Edexcel Economics A-level

Unit 4: The Global Economy

Topic 3: Balance of Payments and Exchange Rates

3.1 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.

Causes of deficits and surpluses on the current account

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.

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.

Measures to reduce a country's imbalance on the current account

- 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 could be 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.
- 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. 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 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.

Significance of global trade imbalances

- 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.

- 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.
- 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.