Balance of Payments

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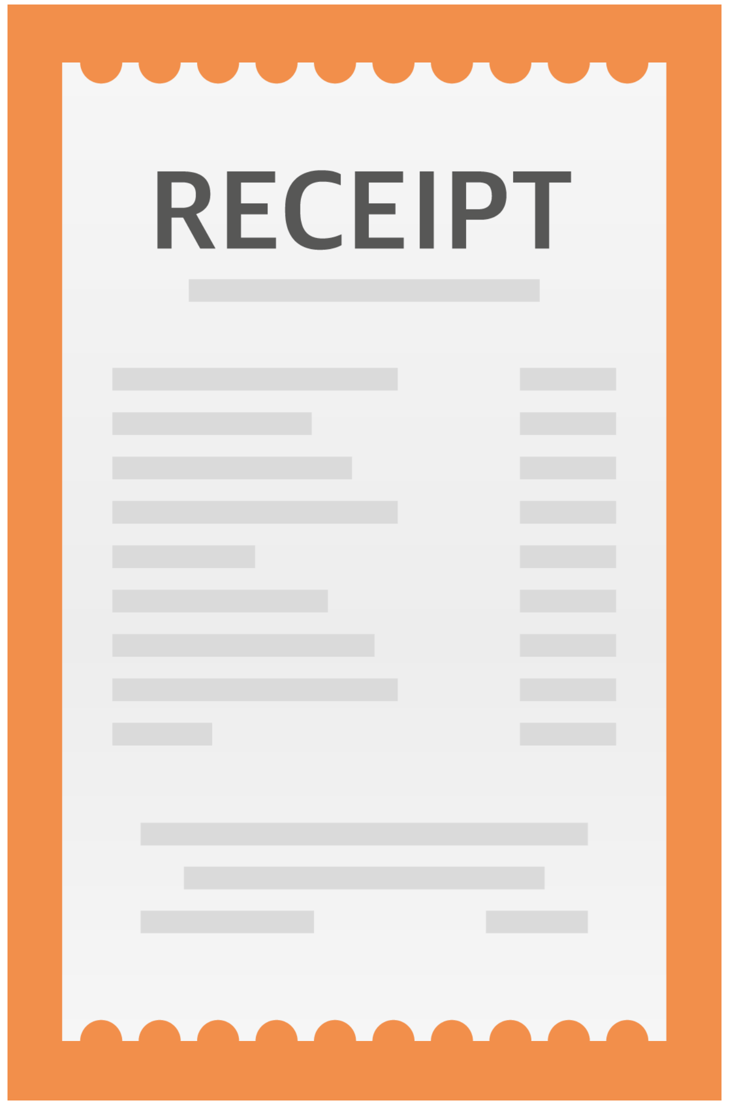
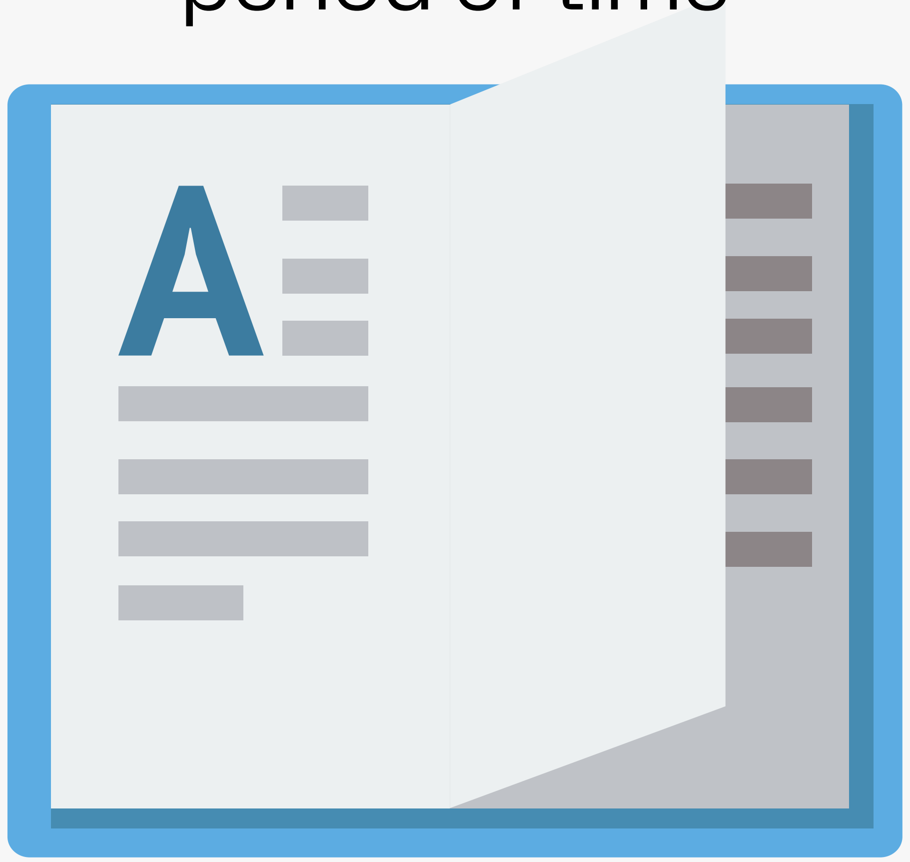


Definition

Balance of Payments (BOP)

A record of the value of all transactions of a country with the rest of the world over a period of time



BOP keeps track of a country's money inflow and outflow.

Main Components

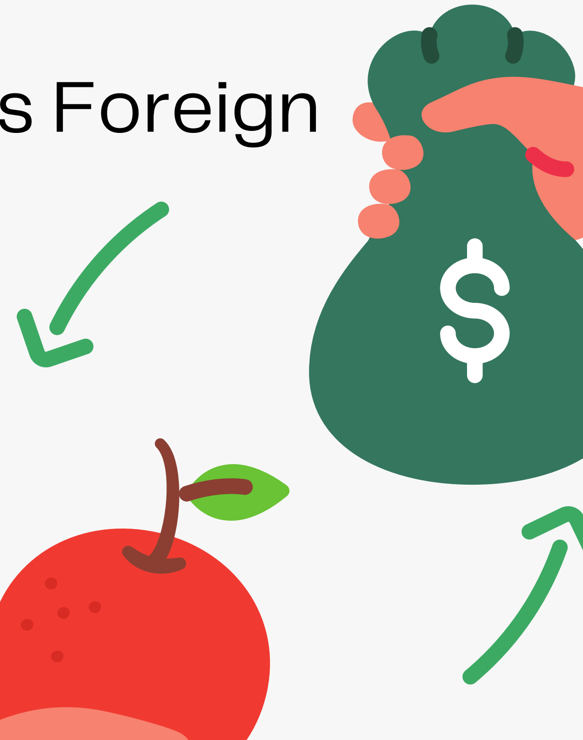
BOP = Current Account + Capital Account
Financial Account = 0

Current Account

The most discussed component of the BOP. The Current Account (CA) is the record of money coming in and out of a country for goods, services, income flows, and current transfers.

Four Components

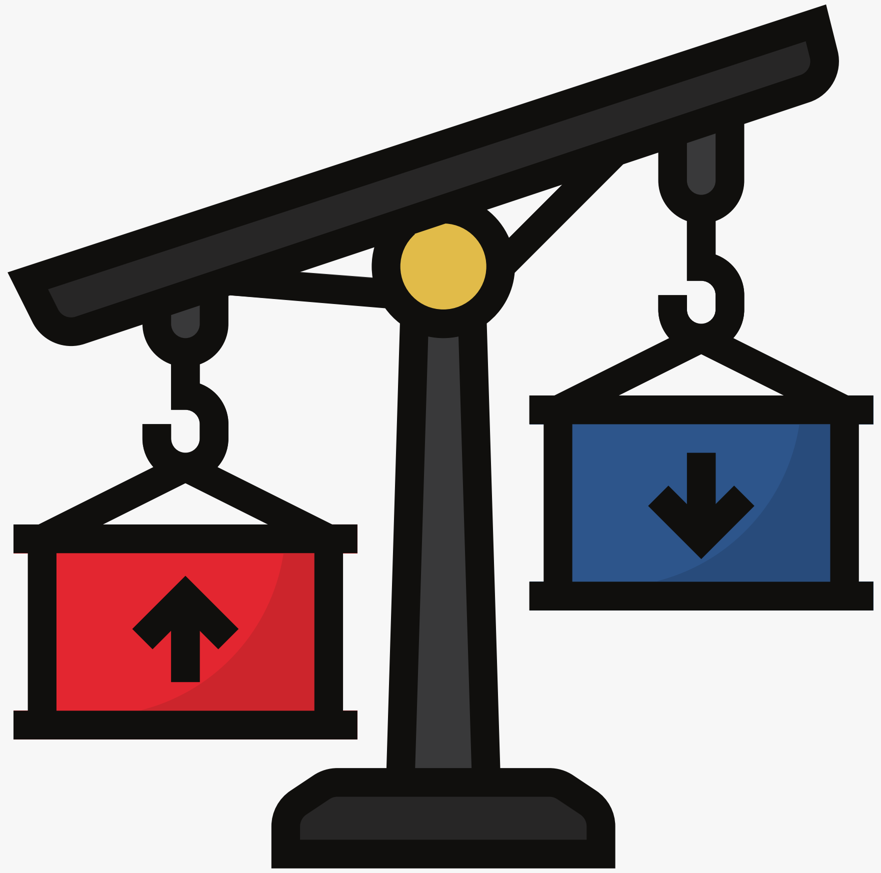
- **Balance of trade in goods**
  - Imports = money leaving the country; Exports = money entering the country
- **Balance of trade in services**
  - Same as goods.
- **Income**
  - Income citizens receiv from investments abroad such as rent, dividents, etc.
- **Current transfers**
  - Transfers of between countries not dealing with investments or payment such as Foreign Aid, Remittances, sending money home to family, etc.



Surplus and Deficit

The main focus when discussing BOP.

- **Current Account Deficit**
  - Exists when the sum of net exports of goods and services plus net income plus net current transfers is negative (or simply when debits or outflows are greater than credits or inflows).
- **Current Account Surplus**
  - Exists when the sum of net exports of goods and services plus net income plus net current transfers are positive (or simply when credits or inflows are greater than debits or inflows).



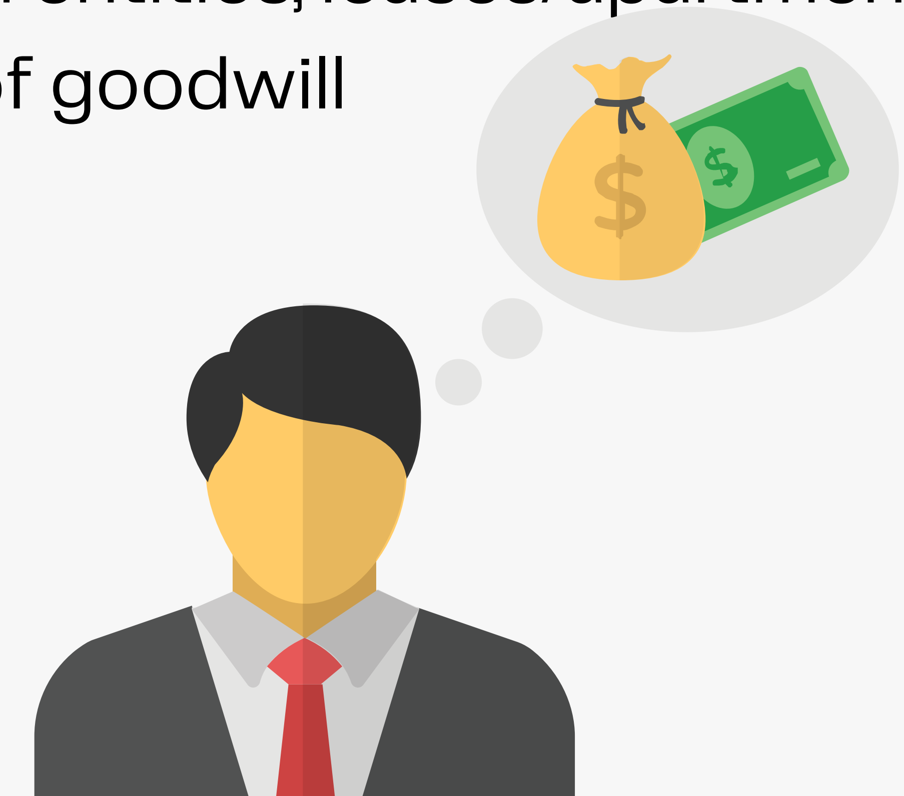
Captial Account

A subaccount of the balance of payments that includes credit and debit entries for nonproduced, non-financial assets as well as capital transfers between residents and non-residents.

Two Components

- **Capital Transfers**
  - Include financial or non-financial assets for items including debt forgiveness, investment, and non-life insurance claims.

- **Transaction in non-production, non-financial assets**
  - Non-produced assets such as patented entities, leases/apartment rentals or other transferable contracts, and payments of goodwill



Financial Account

Records inflows and outflows of portfolio and FDI funds over a period of time, official borrowing and changes in reserve assets.

Four Components

- **Foreign Direct Investment**
  - The purchase of a firm, or part of a firm, by a firm from another country
- **Portfolio Investment**
  - The purchase or sale of financial capital such as stocks, bonds, or currency trading.
- **Reserve Assets**
  - Foreign currencies are held by central banks in reserve. These reserve currencies can be used to adjust exchange rates.
- **Official Borrowing**
  - When a government borrows or lends money to another country. (typically facilitated through IMF World Bank)

The Balance of Payments Explained

Money & Macro

Practice Categorization

Determine which category each transaction would fall into

Also note which country receives money (credit) vs which loses money (debit)

1. An American citizen buys a new Kia from South Korea.
2. A Spanish citizen purchases at a shopping mall in Mexico.
3. Every month, Mohammed sends half of this Canadian paycheck back to his family in Iran.
4. Sam Walton buys 4 million in Chinese stocks.
5. Germany's Deutsch Bank pays 2 million in interest to investors from India.

Practice Categorization

Determine which category each transaction would fall into

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1. An American citizen buys a new Kia from South Korea.
    a. **Current; Credit – SK; Debit –US**
2. A Spanish citizen purchases at a shopping mall in Mexico.
    a. **Capital; Credit – Mexico; Debit – Spain**
3. Every month, Mohammed sends half of this Canadian paycheck back to his family in Iran.
    a. **Current; Credit – Iran; Debit – Canada**
4. Sam Walton (American) buys 4 million in Chinese stocks.
    a. **Financial; Credit – China; Debit – USA**
5. Germany's Deutsch Bank pays 2 million in interest to investors from India.
    a. **Current; Money received from investment is Current; Credit – India; Debit – Germany**

Interdepence Between Accounts

Interdependence

BOP = Current Account + Capital Account / Financial Account = 0

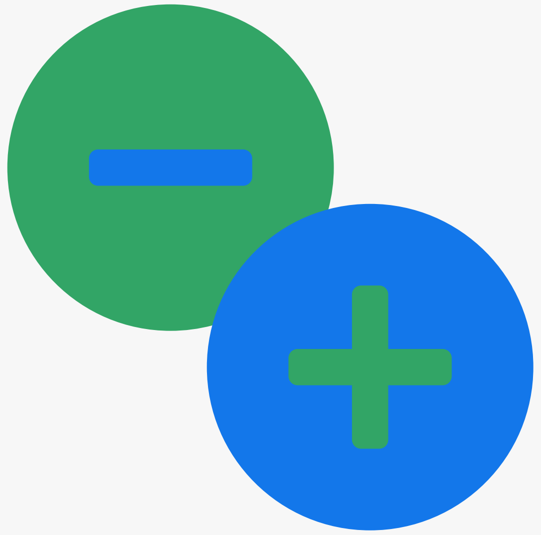
Double Entry

For every recorded entry, there is an equal and opposite entry.

Think about it from the perspective of your own personal checking account.

When you pay money digitally from it, money leaves your account (debit) and is put into another account (credit).

The balance of payments accounts work the same way except in different currencies from different countries.



Balance of Payments Example

Assume Americans buy BMW's from Germany for USD 25 000. The American would pay USD 25 000 and BMW in Germany. Germans have no use for USD so they must exchange them for Euros which would be around EUR 23 700.

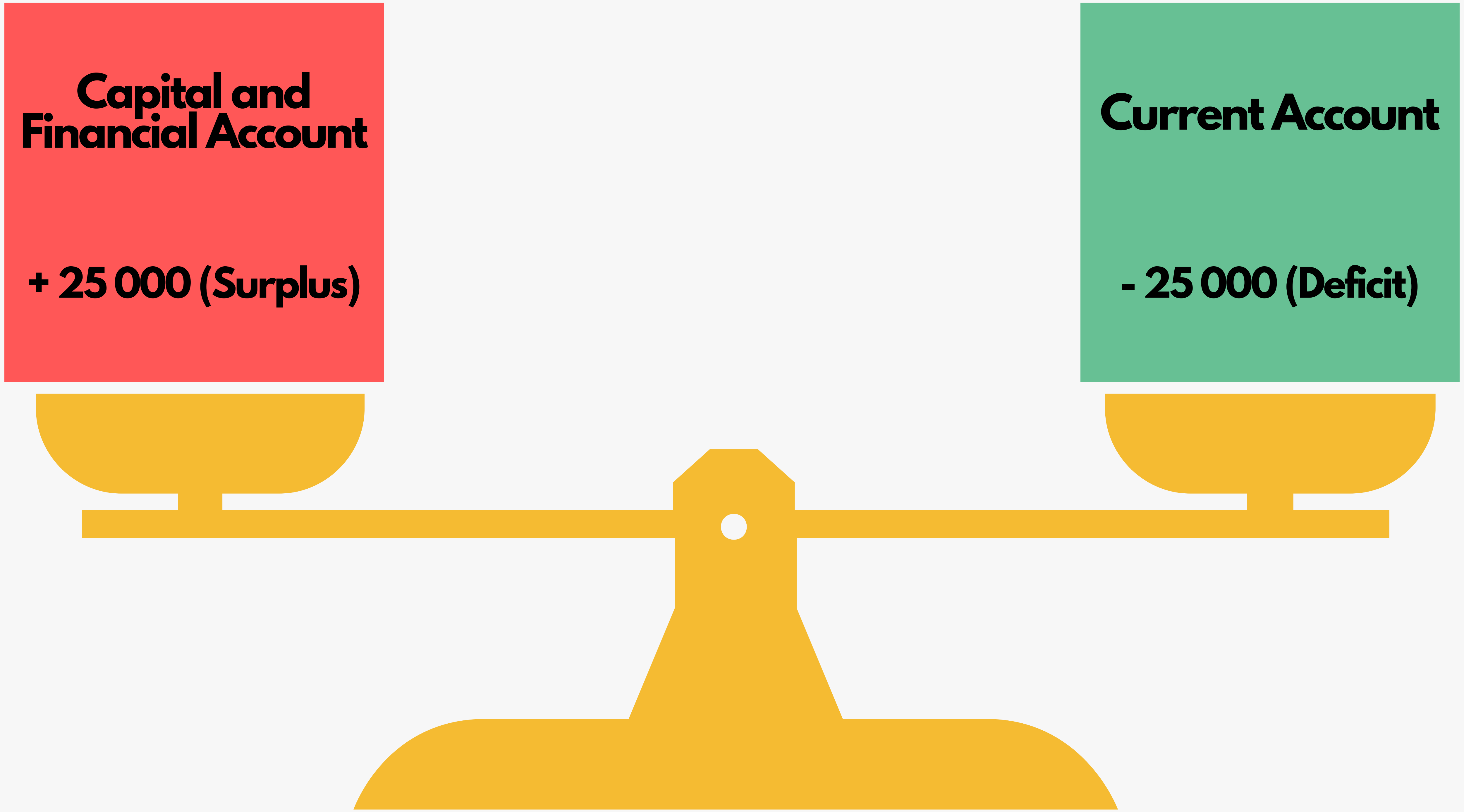
But for which accounts?

America would receive a debit to its current account.

Germany would receive a credit to its financial account as its only transaction is receiving USD and exchanging them for Euros.

Balance of Payments Example

Credits and debits must always offset one another. Balance of payments should always be equal to zero.



Current Account & Exchange Rate

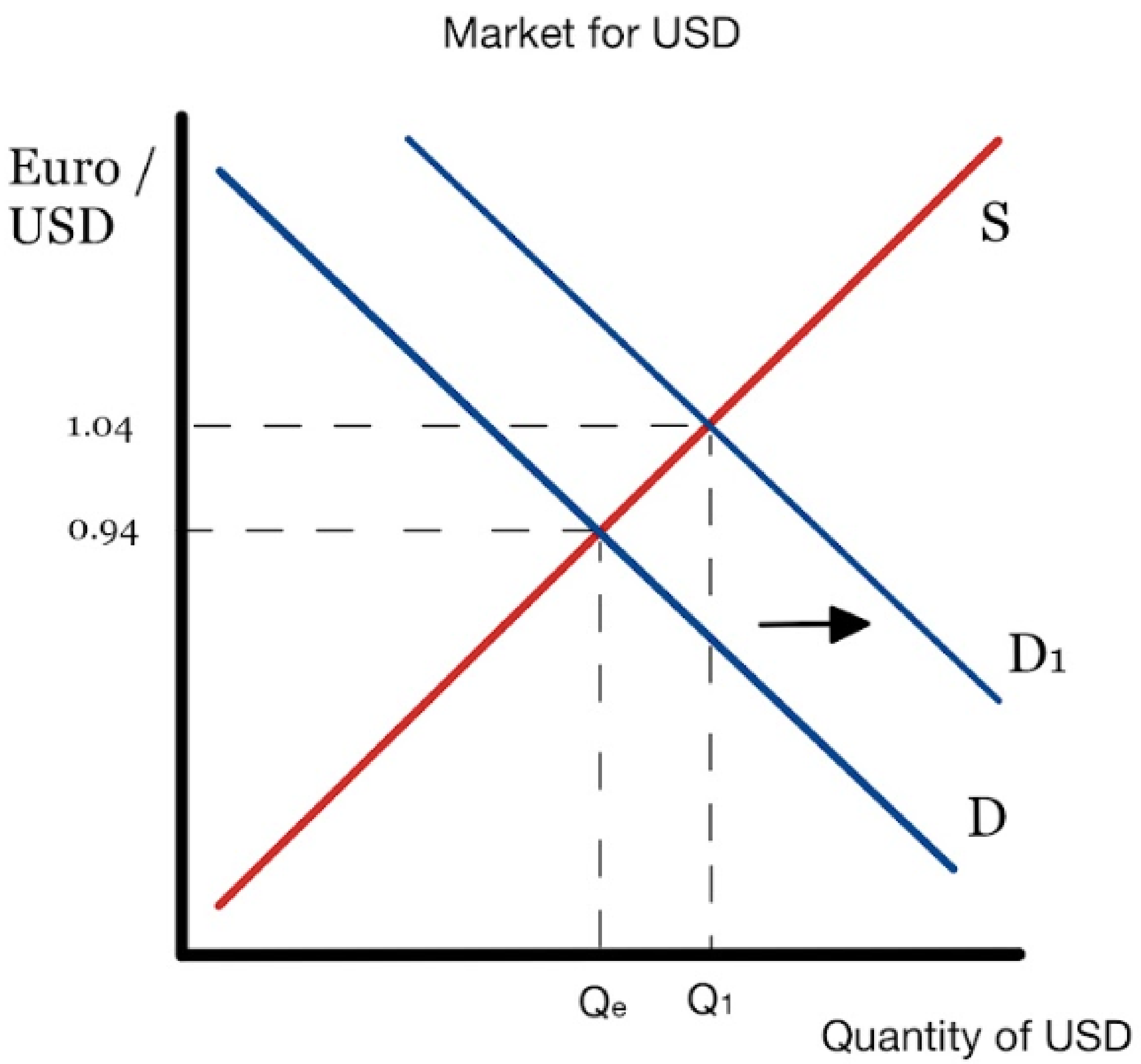
(HL ONLY)

Current Account & Exchange Rate

Current account deficits and surplusses are automatically adjusted under a floating exchange rate system.

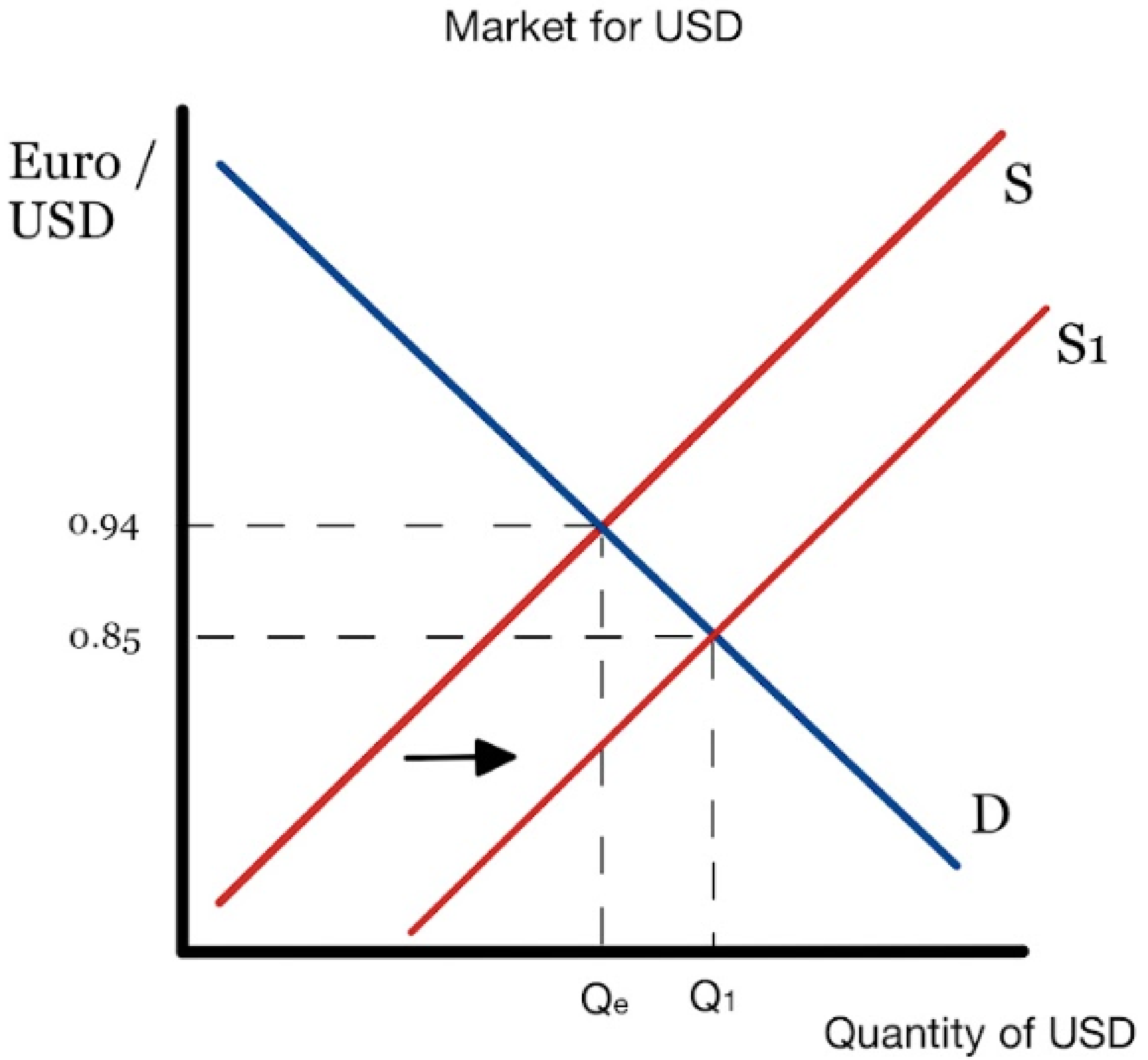
Current Account Surplus Example

If a country exports airplanes for example, they receive a current account surplus. As the payment for these planes eventually exchange to USD, this results in increased Demand of USD. (appreciation)



Current Account & Exchange Rate

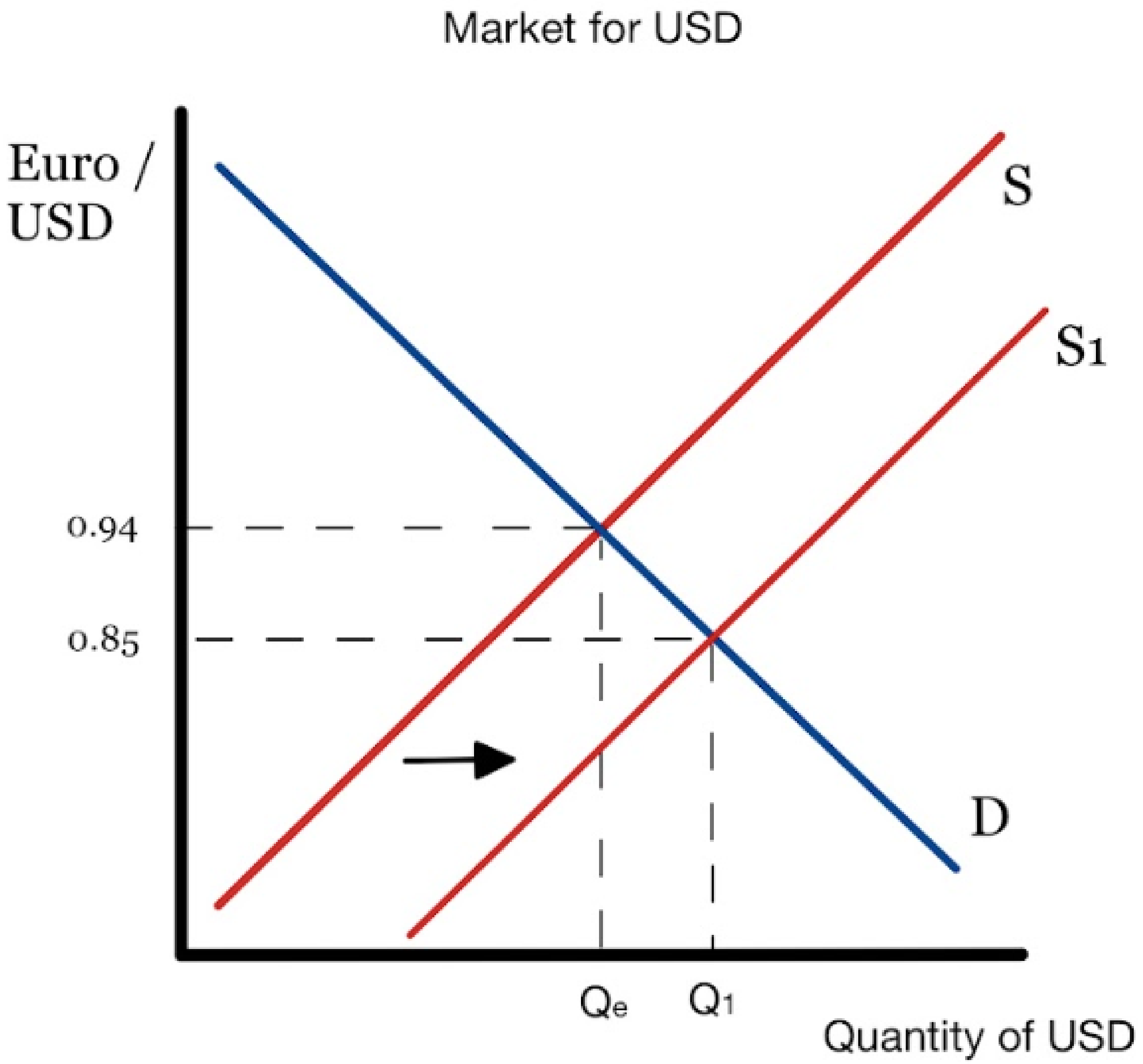
This appreciation causes exports to appear more expensive and result in a decrease in the demand for exports as consumers will buy planes from other countries.



Current Account & Exchange Rate

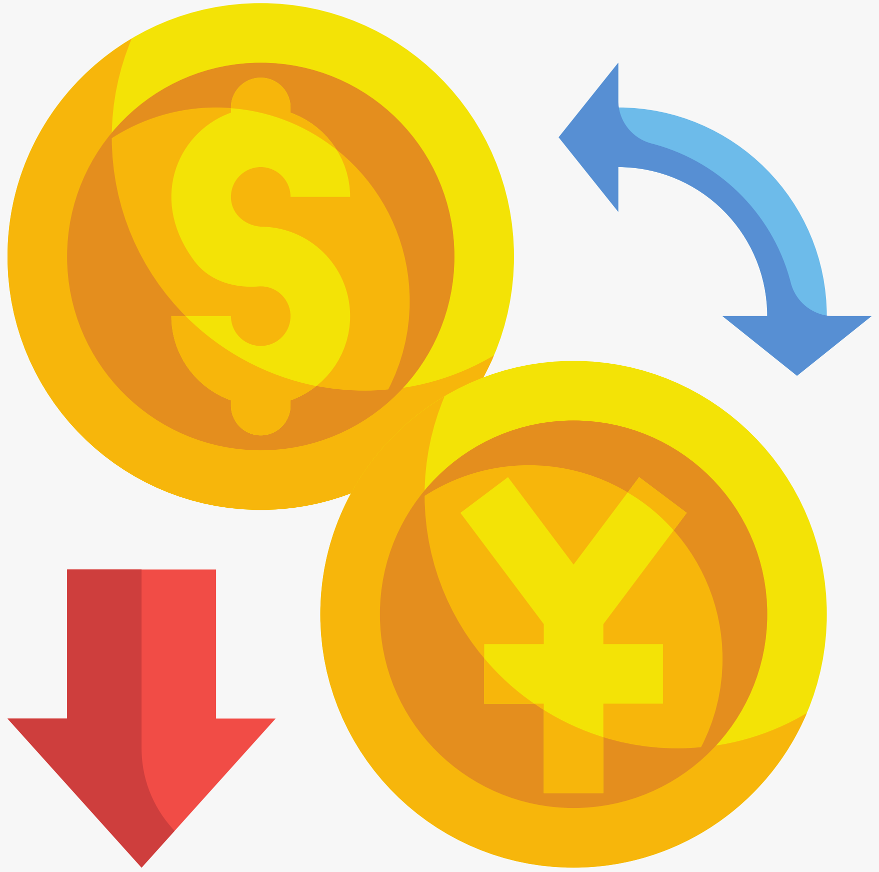
The same exact scenario occurs for a current account deficit.

A current account deficit means money is leaving your country and the supply of your currency is increasing (Depreciation). Exports now appear to be cheaper leading to an eventual increase in Demand.



Financial Account & Exchange Rate

(HL ONLY)

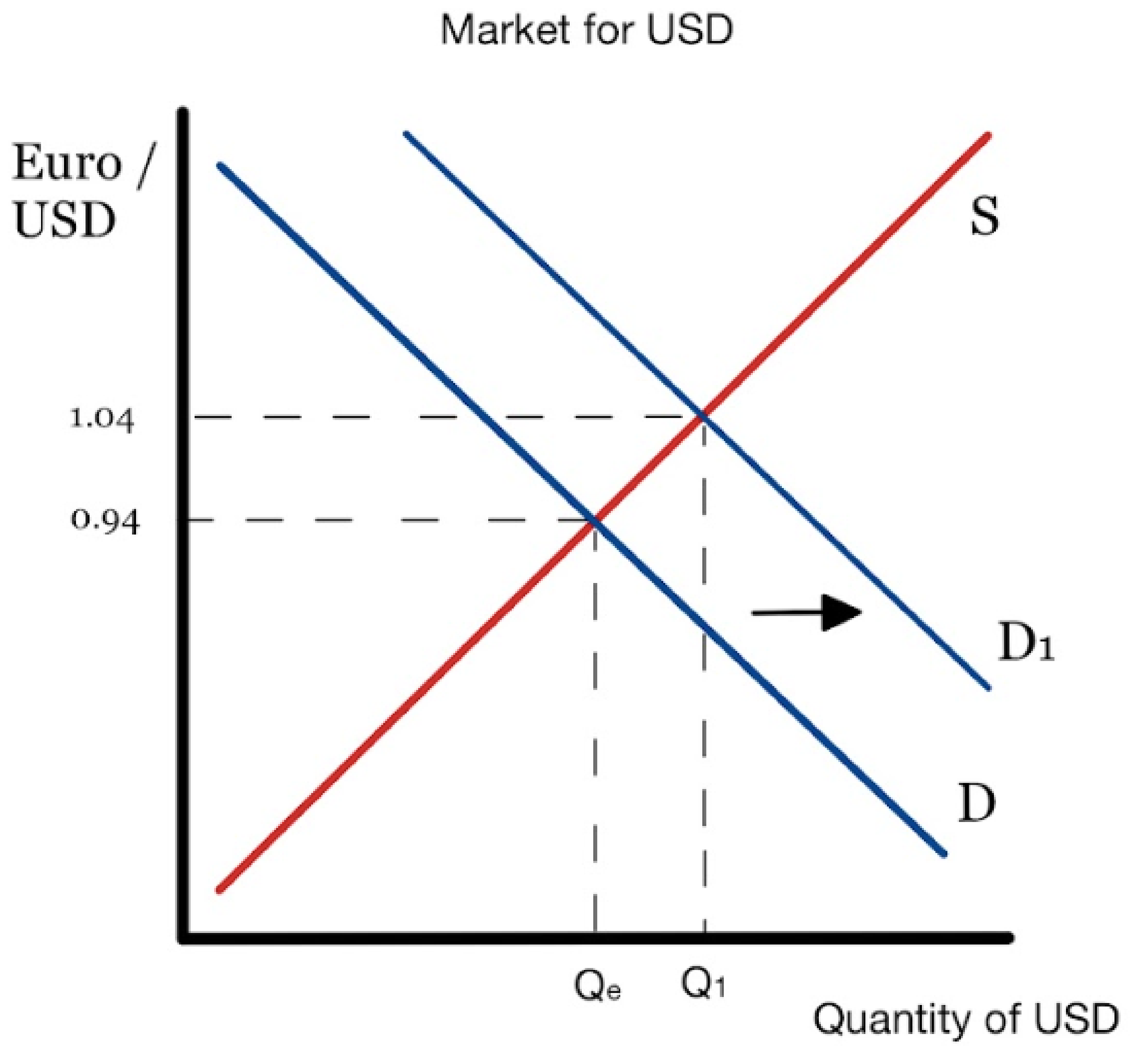


Financial Account & Exchange Rate

Uncertainty and interest rates also have the ability to affect the exchange rate.

Financial Account Surplus Example

If US banks offer a higher interest rate than countries in Europe, USD appreciates due to the increase in demand. However, due to appreciation this results in a decrease in demand for exports r and an increase in demand for imports eventually causing the exchange rate to adjust back down.



Implications of a Consistent Current Account Deficit

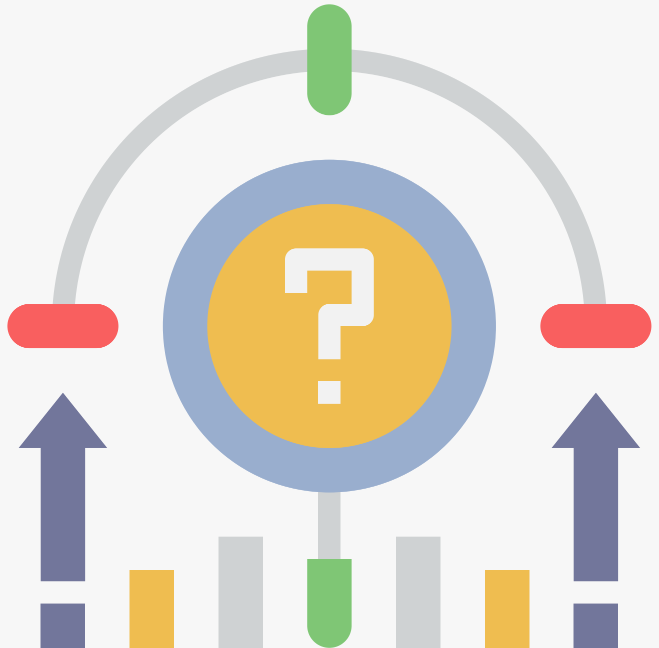
(HL ONLY)

Implications of a Persistant Current Account Deficit

- **Exchange Rates**
  - CA Deficit puts downward pressure on a currency's exchange rate. Typically this adjusts back but there are scenarios for countries that import a large number of raw materials where this damages their economy long-term.
- **Interest Rates**
  - CA Deficits can cause increases in interest rates potentially causing a decrease in AD due to a lack of consumption and investment.
- **Foreign ownership of domestic assets**
  - Due to the decrease in the exchange rate, foreign investors may purchase larger quantities of domestic assets, meaning the money will continue to exit the economy.

Implications of a Persistant Current Account Deficit

- **Debt**
  - If a country's imports are greater than exports persistently, this can lead to indebtedness
- **Credit Ratings**
  - If a country is unable to service its financial account debt (capital payments on loans), it could receive a downgrade in its credit score.
- **Demand Management**
  - CA deficits must be taken into account by governments attempting to use DS policies as government spending can impact the BOP in a negative way.
- **Economic Growth**
  - If a country's citizens consistently buy foreign products and services, domestic producers receive no revenue and are forced to lay off workers and reduce output.

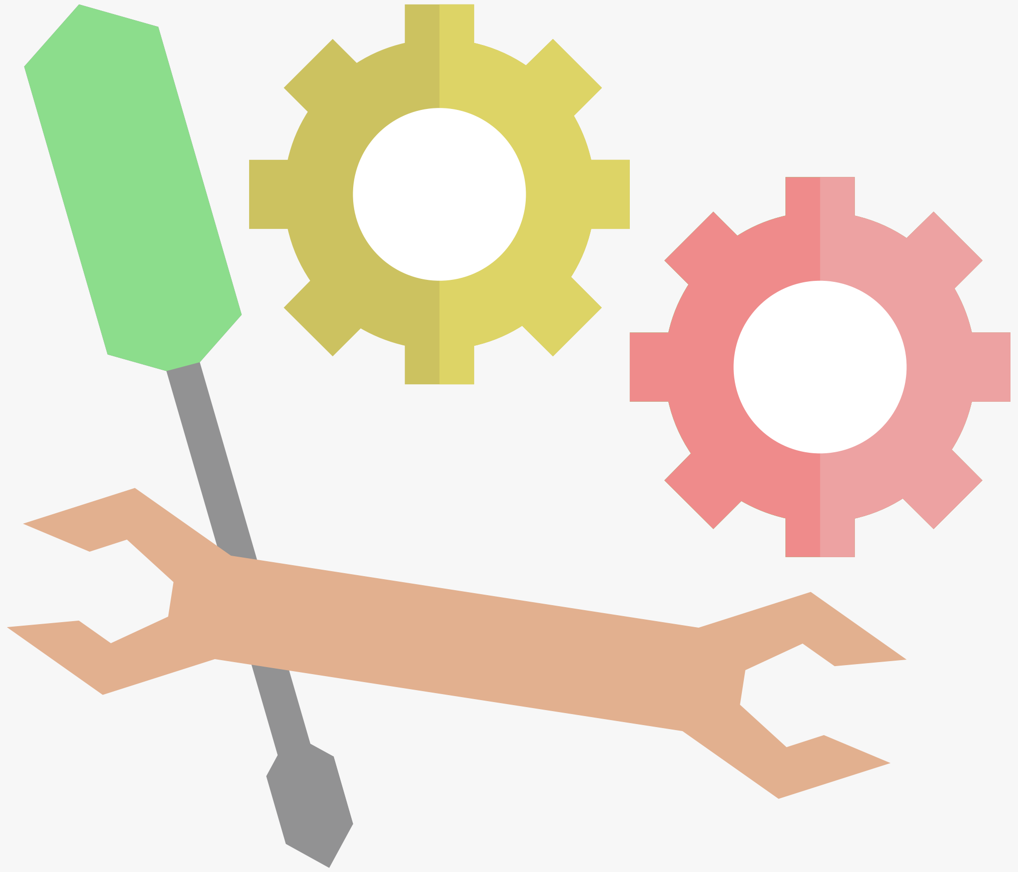


Current Account Deficit Consequences

EconPlusDal

Methods to Correct a Persistent Current Account Deficit

(HL ONLY)



Methods to Correct a Current Account Deficit

- **Expenditure Switching**
  - The goal is to switch consumption from imports to domestic goods by the use of protectionist measures (tariff, quota, subsidy)
- **Expenditure Reduction**
  - Attempting to slow down the economy, a government may use contractionary demand-side policies to reduce aggregate demand.
- **Supply-Side Policies**
  - If domestic producers are simply uncompetitive or not innovative enough to compete in international markets, supply-side policies should be able to help with a focus on production, efficiency, and R&D.

Effectiveness of Methods to Correct a Current Account Deficit

(HL ONLY)

Effectiveness of Measures

Expenditure Switching

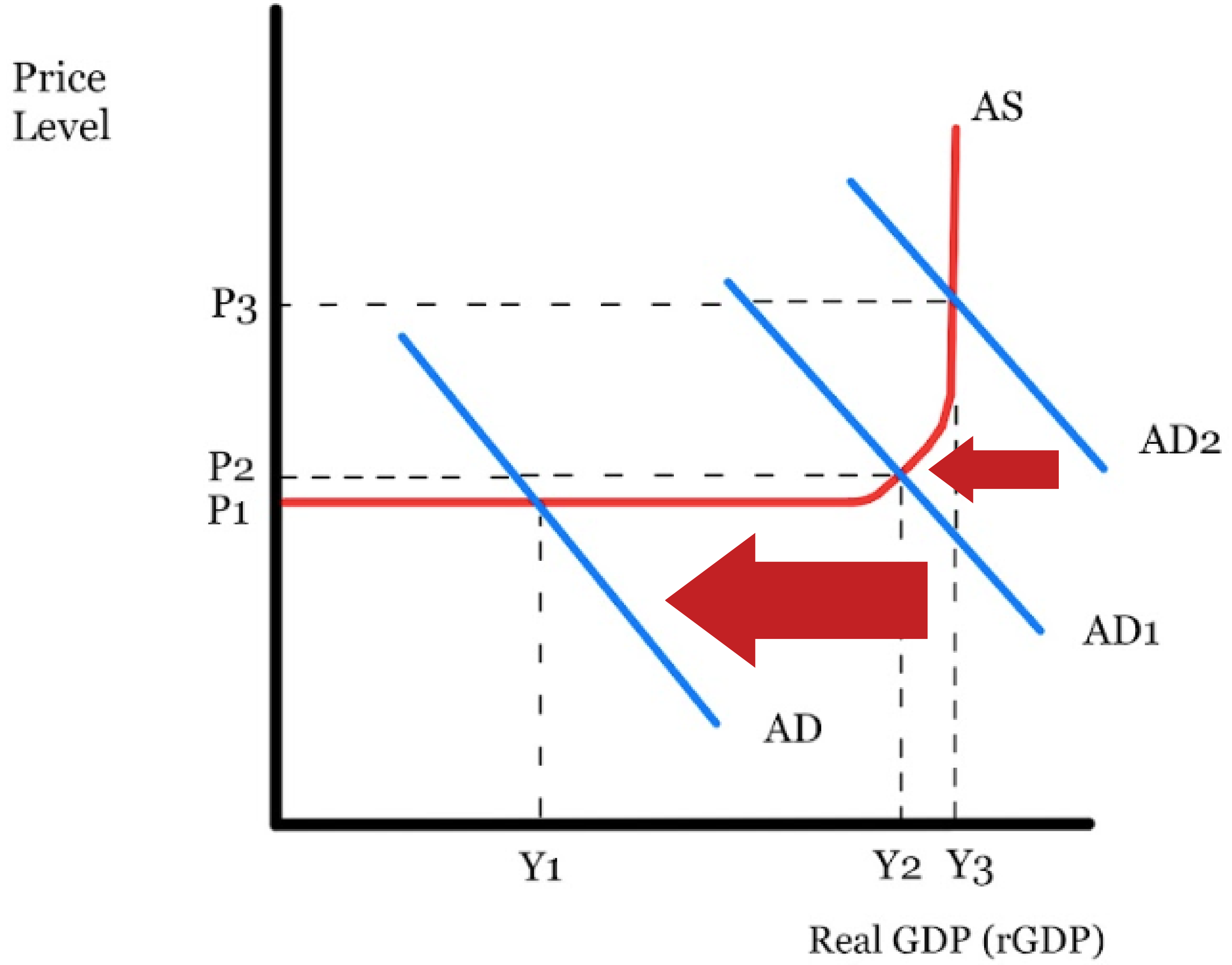
As this method deals with protectionist measures, the primary factor in the effectiveness will be the elasticity of the good on which the tariff or quota is placed. In order for it to be effective, a country must be able to produce the good domestically.

For example, if Cambodia were to place a tariff on electronic semiconductor chips it would not be effective as Cambodia is unable to produce them domestically due to lack of appropriate technology.

Effectiveness of Measures

Expenditure Reduction

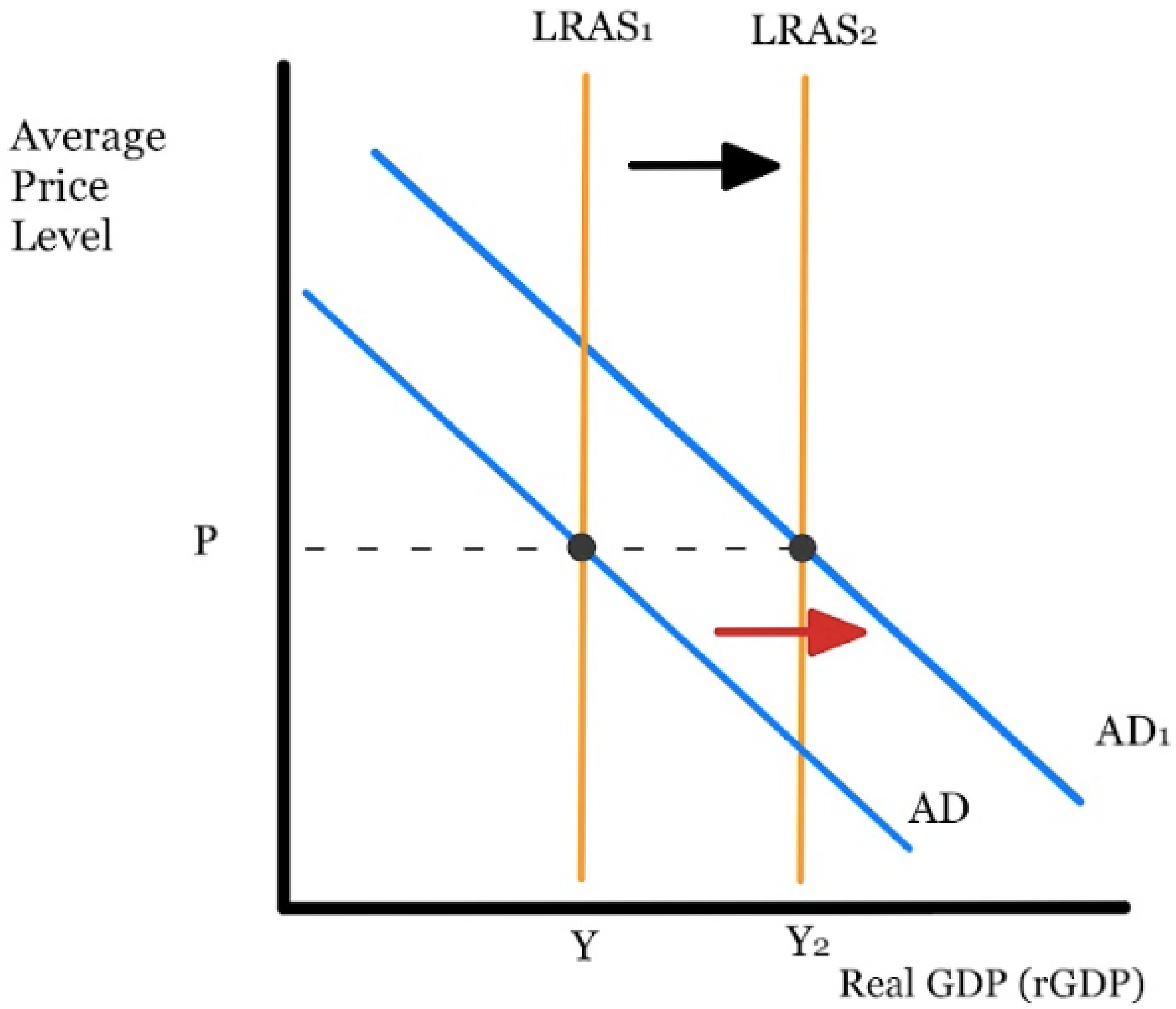
Contractionary Demand-side policies do have the ability to correct a CA deficit. However, too much contractionary policies can lead to a recession and drastic fall in real GDP.



Effectiveness of Measures

Supply-Side Policies

Both expenditure switching and reducing policies don't address the direct issue of why consumers prefer foreign imports over domestic goods. A government may chose to enact SS policies designed to increase efficiency and competition to create better goods and increase export demand.



Balance of Payments - Policies to Correct Current Account Imbalances | Economics Revision

tutor2u

The Marshall-Lerner Condition & The J-Curve

(HL ONLY)

Definition

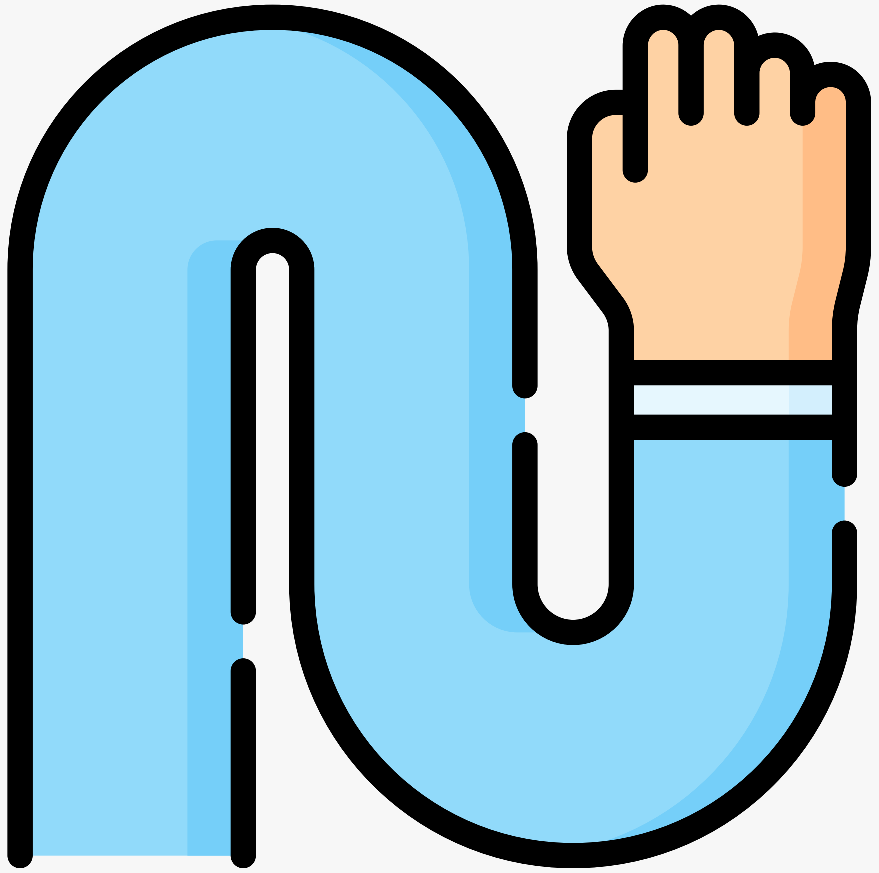
Marshall-Lerner Condition

A condition stating that depreciation or devaluation of a currency will lead to an improvement in the current account balance if the sum of the price elasticity of demand for exports plus the price elasticity of demand for imports is greater than one.

Essentially, if the demand of exports and imports are elastic, it's easy to decrease consumer demand for foreign goods and the current account deficit will correct itself and collect a surplus.

Its All About Elasticity

Essentially, if the demand of exports and imports are elastic, it's easy to decrease consumer demand for foreign goods and the current account deficit will correct itself and collect a surplus.



The same is true for the opposite. If the demand for exports and imports is inelastic, a current account deficit may continue to worsen and further depreciate currency.

Definition

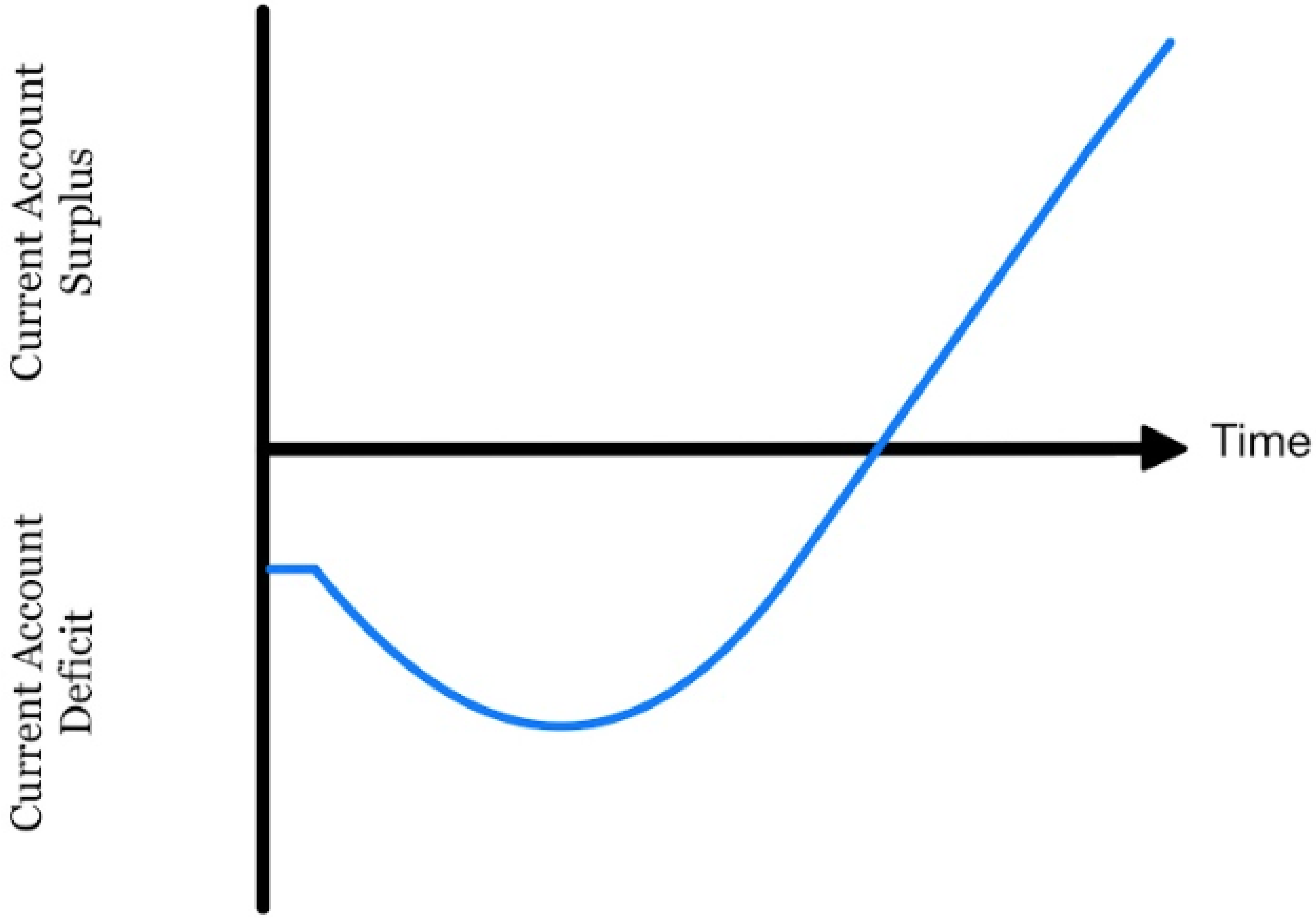
The J-Curve Effect

Following devaluation or a sharp depreciation, a trade deficit will typically widen before it starts improving thus tracing the letter "J" if plotted against time, because the Marshall-Lerner condition is satisfied only after a period of several months following the decrease value of the currency.

In simple terms, it takes time for a current account adjustment to take place.

Diagram

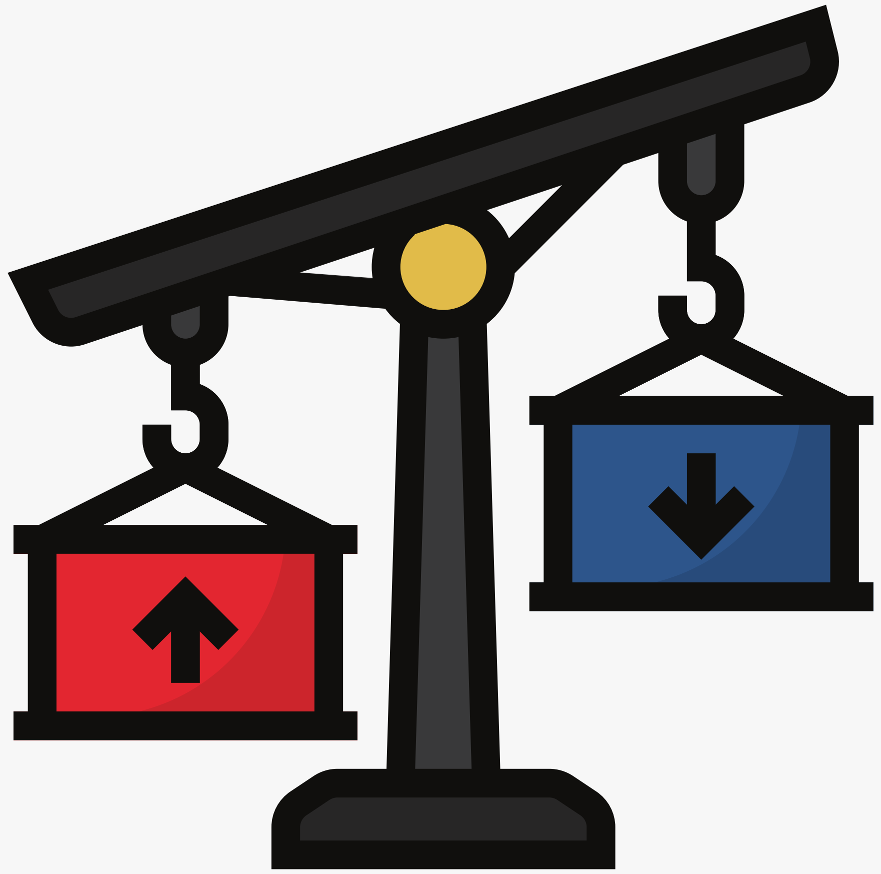
J-Curve Effect



It takes time for consumers to adjust to new prices.

Implications of a Consistent Current Account Surplus

(HL ONLY)



Implications of a Persistant Current Account Surplus

CA surplus occurs only when imports are decreasing and exports increasing.

Domestic Consumption and Investment

- During a recession, consumers may import less or exports may be more attractive.

Exchange Rates

- CA surplus leads to appreciation. Eventually, this decreases exports as they appear more expensive and an increase in imports as the domestic currency is now stronger.

Inflation

- Due to an increase in exports, AD typically increases potentially causing inflation.

Implications of a Persistant Current Account Surplus

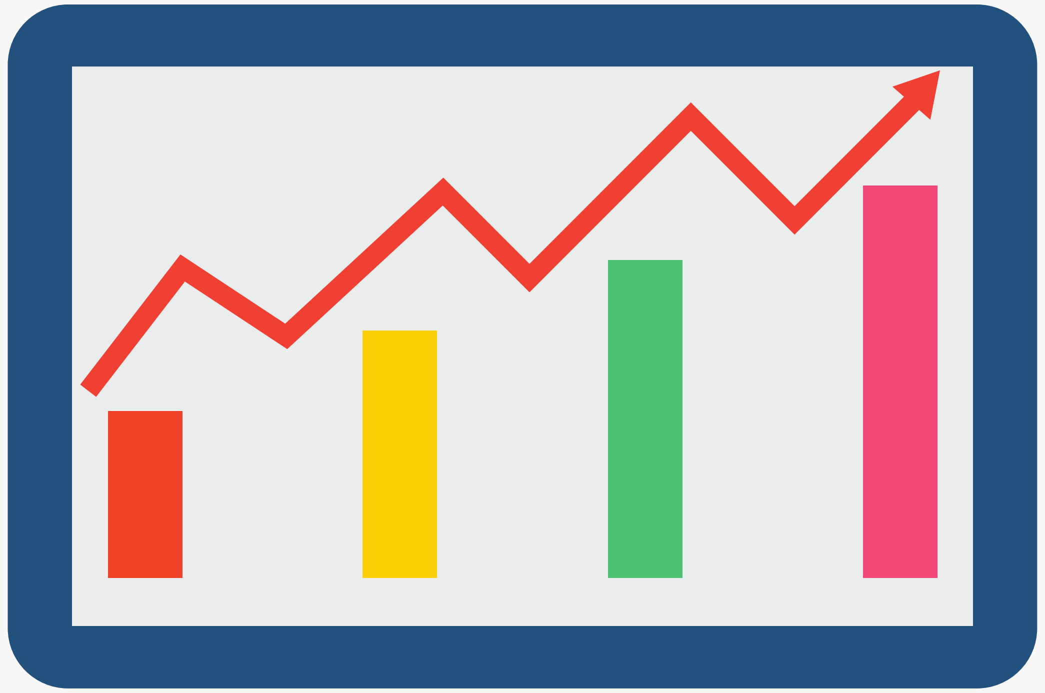
CA surplus occurs only when imports are decreasing and exports increasing.

Employment

- As increasing exports cause AD to increase, the quantity of employed typically increases.

Export Competitiveness

- CA surplus leads to appreciation. Eventually, this decreases exports as they appear more expensive.



Practice Question

Paper 3

Mock/22/ECONO/HP3/ENG/TZ0/XX

Cymru experiences a depreciation in its currency, Cymran Pounds (£s) with the result on imports and exports given in the table below.

Table 5

	Before depreciation	After depreciation
Quantity of Exports	15 600	19 500
Quantity of Imports	16 400	15 580
Average price of Exports	1250	1000
Average price of Imports	750	825

(iii) Using table 5, calculate the elasticities for exports and imports for Cymru. *[4]*

(iv) Using your answer in part (iii), state and explain whether Cymru fulfils the Marshall-Lerner condition and its effect of the depreciation on Cymru's current account. *[3]*

(b) Using the data provided and your knowledge of economics, recommend a policy which the government of Cymru could introduce to correct their persistent current account deficit. [10]

Mark Scheme

Cymru experiences a depreciation in its currency, Cymran Pounds (£s) with the result on imports and exports given in the table below.

(iii) Using table 5, calculate the elasticities for exports and imports for Cymru. *[4]*

$PED = \%\Delta Qd \div \%\Delta P$ => for exports: $((19500 - 15600) \div 15600) \times 100 = 25$

and $((1000 - 1250) \div 1250) \times 100 = 20$ giving $PED = 25 \div 20 = 1.25$ . . . .

for imports: $((15580 - 16400) \div 16400) \times 100 = 5$

and $((825 - 750) \div 750) \times 100 = 10$ giving $PED = 5 \div 10 = 0.5$ . . . .

Answers: PED for exports 1.25 and PED for imports 0.5 . . . .

(iv) Using your answer in part (iii), state and explain whether Cymru fulfils the Marshall-Lerner condition and its effect of the depreciation on Cymru's current account. *[3]*

- Cymru fulfils the Marshall-Lerner condition (1 mark)
- the combined PEDs of imports and exports are greater than 1, being 1.75 $(1.25 + 0.5)$ (1 mark)
- the depreciation will improve the current account (1 mark)

Mark Scheme

(b) Using the data provided and your knowledge of economics, recommend a policy which the government of Cymru could introduce to correct their persistent current account deficit. [10]

Policies **may** include, but are not restricted to:

- Expenditure switching policies
- Expenditure reduction policies
- Supply-side policies