Chapter 28

Balance of payments

Key terms

1. Balance of payments: records all financial transactions between residents of one country and the rest of the world. These residents are made up of consumers, businesses and the government.
2. Capital account: shows the credit or money inflows and debit items or money outflows form non-produced, non-financial assets and capital transfers between residents and non-residents.
3. Current account: where payments for the purchase and sale of goods and services are recorded, along with primary and secondary income flows.
4. Current account deficit: when debits(-outflows of money) are greater than credit (+inflow of money) on current account.
5. Current account surplus: when credits (+inflow of money)are greater than debits(-outflows of money) on current account.
6. Devaluation of a currency: when government or central bank official fixes a new lower exchange rate for the currency in fixed or pegged system of exchange rates.
7. Expenditure reducing: in a balance of payment context, government policies to reduce the level of aggregate demand in order to reduce imports and boost exports.
8. Expenditure switching: in a balance of payments context, government policies such as devaluation or protectionism designed to switch production currently being sold domestically to exports.
9. Financial account: a record of almost all the flows of financial capital into and out of a country; it is split into three main parts.

1. <u>Components of the balance of payments</u>

Balance of payments records all financial transactions between residents of one country and the rest of the world. These residents are made up of consumers, businesses and the government.

- **<u>Inflow</u>** : Flows of money into the country are given a positive (+) (Credit)
- **<u>Outflow</u>** : Flows of money out from country are given a negative (-) (Debit)

Balance of payment = Current Account + Financial Account + Capital Account

1.1 Current Account

- Current account: where payments for the purchase and sale of goods and services are recorded, along with primary and secondary income flows or current transfers of money.

1.2 Capital account

- Capital account: shows the credit or money inflows and debit items or money outflows form non-produced, non-financial assets and capital transfers between residents and non-residents.

1.3 Financial Account

- Financial account: a record of almost all the flows of financial capital into and out of a country; it is split into three main parts including foreign direct investment, portfolio investment and other investment.

2. Reasons for international capital flows on the financial account

- Hot money inflow into a country in order to make speculative gain
- A domestic firms may take out loan from abroad
- Individuals transfer funds abroad.
- Foreign direct investment occurs in order to make profit by investing share or business.

2. Causes of surpluses and deficits on the current account

- **Current account deficit**: when debits(-outflows of money) are greater than credit (+inflow of money) on current account.
- **Current account surplus**: when credits (+inflow of money)are greater than debits(-outflows of money) on current account.

There are a number of reasons why countries run persistent surpluses or deficits on their current accounts.

2.1 Natural resources

- A country may have a large current account surplus from exporting oil.

2.2 Underlying competitiveness

- Some countries may have a large current account surplus as the countries have underlying competitiveness which makes their goods attractive in foreigners' view.

2.3 Exchange rate

- Currency depreciation makes price of exports become cheaper, resulting in higher export revenue.

2.4 Domestic demand

- When a country has high total spending, it may also increase spending on imports, resulting in current account deficit.

2.5 Overspending by consumers and government

- Current account deficit arises from overspending by consumers and government on imports.

2.6 Commodity prices

- A country exporting commodity such as oil can have greater export revenue when its price rises. If prices of commodity rises, export revenue will rises.

2.7 Inflation

- If inflation in the country is relatively higher than other countries, it reduces price competitiveness for exports, resulting in lower export revenue.

2.8 Age composition of the population

- Young people tend to have a lower saving ratio, so consumption is a relatively high proportion of their income. So spending on imports also increases.

3. Measures to reduce imbalances on the current account

There is a variety of ways in which a government can affect the current account of its economy

3.1 Exchange rate changes

- Currency depreciation or devaluation makes price of exports become cheaper. If demand for export is price elastic, currency devaluation results in higher export revenue.

3.2 Deflationary policies

- Deflationary polices reduces AD or total spending, it leads to lower import expense.
- Deflationary fiscal policy; a rise in tax rate and a cut in government spending to reduce AD
- Deflationary monetary policy; a rise in interest and a cut in money supply to reduce AD

3.3 Supply-side policies

- Reducing corporate tax (tax on profit) => it reduces cost to firms and price of exports
- Giving subsidy => it reduces cost to firms and price of exports
- Providing education and training => it increases labour skills and productivity to produce exports.
- Deregulation => it allows small forms to start up and encourages MNCs to invest in the country => MNCs contribute export revenue.

3.4 Protectionism

- Tariff makes price of imports become higher => it reduces demand for imports and also import expense.

3.5 Currency controls

- Government may impose or tighten currency controls or foreign exchange controls on the purchase of foreign currency by domestic people and firms.

4. The significance of global trade imbalances

- If a country has current account surplus, another country will have current account deficit.
- Persistently running a current account deficit means a country is building up it liabilities to the rest of the world. It can cause problems such as national debt, lack of international competitiveness, and currency depreciation.

Exercise Chapter 28

Balance of payments

1. In 2016 the current account deficit of the Balance of Payments in Canada was US$67.7 billion and in Brazil it was US$23.5 billion.

(A) Assess possible causes of a deficit on the current account. (15 marks)

(B) Discuss the significance of current account deficits to a country of your choice. (25 marks)