ESCP EUROPE

BUSINESS SCHOOL

Chapter 7: Balance of payment

International Economics

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Outline

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Introduction

- **Balance of payments (BOP)** accounts are an accounting record of all monetary transactions between a country and the rest of the world. These transactions include payments for the country's exports and imports of goods & services, financial capital, and financial transfers.

- A country has to deal with other countries in respect of 3 items:
  - <u>Visible items</u> which include all types of physical goods exported and imported
  - <u>Invisible items</u> which include all those services whose export and import are not visible. e.g. transport services, medical services etc
  - <u>Capital transfers</u> which are concerned with capital receipts and capital payment

Definition

- According to **Kindle Berger**: "The balance of payments of a country is a systematic record of all economic transactions between the residents of the reporting country and residents of foreign countries during a given period of time"

- It is a systematic record of all economic transactions between one country and the rest of the world.
- It includes all transactions, visible as well as invisible.
- It relates to a period of time. Generally, it is an annual statement.

- It adopts a double-entry book-keeping system. It has two sides: credit side and debit side. Receipts are recorded on the credit side and payments on the debit side.

Components of BOP

1. Current Account

- BOP on current account is a statement of actual receipts and payments in short period.
- It includes the value of export and imports of both visible and invisible goods. There can be either surplus or deficit in current account.
- The current account includes: export & import of services, interests, profits, dividends and unilateral receipts/payments from/to abroad

2. Financial/Capital Account

- It is difference between the receipts and payments on account of capital account. It refers to all financial transactions.
- The capital account involves inflows and outflows relating to investments, short term borrowings/lending, and medium term to long term borrowing/lending
- There can be surplus or deficit in capital account
- It includes: private foreign loan flow, movement in banking capital, official capital transactions, reserves, gold movement etc.

Balance of Payments

A deficit on the current account
is balanced by
a surplus on the financial account

Financial account

- Direct investment
  (FDI)
- Portfolio investment
  (bonds, saving, equities)

+ $52bn
(surplus)

Current account

- Trade in goods
- Trade in services
- Investment incomes
- Transfer payments

- $52bn
(deficit)

This country is using capital inflows to finance consumption of imports and investment.

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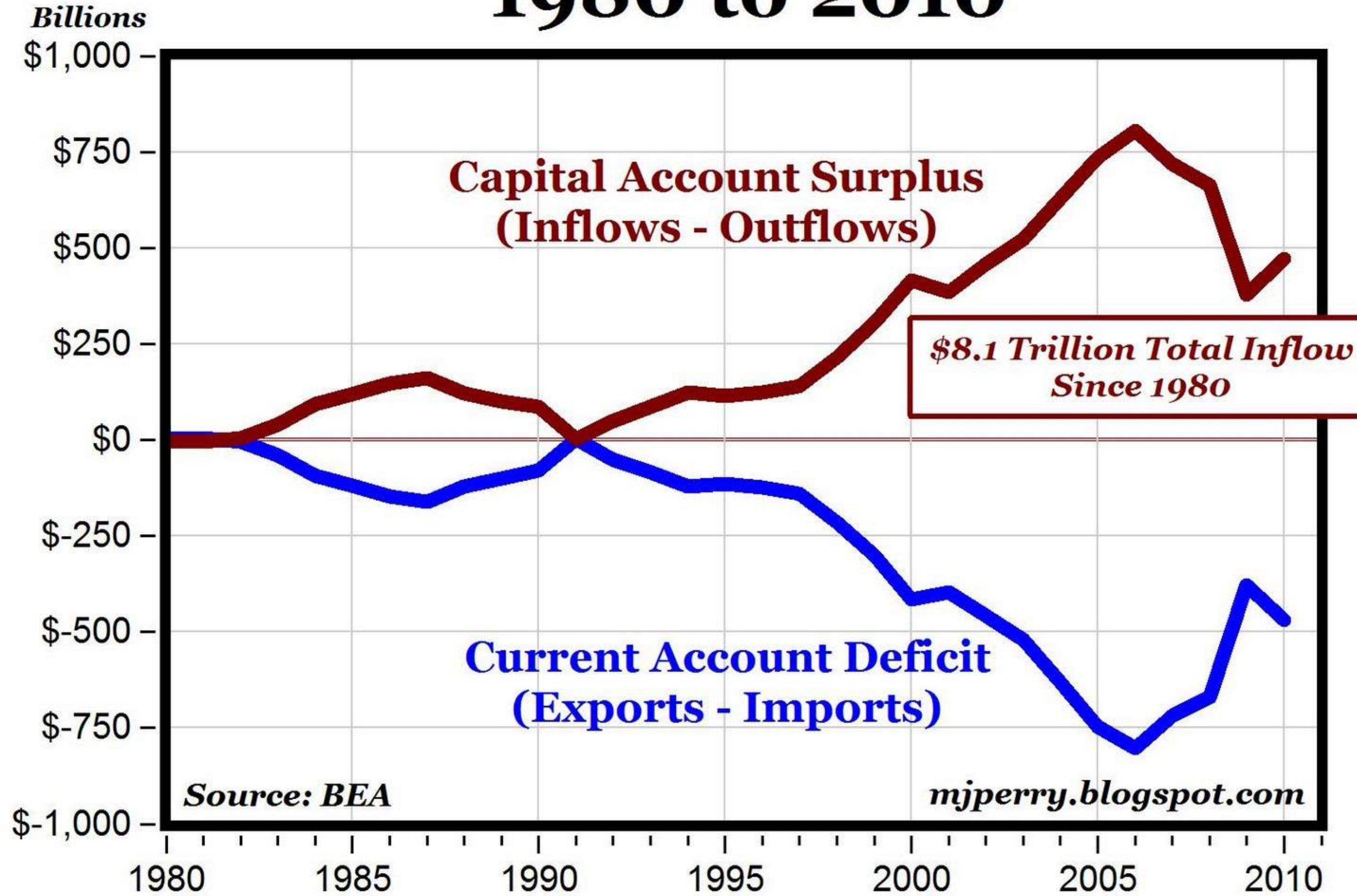
U.S. Balance of Payments
1980 to 2010
Billions
$1,000
$750
$500
$250
$0
$-250
$-500
$-750
$-1,000
Capital Account Surplus
(Inflows - Outflows)
$8.1 Trillion Total Inflow
Since 1980
Current Account Deficit
(Exports - Imports)
Source: BEA
mjperry.blogspot.com
1980
1985
1990
1995
2000
2005
2010

Effects of a current account deficit

- Imports greater than exports, so expenditure is leaving the economy to buy imports.
- Current account deficit may cause depreciation as there is greater demand for imports and foreign currency.
- A current account deficit is financed by attracting capital inflows, e.g. foreigners buying domestic assets. This means foreigners hold a greater claim on assets and dividends. (Could also make country vulnerable to capital flight)
- A current account deficit may be a sign the economy is uncompetitive. Consumers prefer to buy cheaper imports than domestic goods.
- The benefit of a current account deficit is that it allows higher levels of domestic consumption than otherwise possible because we are buying from abroad.

Evaluation

- A deficit financed by long-term capital investment is more sustainable than a deficit financed by borrowing.
- A deficit may occur due to high growth and strong consumer spending – rather than uncompetitiveness.
- Some countries like US and UK run current account deficits, but they have many foreign assets.
- Other countries like Russia and Venezuela have experienced a balance of payments crisis because they have been adversely affected by a fall in the price of oil which damages export revenue very quickly and developing countries more vulnerable to international investors withdrawing.
- A devaluation in the exchange rate could restore competitiveness and improve current account. But, would devaluation hurt or help the economy?

Problems associated with a current account deficit

- Exchange rate could fall – causing inflationary pressures. This is more of a problem when country follows some kind of exchange rate target, e.g. the UK in 1976 crisis. (leading to currency crisis)
- A deficit financed by financial flows could be vulnerable to capital flight if foreign investors decide to sell assets and return the money. This is a problem for developing economies who become seen as a risky place to invest.
- In the Euro, large current account deficits of Spain, Greece and Portugal were a sign of an uncompetitive economy. In the Euro, they couldn't devalue to restore competitiveness leading to lower economic growth because of depressed export demand.
- With current account deficit, foreigners have an increased claim on domestic assets.

Should we worry about the current account deficit?

- Some economists suggest that concerns over current account deficits are misplaced – so long as deficit is ‘manageable’ and financed by sustainable capital flows

  - UK and US have run persistent current account deficits for long periods without any adverse impact

  - Current account deficits financed by capital flows mean the country is attracting Foreign Direct Investment (FDI) – which is increasing domestic productive capacity

Summary – should we worry about a trade deficit?

- **Yes:**
  - Suggests economy is relatively uncompetitive we cannot export as many goods as we import.
  - Suggests economy is unbalanced – encouraging consumption at expense of saving, investment and exports
  - Can lead to future devaluation in exchange rate to restore balance.
  - Global credit crunch showed that capital flows, necessary to finance a current account deficit can suddenly dry up.
  - A trade deficit is a much bigger problem for countries in the Euro, who can't devalue to restore competitiveness. Their loss of competitiveness is leading to lower growth and higher unemployment.

- **No:**
  - Trade deficit may be consequence of rapid growth, which causes higher consumer spending.
  - Trade deficit financed by long term capital flows helps economy with financing inward investment (e.g. we run trade deficit with China, but China finances the deficit by investing in nuclear power stations in the UK.
  - If the trade deficit is too large, it will cause a depreciation in the exchange rate to restore competitiveness and improve trade deficit.
  - There are more pressing economic priorities than a trade deficit

How to correct the Balance of Payment?

1. **Devalue the exchange rate** – cheaper exports and more expensive imports should improve current account.

   This assumes demand for exports and imports is relatively price elastic. See: effects of devaluation in exchange rate
2. **Reduce consumer spending** – Tight fiscal/monetary policy will lead to a slowdown in consumer spending – reducing imports and improving the current account. Export demand will be unaffected by domestic monetary policy. Also, lower domestic demand should reduce inflation. Lower inflation should improve competitiveness of exports

   But, this will conflict with objectives of higher economic growth.
3. **Supply-side policies** – in the long term, efforts to improve productivity can improve the competitiveness of exports.

Further reading

- Chapter 12 : International Economics by Alan M. Taylor and Robert Feenstra, 3rd edition (2014)