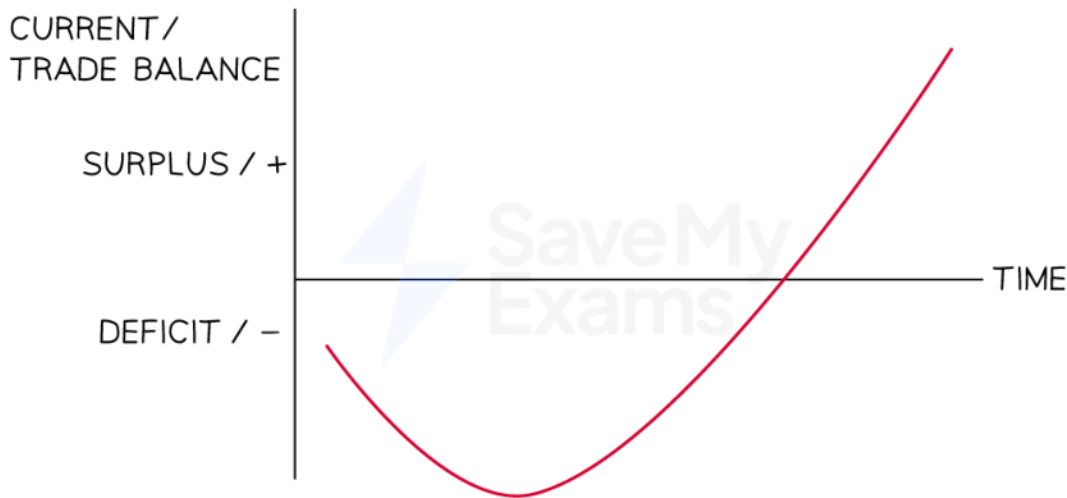
- When a currency is **devalued in a fixed exchange rate system or experiences depreciation in a floating exchange rate system**, it makes the country's exports cheaper
- **Depreciation** of the currency causes **exports** to be cheaper for foreigners to buy and **imports** to the UK are more expensive
- The **extent** to which this depreciation improves the **current account balance** depends on the **Marshall-Lerner condition**
  - This follows the **revenue rule** which states that in order to increase revenue, firms should **lower prices** for products that are price elastic in demand
  - If the **combined elasticity** of exports/imports is less than 1 (inelastic), a depreciation (fall in price) will actually **worsen** the current account balance

### The J-Curve Effect

- It is also important to recognise that **there is a time lag** between the depreciation of the currency and **any subsequent improvement in the current account balance**
- This time lag is explained by the **J-Curve effect**
  - It takes **time** for firms and consumers to respond to changes in price
  - Once it becomes evident that price changes will last for a longer period of time, firms and consumers change their patterns
  - E.g. a firm in the USA has been importing electric scooters from the UK. If the **Euro depreciates**, the price of scooters in France becomes relatively cheaper. In the short-term, the USA firm will not switch immediately to purchasing scooters from France as the **exchange rate** may soon bounce back. They also have a good relationship with their UK suppliers. In the **long term** they are likely to switch



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*The J Curve explains what happens to a trade balance over time when the country's currency depreciates*

## Diagram Analysis

- In the short run, the **sum of PEDs for exports and imports was less than one / inelastic** (or the Marshall-Lerner condition was not fulfilled) so the deficit widens
- However, in the long run the **Marshall-Lerner condition is met** so it leads to a surplus
- With any currency depreciation/devaluation, the trade balance will initially worsen before it improves



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## 4.6.5 Persistent Current Account Surpluses

### Implications of a Persistent Current Account Surplus

- A persistent current account surplus occurs when a country consistently **exports more goods/services than it imports**
- The implications of this occurring can be summed up as follows

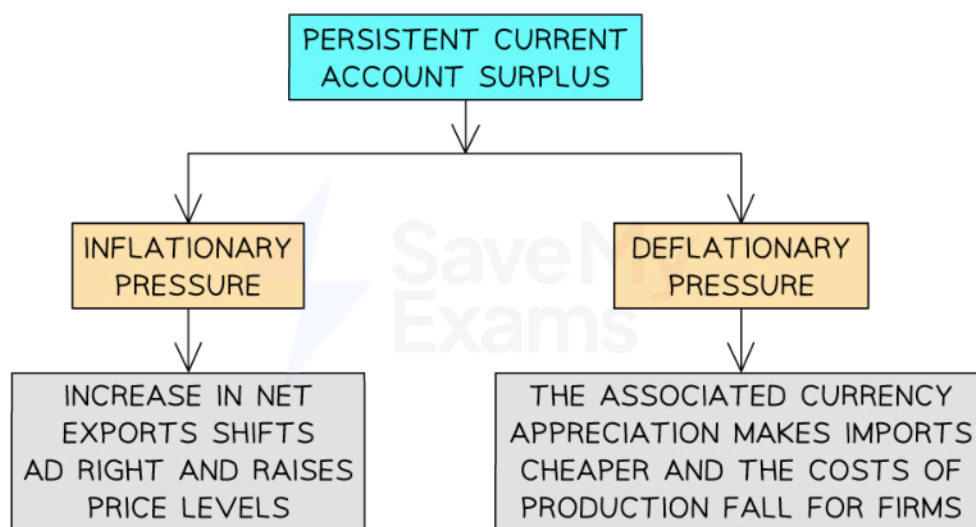
#### 1. Rising consumption and investment

- **Investment increases** as exporting firms are making excellent profits
- With a higher level of profits in the economy, domestic income rises leading to **an increase in consumption**

#### 2. Appreciating Exchange Rates

- With higher exports, foreigners demand more of the local currency to pay for their goods/services **leading to currency appreciation**
- Appreciating exchange rates make the economy less desirable as a destination for **foreign direct investment**

#### 3. Both an inflationary and deflationary effect on price levels



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- The **net effect on inflation** will depend on the extent to which domestic firms rely on imported raw materials used in their production process

#### 4. Employment

- With rising demand for exports, unemployment usually falls as **exporting industries require more workers**
- Rising profits usually result in **increased investment** which may mean that even more workers are required
- Decreasing unemployment creates a **higher average domestic income** and much of this income is spent domestically
  - Non exporting domestic industries **may also require more workers** to help meet the rising domestic demand

#### 5. Export competitiveness

- Appreciating exchange rates associated with a persistent surplus, will gradually erode the nation's export competitiveness over time
- The **extent to which this is eroded** will depend on the price elasticity of demand for the country's exports
  - if PED for their exports is **inelastic**, then currency appreciation will not impact the competitiveness as much as it does when the PED for exports is **elastic**



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