CIE Economics AS-level

Topic 4: The Macroeconomy

c) Balance of payments

Notes

Components of the balance of payments using the IMF/OECD definition

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.

Meaning of balance of payments equilibrium and disequilibrium

Equilibrium: The components of the Balance of Payments should balance. That is, the sum of the accounts should be zero. This is because the outflows of finance should match inflows.

Disequilibrium: This occurs where there are large current account deficits (or surpluses).

Causes of balance of payments disequilibrium

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.

- **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 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.

Consequences of balance of payments disequilibrium on domestic and external economy

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