Discuss the alternative policies a government may use to improve a deficit in the Balance of Payments (BOP)

Edward Cohen

There are many ways a government can improve a deficit of the BOP. First we must define the key terms. A deficit is the falling short of revenue as compared with expenditure; the amount of this deficiency; the amount required to make assets balance liabilities.

The Balance of payments is a record or overall statement of a country's economic transactions with the rest of the world, usually over a year.

Now it is clear what the question means it is important to understand what causes a deficit in the BOP. There is often a tendency for UK consumers to buy foreign output goods leading to an increase in the amount of imports coming into the county. Often the domestic market cannot cope with the demand so imports are made to satisfy demand. Some UK firms have high non-competitive prices so foreign goods are preferred. Also the quality, designs reliability and after sales service are important. Declining comparative advantages in many areas – the advantages are that countries have in producing certain goods and services change over time as technology alters and other countries exploit their economic resources and develop competing industries. UK manufacturing industry has suffered over the years from the emergence of low cost production in newly industrialised areas such as South Korea and other parts of Europe.

A controversial opinion is that the overvalued exchange rates mean that UK exports are very high but imports are relatively cheap. Foreign consumers are inevitably not going to buy as much British goods. What's more, as the imports are cheaper British people buy foreign goods. The UK used to be a major exporter of oil from the North Sea fields. Finally this market is now past its peak and doesn't contribute much to the BOP.

Protectionist methods are designed to make sure that domestic produce can compete with international produce so that there is a better balance of imports and exports.

First of all quotas; this affects the supply of imports. You make barriers on supply prices higher than normal. With quotas the higher prices will mean that foreign firms make higher profits. Quotas can be in terms of volume or value permitted. Sometimes the domestic government sells licenses to foreign firms they in turn buy and sell licenses amongst each other. Some countries reach export agreements to limit their goods to a specific quota. Whilst other countries can make it difficult for firms to import by imposing restrictions and being deliberately bureaucratic.

Exchange control is another method; governments try and stop domestic consumers from spending too much on imports. They can do a number of things; they can restrict the amount of foreign currency available to the public,

they can allow the exchange rate to drop by actively intervening. Domestic producers can lower their prices below the market equilibrium by making export subsidies.

The final method is tariffs. It can be defined as a tax on imports and is used to restrict imports and raise revenue for the government. The diagram (figure 1) shows the market price at Wp, Qs is how much they can supply the price and Qd is what the consumer demands. As Qd > Qs imports will come into the economy and satisfy demand.

A tariff is placed on the value of imports. This raises the value of imports as a result, domestic demand contracts and domestic supply expands. Home producers can supply more at a higher price, it gives them a competitive boost and the volume of imports reduced.

The effects will be dependant on price elasticity of demand and the price elasticity of supply. A tariff will have greater effect the more elastic the demand and supply. If demand is inelastic then the tariff will have little effect on the level of imports.

Whilst some would argue that by imposing these types of import controls is negative and does little for international trade or relations there are many justifications for it.

They would argue it leads to loss of economic welfare and an increased level of efficiency. There will be higher prices and a smaller pool of variety for the consumer. Firms that are protected by the government may have little incentive to reduce production costs. There is the danger that if one country imposes import controls there will be retaliatory action and a decrease in world trade.

However the justifications are as follows; the infant industry argument is an example; certain industries possess a potential comparative advantage but haven't exploited the economies of scale. Short-term protection of nursery industries allows them to grow when it has grown sufficiently there is no need to protect it and can trade on the international stage. The drawback of this is that the industry will never reach full efficiency because it's free of the disciplines of foreign competition.

It also protects against dumping this is when the sale of a good is below the cost of production. In the short-term consumer's benefit from low prices of foreign goods, however in the long - term domestic businesses will go out of business resulting in the foreign firm having the monopoly over the market. The consequence of this will be that they can then charge what they like.

Another important factor is externalities and import controls. Protecting de – merit goods such as alcohol, tobacco and narcotic drugs. By imposing high tariff barriers on these or just banning them it can safeguard society.

There are also non-economic reasons a country may not want to specialise because if the market declines or there is a better competitor then there will be mass unemployment. Domestic employment is key government

objectives so by protecting industry you are ensuring jobs. Protection may be for political reasons, for instance the UK does not trade with Nigeria and Iraq.