Economics Essay – Balance of payment.

1) What is the meaning of a balance payment deficit?

2) What can the government do to reduce balance of payment deficit?

3) What are the long term and the short-term problems of a balance and payment deficit and their solutions?

The balance of payments measures all flows of money between the UK and the rest of the world. The current account records the movements of all goods and services into and out of the UK. The capital account measures all capital flows carried out by individuals, firms and governments (usually for investment purposes).

The current account records the movement of all goods and services into and out of the UK. Trade in goods, this section records all trade in goods hence the old name "visible". There are hundreds of different items that fall under this category. Oil is one of the biggest, especially given that the UK has been a net exporter of oil for the last 20 years. All manufactured goods are included, like cars, all household appliances, computers and anything else you can think of.

If the UK sells a Rover car (made in Britain) to someone in a French car showroom, then this is called an export and appears as an inflow of money (+) in the 'trade in goods' section of the current account. If Renault (the French Car Company) sell a car to someone in a British car showroom, then this is called an import and appears as an outflow of money (-) in the same section.

The 'trade in goods' balance is often referred to as the trade balance. This is the total value of exports of goods, subtracting the total value of imports of goods. In the case of the UK, this balance is nearly always negative, so it is known as the trade deficit; the UK always imports more goods than it exports.

Trade in services,(in the old days services, investment income and transfers were all lumped in together in the 'invisibles' section). The current account only had two sections: visible and invisible.

Trade in services is now a separate section. Although it is not quite so easy to picture international trade in services (only about 20% of all services are potentially tradable), some examples include financial services (e.g. banking and insurance), transport services (particularly shipping), law, accountancy, management consultancy and tourism.

It is important to follow the money. Unlike the 'trade in goods' section, where the good goes one way and the money goes the other, with the 'trade in services' section the money tends to follow the service. If a British person goes on holiday to France flying with Air France, all payments will count as imports because the money flows out of the UK (-). The payment for the flight goes back to France, and any money actually spent on food, drink and hotels ends up in France.

Investment income, makes sense because interest, profit and dividends are all forms of income earned on investments. Interest is earned on bank deposits and government bonds, profit is earned from investments in a business enterprise and dividends are earned annually on shares.

The key point to note here is that these incomes (annual flows of money) are derived from invested capital (stocks of wealth) that appears in the capital account. This is the crucial link between the current and the capital accounts. Interest is earned on money invested in the 'other investment' section of the capital account, and the bonds in the 'portfolio investment' section of the capital account (see the green line on the diagram above). Profit is earned on money invested in businesses in the 'direct investment' section of the capital account (see

the red line of the diagram above). Dividends are earned from the investment in shares that appear in the 'portfolio investment' section of the capital account (see the blue line on the diagram above).

Transfers

This also used to be under the old 'invisibles'. Transfers are now separated into a separate section because they are different in the sense that they do not reflect any actual trade. This section is split into two; government transfers and transfers ma de by other sectors.

Government transfers include contributions to the EU (most of which is used for the Common Agricultural Policy or CAP) and foreign aid. These are flows of money out of the UK (-). The 'other sectors' section many highlights the transfe r of assets by individuals to foreign bank accounts.

The capital account

The Capital account measures all the short term and long term monetary transactions between the UK and the rest of the world. Generally, these flows of money are associated with saving and investment, but speculation has become a big part of the account in recent years. Officially, the name has changed to 'Capital and Financial Accounts', but examiners seem to be happy for you to use 'capital account', probably because it is a lot less hassle to write down under exam conditions! Here are the four main sections.

Direct investment

This refers to money that flows across national boundaries for the purpose of investing in a business enterprise. Essentially, it records the transfer of owners hip of UK or foreign businesses. It also records money invested abroad for a new business venture. When Marks & Spencer build a new store in, say, Hong Kong, this will count as an outflow of money from the UK (-) in the direct investment section of the capital account. When Nissan built its factory in Sunderland, this counted as an inflow of money (+) in the same section.

Note that earnings from these investments (profit) appear in the investment income section of the current account. The initial investment by M & S in Hong Kong will appear as a one off outflow of money from the UK (-) in the capital account, but each subsequent year M & S should make profits (hopefully!). These will appear as inflows of money into the UK (+) in the investment income section of the current account.

Portfolio investment

This is money that flows across national boundaries for the purpose of investing in shares and bonds. If someone in the UK buys some shares in an American company, this will count as an outflow of money from the UK (-) in the portfolio investment section of the capital account. If an American buys some shares in a British company, this will count as an inflow of money into the UK (+) in the same section

Again, note that the earnings from these shares and bonds (dividends and interest) will appear, in subsequent years, in the investment income section of the current account. For as long as the UK citizen holds onto the American shares, he will receive an annual dividend, which will represent an inflow of money int o the UK (+) on the investment income section of the current account.

Other investment

This section can be quite hectic because it includes short -term 'hot money' banking flows. It also includes net government borrowing from foreigners.

Official reserves

This refers to the reserves of gold and foreign currencies held by the Bank of England for use by the government. The government might use some of their reserves to artificially manipulate the value of the pound; although this rarely happens any more because the pound is freely floating and the government do not seem particularly keen to intervene in currency markets. After the last government's horrific experience of trying to defend the pound within the Exchange Rate Mechanism, all governments since have left the pound alone to find its own level in the currency markets.

Net errors and omissions

You may know this as the balancing item. I'm afraid this name has changed as well. The new name actually makes more sense. The term 'balancing item' suggests that this entry is an actual 'item'. This is misleading. The balancing item was only ever a number stuck into the account to represent mistakes, so the new name is entirely appropriate.

As you will see in the next section of this QuickLearn, the balance of payments always balances, so, theoretically, the net errors and omissions item should always equal zero. That it rarely does reflects the fact that it is very difficult to collect all of the data required for the balance of payments in a totally accurate fashion. Millions of pieces of information have to be collected from around the world. There is often a time lag as well. It is interesting to note that when past figures for the balance of payments are revised as the years go by, the figures for 'net errors and omissions' get smaller and smaller as the errors are found and corrected.

Why does the balance of payments always balance?

Before we start, here is the relevant formula for the balance of payments.

Current account balance + Capital account balance + net errors and omissions = 0

As we said above, net errors and omissions simply reflect mistakes. Assuming no mistakes are made, then the formula will look like this.

Current account + Capital account = 0, hence Current account = Capital account.

In other words, if a country has a deficit on the current account (more imports than exports) then it must have an equal and opposite surplus on the capital account (and vice versa).

Let's think about this. If you buy a Mercedes car, what are the flows of monies involved? You go to the Mercedes showroom and buy the car using pounds. This money will end up back in Germany. But the German owners of Mercedes do not want the money in pounds. They will want Euros.

How are the pounds changed into Euros?

In the currency market, which forms part of the capital market.

Where will this transaction appear in the balance of payments?

In the capital account, probably under 'other investment'.

So, as you can see, any transaction that takes place in the current account must have an equal and opposite transaction somewhere in the capital account. Of course, in the real world, countries that run large current account deficits (like the UK) have to attract this foreign currency in the first place. This is not such a problem in the UK; we are lucky that we have successful and sophisticated capital markets. Go to the next QuickLearn to find out more about how the UK manages to attract foreign investment to keep the capital account in surplus.

The UK balance of payments

Although the capital account is important, when economists talk about a trade deficit or a balance of payments deficit they are referring to part, or all, of the current account. It is the current account that measures whether a country can 'pay its way' in the world and so it is of more interest to economists.

The UK usually has a current account deficit. This means that the capital account is usually in surplus. The reasons for this are covered later in this QuickLearn. First of all, let's look at some recent trends in the all-important current account.

Recent trends

The table below gives you some idea of the UK's strengths and weaknesses when it comes to trade with the rest of the world. All figures are in billions of pounds.

Year	Balance on goods	Balance on services	Investment income balance	Transfer balance	Current account balance
1980	+1.4	+3.7	-0.2	-2.0	+2.9
1981	+3.3	+3.8	+1.3	-1.5	+6.9
1982	+1.9	+3.0	+1.5	-1.7	+4.7
1983	-1.5	+3.8	+2.8	-1.6	+3.5
1984	-5.3	+4.2	+4.3	-1.7	+1.5
1985	-3.3	+6.4	+2.3	-3.1	+2.3
1986	-9.6	+6.2	+4.6	-2.2	-1.0
1987	-11.6	+6.2	+3.9	-3.4	-4.9
1988	-21.5	+4.0	+4.6	-3.5	-16.4
1989	-24.7	+3.7	+3.5	-4.6	-22.1
1990	-18.7	+4.0	-0.6	-4.3	-19.6
1991	-10.2	+4.5	-2.0	-0.7	-8.4
1992	-13.1	+5.7	+2.1	-4.8	-10.1
1993	-13.3	+6.6	+0.7	-4.6	-10.6
1994	-11.1	+6.5	+7.8	-4.7	-1.5
1995	-11.7	+8.9	+6.0	-7.0	-3.8
1996	-13.1	+8.9	+8.1	-4.5	-0.6
1997	-11.9	+12.4	+11.1	-5.1	+6.5
1998	-20.5	+12.6	+14.2	-6.4	-0.1
1999	-26.8	+11.5	+8.3	-4.1	-11.1
2000	-28 to -30?	+10 to +12?	+4 to +8?	-4 to –6?	-16 to –18?

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* denotes that these figures are predictions for the full year. The red figures in the 'current account balance' column highlight years of current account deficits. It should be noted that all of these figures are not adjusted for inflation. A 20 billion deficit in the late 80s is relatively worse than a 20 billion deficit in the late 90s.

A quick glance at the table tells us that the UK nearly always has a deficit on the 'trade in goods' and 'transfers' sections, but nearly always has a surplus in the 'trade in services' and 'investment income' sections. For extensive discussion on why the UK seems to have deficits in goods and surpluses in services, see the relevant sections later in this QuickLearn.

Overall, the trade deficit dominates, so the current account tends to be in deficit as well. 1997 was the first year since 1985 that the UK had a current account surplus, 1998 was a year of virtual balance, but declining investment income and increasing trade deficits forced the current account back into deficit in 1999 and 2000 is predicted to be another messy year. Tim Congdon of Lombard Street Research thinks the trade deficit alone will be 25 billion pounds based on the first four months of 2000. Many thought it might top 30 billion once half the year's data was collected. You need to check data as it comes in to see if these predictions come true. All good broadsheet papers (they're the big ones!) will publish the figures as they are announced.

The surplus for investment income seems to be on a downward trend. This may be due to the fact that foreigners own more assets in the UK than UK residents do in foreign countries. In the 80s the situation was the other way round. The fact that the investment income section is still in surplus must be due to the fact that UK investments abroad are earning more income than foreign investments in the UK. But if foreigners keep investing more money in the UK (which is a good thing for other reasons – see later) than we do abroad, this section of the current account could slip into deficit, and then the only section of the current account in surplus will be 'trade in services'. Very worrying!

An interesting trend to note over the year 2000 is the fact that the goods deficit with EU countries has been less than the goods deficit with non-EU countries, despite the fact that the pound is relatively strong against the Euro. This is due to the fact that the EU economy is improving, whereas non-EU countries are faring less well (the USA particularly is growing less quickly). Whilst manufacturers complain about the strong pound, it seems that the strength of the economies into which they export is a bigger factor.

It should also be noted that rising imports is not a bad thing if they are used to enhance the domestic production process. There has been record growth in the imports of computers, semi-conductors and high tech products, which will all help to add value to UK production. Imports are rising at an annual rate of 2.2% from the EU, but 21% from non-EU (TVs and videos, but also things that help UK manufacturing).

How does a government reduce a current account deficit?

Expenditure switching and expenditure reducing policies

Before we get started, it should be noted that the current government, and recent governments, in the UK do not actually care about the current account deficit. They believe that it will be financed more or less indefinitely. They are much more concerned about the control of inflation. Examiners are keen that you understand how deficits can be reduced, but the following policy measures are not at the forefront of the Chancellors mind at the moment!

These polices were relevant in the 50s and 60s, especially when the UK was part of the Bretton Wood fixed exchange rate system. They are also relevant to any country that cannot finance current account deficits over the long run as easily as the UK seems to be able to do.

Expenditure switching policies

These are policies that a government may use to switch consumers' expenditure away from imports and towards home produced goods. There are two main types - using import controls like tariffs and devaluing the exchange rate. Let's look at these two in turn.

Import controls

Of course, this policy is not as relevant as it was in the past. Nowadays, the World Trade Organisation (WTO) would not let a country get away with tariffs just because it wasn't very happy with its current account deficit.

If a country levies tariffs (a tax on imports) on various imports, then their prices will rise relative to the home produced goods and so the demand for imports should fall and switch to domestically produced goods. This will be good for domestic producers as well as helping the current account deficit to fall. The foreign firm could absorb the cost of the tariff, take a cut in profits and not raise their price, but this is not a long term solution for them. Tariffs generally cause import prices to rise.

Apart from the fact that this is difficult to implement nowadays, the resulting trade war that is likely if a policy of import controls did get past the WTO would be disastrous.

A devaluation of the exchange rate

Of course, in a world of floating exchange rates, a currency should automatically change in response to a current account surplus or deficit. The change should also automatically correct the balance of payments disequilibria.

A current account deficit in the UK, for example, will mean that the demand for pounds to buy UK exports is lower than the UK consumers' demand for foreign currency to buy imports. The value of the pound will fall, making exports relatively cheap and imports relatively more expensive. UK consumers will switch their purchases from imports to home produced goods, and consumers from other countries will switch their purchases from their home produced goods to UK exports. The UK's current account deficit should reduce back to equilibrium.

A very nice story, which should work in theory, but in the real world life is never that simple!

In the days of the Bretton Woods fixed exchange rate system, the UK would often find itself in a deficit situation. The governments of the time tended to try all other policies to reduce the deficit. Devaluation was the last resort. It was a sign that you had failed. When a country is a member of an exchange rate system, it is the foundation stone around which the rest of government macroeconomic policy is built.

And why do governments avoid devaluation at all costs, even though it makes industry more competitive? The resulting higher import prices lead to higher inflation. Since the Second World War, the inflation rate of the UK has been higher, on average, than all developed countries. It is not a coincidence that the UK has seen the value of the pound fall dramatically over the same period. Devaluation is the easy way out for exporters but is a poor long term option. See the topic called 'Exchange rates' for more discussion on these issues.

Today, the UK has a floating exchange rate. In theory (as explained above) current account deficits should automatically cause the pound to fall in value to help reduce the deficit. But the pound has been strong for the last four years regardless of the trade position of the UK.

As we said earlier, currency transactions as a result of exports and imports account for less than 10% of daily turnover. The key to the value of the pound nowadays is speculation. The 'markets' think the UK economy is doing pretty well, so investors buy the pound instead of

other currencies. These investors obviously don't think the current account deficits are a problem otherwise they would take fright and sell their holdings of sterling.

So even if the government wanted to pursue the 'devaluation' policy option to reduce a current account deficit, nowadays, it simply doesn't have the clout in the currency markets to affect the value of the pound. Look what happened on Black Wednesday!

Expenditure reducing policies

Any government policy designed to reduce demand in the economy and so reduce consumer spending in the economy (and on imports in particular) falls into this category. On the fiscal policy side the government could increase taxes or reduce public spending. On the monetary policy side, interest rates could be raised (although this is now the job of the MPC).

If consumer spending falls in an economy, then spending on all goods and services, including imports, will fall. This will reduce a current account deficit.

The big problem with this policy is that the deflation in the economy is likely to cause, at the very least, a slowdown and possibly a recession. In the 50s and 60s UK governments used to announce deflationary measures in almost immediate response to bad trade figures (a rise in interest rates, a tax on luxury goods or a clampdown on bank lending). Nowadays, governments wouldn't dare to announce excessive cuts in government spending or large rises in taxes. Gordon Brown may well sneakily raise taxes on less visible things (like dividends on shares bought to build a pension), but to announce an increase in income tax is considered to be electoral suicide!

Anyone can cure a current account deficit by having a recession (or cure high inflation for that matter – see the last two recessions!). This is why this 'expenditure reducing' policy of deflation was often used in conjunction with something like a devaluation. The deflation would create the spare capacity in the economy and the devaluation would increase aggregate demand again back up to the full employment level. Both policies should, at the same time, reduce the current account deficit.

Policies to improve competitiveness

So, import controls are difficult to impose in today's world of free trade and the WTO. The value of the pound may well fall, but only if the currency markets allow it. Deflation is completely out of the question given the risk of recession and its political difficulties. How else can a government try to reduce a current account deficit?

For most manufacturing firms, it seems the only way to sell more goods abroad and to persuade UK consumers to buy more home produced goods rather than imports is to become more competitive, particularly in terms of 'non-price' factors. In terms of the most worrying 'price' factor, there is not much that they can do about the strong pound.

Governments can help in this field by providing tax relief for capital investment and for research and development. They can provide training to improve the skills of the workforce and invest money into education generally so that the quality of all school leavers improves.

The J-curve and the Marshall Lerner condition

The success or otherwise of a devaluation in terms of reducing a current account deficit depends on the Marshall Lerner condition. This condition said that, for a devaluation to be successful in terms of a reduced current account deficit, the sum of the elasticity of demand for UK exports and the elasticity of demand in the UK for imports must be greater than one.

The J-curve simply shows that, following a devaluation, a country's current account deficit may actually increase in the short run before in falls and disappears.

Both of these concepts need a good understanding of exchange rates. For this reason, details of these concepts can be found in the topic called 'Exchange rates'.