Balance of Payments

1)

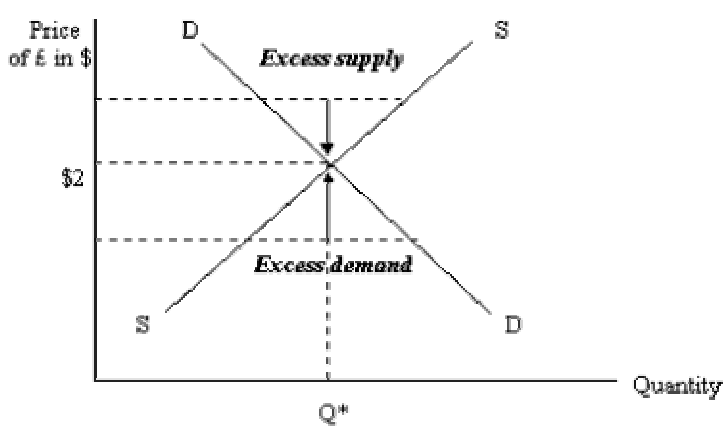
The Balance of Payments is the resultant of all the goods (visible) and services (invisible) purchased and sold between the residents of the UK and the rest of the world. The transactions are calculated in to a sum called the balance of payments – this is calculated and should equal '0' – if not a small balancing amount is added. The country is defined a 'net lender to' or a 'net borrowing from' depending if there is more money (in terms of goods and services) going in or out of th e country.

If there is a deficit in the current account then this will mean that the UK is importing more than it is exporting to the rest of the world. Deficits lead to overseas debts, these debts increase with time because of interest. Even though debts are accumulated economic growth counteracts this as it is easier to combat overseas debt in time – as the debts can't grow faster than nominal income.

There is a large income elasticity of demand for most imports as they usually are luxury goods – this means that if income decreases the demand for the products will decrease dramatically – also if income increases – the demand will also increase.

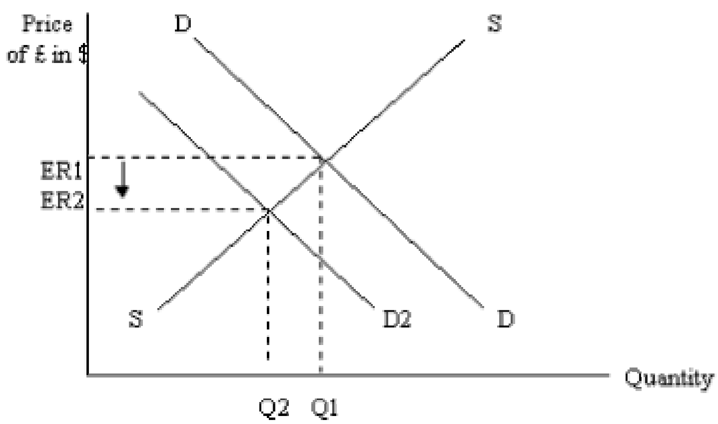
One of the major affects on the current account is the exchange rate – making the exchange rate higher per $ will mean that it will be harder for exports to export – but easier for importers to import. Price elasticity of demand for exports will increase but imports will decrease.

The exchange rate is based on a demand and supply diagram, which is Shown:



This diagram shows that at point Q* and $2 there is an equilibrium between demand and supply, so if the government (Bank of England) wishes to change the exchange rate £'s will need to be bought or sold.

A fall in the value of sterling (*depreciation*) means one pound now buys fewer dollars. Sterling depreciates if an American demands fewer pounds (shown in the diagram below) or if UK citizens offer more pounds. UK exports become cheaper and UK imports become dearer. Hence, a sterling depreciation improves the balance of payment, as shown on the diagram.



The Exchange rate moves from ER1 to ER2 as demand decreases (supply is constant). A rise in the value of sterling (*appreciation)* means one pound now buys more dollars. UK exports become dearer and UK imports become cheaper. Hence a sterling appreciation worsens the balance of payments.

The rate of inflation within the UK – this will mean that the residents in the UK have less to spend which will mean (income elasticity of demand) will lead to an decrease in the amount of imports demanded because growth will be slowed - this links in with exchange rates adjustments as they are both directly linked in the equation (Y= C+I+G+ [X-M]).

North Sea oil prices can affect the balance of payments – as it is the most significant input in 'goods'. The volume of oil sold overseas will have a huge impact on the deficit as it plays a huge part in the exporting part of the UK.

Other major aspects which will impinge on the competitiveness of the UK are for example the changes in pattern of comparative advantage. The *principle of comparative advantage* states that countries will benefit by concentrating on the production of those goods in which they have a relative advantage.

For instance, France has the climate and the expertise to produce better wine than Brazil. Brazil is better able to produce coffee than France. Each country benefits by specialising in the good it is most suited to making.
France then creates a surplus of wine which it can trade for surplus Brazilian coffee

2)
The continued deficit on the current account of the balance of payments I think does not really matter. For example nobody worries about the balance of payments of Thanet, because nobody bothers to collect the figures; therefore the balance of payments 'problem' of the UK would not exist if we ignored it. However Thanet does not have its own currency and Thanet's currency is part of a much larger one (UK). As the UK becomes more and more integrated into Europe – it could be argued that the balance of payments with the Europe would not matter. Trade would turn into 'domestic' rather than 'international'. However, the balance of payments is important to the extent that it creates monetary strains, and also can affect the 'real' economy. Debts by the previous generation will need to be paid back by future generations.

AN ALTERNATIVE VIEWPOINT would be that the deficit is of little importance to the UK as a whole due the continuing fact that it is readily financed by the self-sufficient capital account flows. it is important to distinguish the question whether the current account deficit matters for causing currency crises or for other things, like long-term growth. The statement attributed to Nigel Lawson is that the current account deficit is not a cause for concern if the foreign borrowing goes to the private sector. Lawson himself later clarified it by adding the qualification that this is not to say that high current account deficits will never lead to a crisis. (Capital account is the account which has fixed assets owned by foreigners).

So, to summarise whether there exists an external constraint determines the importance of the current account – if there is one then the current account needs to have more detail paid attention to. Otherwise the problem would be insignificant. People such as the ex chancellor also agree with my opinion that it does not matter – but it should not be ignored – if left to its on devices it may manifest into something much larger and more significant. A floating exchange rate or a single currency will not help the situation any more. Under a floating exchange rate it will reappear in the guise of inflation and with one currency it will result in the economic decline in the region involved. A single currency will not be able to control countries with different inflation desires but have one consistent rate which will mean that economic growth will be prohibited in countries where it is required and forced where it is not.