WJEC (Wales) Economics A-level

Macroeconomics

Topic 2: Macroeconomic Objectives

2.4 The balance of payments

Notes

Components of the balance of payments

The balance of payments 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.
  Income transfers are from the net earnings on foreign investment as well as net cash transfers. They include salaries and dividends.
  Current transfers are transfers that have no return, such as aid and grants. It includes the payments the UK makes for being a member of the EU. They have traditionally been negative for the UK, due to these contributions and because of overseas aid.

- **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 imbalances

The components of the balance of payments should balance to give a net value of 0. However, each component can have an imbalance, which means there is either a deficit or surplus on the component. For example, the UK has a net deficit on the current account, whilst there is a net surplus on the capital and financial accounts.

Causes of balance of payments imbalances

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:** During periods of economic growth, consumers have high levels of spending. In the UK, consumers have a high marginal propensity to import, so there is likely to be more spending on imports. This leads to a worsening of the current account deficit. However, export-led growth, such as that of China and Germany, means a country can run a current account surplus and have high levels of economic growth.
- **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.

Capital account deficits and surpluses

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.

- **Attractiveness to foreign investors:** A capital account surplus could be caused by incoming finance from investors buying UK bonds, securities and other financial derivatives. This could help fund a current account deficit. The UK is considered an attractive place for investors, so it has a surplus on the capital account.

The distinction between absolute and comparative advantage

A country has **absolute advantage** in the production of a good or service if it can produce it using fewer resources and at a lower cost than another country.

Comparative advantage occurs when a country can produce a good or service at a lower opportunity cost than another country. This means they have to give up producing less of another good than another country, using the same resources.

Countries can specialise where they have comparative advantage. This increases economic welfare.

The benefits of free trade

Free trade is the act of trading between nations without protectionist policies, such as tariffs, quotas or regulations.

Free trade provides the following benefits:

- Countries can exploit their comparative advantage, which leads to a higher output using fewer resources and increases world GDP. This improves living standards.

- Free trade increases economic efficiency by establishing a competitive market. This lowers the cost of production and increases output.

- By freely trading goods, there is trade creation because there are fewer barriers. This means there is more consumption and large increases in economic welfare.

- More exports could lead to higher rates of economic growth.

- Specialising means countries can exploit economies of scale, which will lower their average costs.

Calculation of terms of trade:

The terms of trade measures the volume of imports an economy can receive per unit of exports. It is calculated by the index price of exports over the index price of imports.

Terms of trade above 100 are improving, whilst those below 100 are worsening.

An example calculation is:

- The index price of exports increases by 15%. The index price of imports increases by 20%. The terms of trade are (115/120) x 100 = 95.83. This means that the terms of trade has reduced, so the economy gets fewer imports per unit of exports.

Factors influencing a country's terms of trade:

Globalisation has meant that the price of invisibles, such as services, has been less impacted than visibles, such as manufactured goods. The price of manufactured goods has fallen more than services. This means that the terms of trade of countries, such as the UK which export more services and import more manufactured goods, has improved.

The **Prebisch-Singer hypothesis** suggests that over time, due to falling commodity prices in relation to manufactured goods, the terms of trade for developing countries has fallen. Due to globalisation reducing the price of manufactured goods, this effect has been offset slightly.

The price elasticity of demand impacts the terms of trade. The more inelastic the demand for exports than imports, the more favourable the terms of trade, since the country can demand higher prices for exports.

If a country only imports manufactured goods and only exports primary goods, then the terms of trade will be worse.

An appreciation in the country's exchange rate results in an improvement in the terms of trade, since this results in an increase in export prices and a decrease in the price of imports.

If a country employs a protectionist measure, then the terms of trade will improve because imports are restricted. This is providing other countries do not retaliate.

A country with a higher population demands more imports, so they are likely to have a relatively worse terms of trade compared to a country with a smaller population.

The impact of changes in a country's terms of trade:

Improving terms of trade mean the economy can import more goods for each unit of export. This can help reduce the effects of cost-push inflation, since import prices are falling relative to export prices. It could also help improve standards of living for consumers in the country.

However, it can mean that the balance of payments worsens, since there are fewer exports and more imports.

Worsening terms of trade means that for every import, the country has to export more. It could make the price of new technology more expensive, which might limit productivity.

It could lead to a fall in living standards, and because it is more difficult to earn foreign currency, it becomes harder to pay foreign debt.

Consequences of imbalances on the balance of payments

- 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.

Why achieving a sustainable balance of payments position is an important macroeconomic policy objective

- The UK government aim for the current account to be satisfactory, so there is not a large deficit. This is usually near to equilibrium.
- A balance of payments equilibrium on the current account means the country can sustainably finance the current account, which is important for long term growth.

- If it becomes difficult to attract sufficient capital flows, the pound could depreciate. This could lead to inflationary pressures on the UK price level.
- 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.
- 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.

Solutions to correct current account deficits

- **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**

- 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.