AS – ECONOMICS (9708)

MACRO

CHAPTER 3: Balance of Payments

Topics
1. Structure of BOP
2. Causes of BOP Disequilibrium
3. Consequences of BOP Disequilibrium
4. Policies to Correct BOP Disequilibrium

TOPIC 1: STRUCTURE OF BOP

1. BALANCE OF PAYMENT

Definition: A set of accounts showing the transactions conducted between residents of a country and the rest of the world. Money coming into the country creates credit items, which have a positive sign. Money going out of the country gives rise to debit items and is recorded with a negative sign. It consists of FOUR components:

1. Current account
2. Capital account
3. Financial account
4. Net errors and omissions

BOP = Current Account + Capital Account + Financial Account + Net Errors and omissions

2. CURRENT ACCOUNT

Definition: It is a part of BOP account which records exports and imports of goods and services. The current account has FOUR parts:

1. Visible trade balance
2. Invisible trade balance
3. Income flows
4. Current transfers

Current Account = Visible trade balance + Invisible trade balance + Income flows + Current transfers

1. Visible trade balance

Definition: This is the part of BOP accounts which records exports and imports of goods only. This is also known as balance of trade in goods. Exports are goods sold to other counties whereas imports are goods bought from other countries. Example: export and import of cars, wheat, rice, machinery etc.

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Visible Trade Balance = Visible Exports – Visible Imports

2. Invisible trade balance

Definition: This is the part of BOP which records exports and imports of services (intangible products) like banking, education, insurance, shipping, tourism etc. Example: An American tourist spends money in Pakistan is an invisible export for Pakistan. Whereas giving Cambridge International Examination exams is regarded as an invisible import for Pakistan.

Invisible Trade Balance = Invisible Exports – Invisible Imports

Note: In order to understand imports and exports we should see the flow of money. The country paying is importing and the country selling is exporting.

Note: The sum of visible trade and invisible trade is known as balance of trade, or net exports.

3. Income flows

Definition: This is the part of BOP which is a record of a county's net income earned from capital flows. Example: Interest, profits, and dividends paid to foreigners vs. incomes earned from assets owned by domestic residents and firms.

Net Income flows and transfers = Income flows earned – Income flows sent

4. Current transfers

Definition: These are payments made and received for which there is no corresponding Exchange of an actual good or service. Examples: Money from international organizations, foreign aid and remittances.

2. CAPITAL ACCOUNT

Definition: It records the flow of funds into and out of the country associated with acquisition or disposal of fixed assets, the transfer of funds by migrants and the payment of grants by government for overseers projects. It is usually a small part of the BOP.

3. FINANCIAL ACCOUNT*

Definition: This records the flow of money into and out of the country for the purposes of investment or as deposits in banks and other financial institutions. It is made up of FOUR parts:

Part	Description
1. Direct investment	This covers the building of a factory in another country and the takeover of an existing firm in another country (debit items) or the setting up of a new plant or the takeover of a firm in the country by a foreign firm (credit items).
2. Portfolio investment	This includes the purchase and sale of government bonds and shares that do not involve legal control of a firm.
3. Other investments	This part covers shorter-term movements of financial investment including bank loans and inter-government loans. Direct, portfolio and other investments generate investment income that appears in the income section of the current account.
4. Reserve assets	These are made up of the government's holdings of gold, foreign exchange reserves, Special Drawing Rights and changes in the country's reserve position in the IMF. Reserves are kept to settle international debts and to influence the value of the foreign exchange rate. Additions to the reserves are shown as debit items while reductions to the reserves are shown as credit items. This is because, for instance, if the central bank sells some of its foreign currency, it will be gaining its own currency in exchange, so there will be a flow of currency into the country.

4. NET ERRORS AND OMISSIONS

Definition: A figure included to ensure the balance of payments balances. Also knows as balancing items. This is made because balance of payments as a whole must always balance. This is because any credit item has to be matched by a corresponding debit item. Example: Deficit in current a/c must be matched with a surplus in the capital and financial accounts.

Example
Before Net errors and omissions:
current account + the capital and financial accounts = - $2,000 million
This means that $2,000 million more must have come into the country than was recorded. In this case, a net errors and omission figure of plus $2,000 million would be added.
After Net errors and omissions: Cr → 2000 mill Dr → outflow in form of import
current account + the capital and financial accounts + net errors and omission (+2000) = 0

5. BOP EQUILIBRIUM AND DISEQUILIBRIUM

Definition | BOP Equilibrium: An BOP equilibrium means that all accounts are balanced. When one account's deficit* is covered by surplus* of another account. It might also be the case when deficit of one year is covered by next year surplus and vice versa. Here the exchange rate doesn't change.

Definition | BOP Disequilibrium: This is a situation when surpluses or deficits persists for many years.

BOP Deficit	BOP Surplus
*Deficit = Money Inflow < Money Outflow	*Surplus = Money Inflow > Money Outflow
This happens when: 1. Reserves ↓ 2. Loans ↑ Interest payments ↑ 3. Unemployment ↑	This happens when: 1. Inflation ↑ 2. Retaliation by trading partner

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An economy experiences alternatives shortages/deficits and surplus in it's current AC. What is going to be the impact on BOP
Answer: stable.

TOPIC 2: CAUSES OF BOP DISEQUILIBRIUM

The disequilibrium can occur in any of the following accounts:

1. Current account
2. Capital account
3. Financial account

1. Disequilibrium in the Current Account

A disequilibrium can occur because of a deficit or a surplus. Deferent created due to two reasons 1) Exports ↓ Import ↑ 2) Net emigration

Cause of a Deficit	Description
1. Domestic Economy Grows	When an economy grows it needs more resources. These firms import raw material, labor and machinery from abroad which leads to a deficit. This is however not harmful since the country expanding today will make better products and will increase its exports in the future.
2. Recession in Trading Partner	If the economy of our trading partner drops it will lead to a decline in our exports. This is also known as cyclical deficit. However this problem will be resolved once the economy starts to grow hence it is self-correcting.
3. Structural Issues	This is a more long term source of deficit and is of a higher concern. This happens because the quality of exports is low, the labor and capital in the country is not productive hence higher costs, an overvalued exchange rate which makes exports expensive etc.

2. Capital account

A disequilibrium can occur because of a deficit or a surplus.

Cause of a Deficit	Description
1. Net Emigration	This is when individuals from a country take their assets to another country because the other country had better opportunities.

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3. Financial account

A disequilibrium can occur because of a deficit or a surplus.

Cause of a Deficit	Description
1. Money Flowing Out	It may also be short-term, resulting from hot money flowing out of the country in search of higher interest rates and in expectation that other currencies may rise in value.
2. Lack of Confidence in the country's economy	Foreign owners of firms and shares in the country may sell these in large quantities. This movement of firms and funds out of the country reduces tax revenue and employment and may result in the country moving into a recession.

Note: A financial account deficit is not necessarily a problem, especially as it will give rise to an inflow of profits, interest and dividends in future years however, if it results from a long-term lack of confidence in the country's economic prospects. Indeed, such a concern might result in a problems.

Same consequences for current account deficit

TOPIC 3: CONSEQUENCES OF BOP DISEQUILIBRIUM

The consequences of a DEFICIT

Factor	Description
1. Increase in standard of living	This will happen because the country will be consuming more goods and services that it produces. However if it is not covered up by investment income the country might need to borrow or use its reserves.
2. Pay interests, profits and dividends	In case of a deficit the country needs investors and borrowing. This will lead to outflow of interests, profits and dividends which will in the future weaken the investment income.
3. Lower AD	Though a lower AD will reduce demand pull inflation however it will also lead to reduced employment and will slow down economic growth.

The consequences of a SURPLUS

Factor	Description
1. De-industrialization	When an economy has large surpluses they use it to purchase industrial goods from abroad. This also results in overvaluation of currency which further reduces the demand for goods leading to lower industry.
2. Restrictions by trading partners	When an economy is in surplus others must be in deficit. Looking at this other economies start placing restrictions on imports which will reduce world trade. This in the long run might lead to huge deficits in the country's economy.
3. Inflation	When there is a surplus the X > M. This will lead to a higher AD which will cause demand pull inflation. This will only be beneficial if the economy is below employment hence this will lead to economic growth and employment however if the economy is at full employment this will lead to high rates of inflation. and the economy grow
4. Lower living standards	This is because the reserves of foreign currency can be turned into goods and services for the population but the govt. is no using them.

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TOPIC 4: POLICIES TO CORRECT BOP DISEQUILIBRIUM / current account deficiets.

The government can use several polices to correct BOP disequilibrium:

1. Expenditure Dampening Policies / Reducing policies
2. Expenditure Switching
3. Exchange Controls
4. Supply Side Policies

1. EXPENDITURE DAMPENING POLICIES

Definition: Expenditure dampening policies aim to reduce demand in the economy, so spending on imports fall. The govt. can the following TWO types of policies to reduce the demand for imports:

1. Contractionary Fiscal Policy
2. Contractionary Monetary Policy

1. Contractionary Fiscal Policy

Definition: This policy aims to reduce govt. spending and increase taxes. This will cause a decrease in aggregate demand and hence national income. When the income falls in the economy people tend to import less hence reducing the BOP deficit. This also helps control demand-pull inflation

G↓& T↑ → AD↓ Y↓ Imports (M) ↓

Limitation of Contractionary Fiscal Policy

Limitation	Description
1. Short-run solution	This is because once the policy measures are stopped, households and firms are likely to go back to spending the same amount on imports relative to the amount of export revenue earned.
2. Unemployment	Raising taxes may also have adverse side effects. They lower demand, which may increase unemployment and slow economic growth. Higher taxation can also create disincentive effects and so may reduce aggregate supply.

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2. Contractionary Monetary Policy

Definition: This policy aims to reduce money supply and increase interest rates. This will cause a decrease in aggregate demand and hence national income. When the income falls in the economy people tend to import less hence reducing the BOP deficit.

MS↓& Interest Rates↑ → AD↓ Y↓ Imports (M) ↓

Limitation of Contractionary Monetary Policy

Limitation	Description
1. Difficult to control money supply	This is because commercial banks have an incentive to lend, and they will try to get around the limits that the central bank imposes in them.
2. Time Lags	Interest rates take time to be effective. Since it will take time for consumers to adjust their spending.
3. High unemployment and lower GDP	This is because when AD is low, less goods are demanded hence lower economic output which leads to an increase in unemployment.

4. Lower foreign direct investment	Foreign firms might not invest as it would raise foreign firms cost since buying machinery and land on interest would now be expensive. Furthermore the firms see a falling demand which will increase chances of failure.
5. Exchange rate might not work	This policy won't work if the combined PED of exports and imports is less than 1. (Marshal Lerner Condition).
6. Short-term solution	Only a short-term solution just like the fiscal policy. However if an economy moves towards free floating system this can be effective in solving a deficit if previously the exchange rate was set above the equilibrium or artificially appreciated.

Evaluation of Expenditure Dampening Policies

1. These policies will produce effective results in a developed economy because the money markets are well developed which leads to an effective transmission of the policies.

2. While applying these polices the govt. must ensure that the economy is not operating in a liquidity trap because a change in the money supply fails to change the interest rates.

3. If people in an economy do conspicuous consumption this might limit the effectiveness of the polices.

2. EXPENDITURE SWITCHING

Definition: Expenditure-switching policies aim to switch consumer spending towards domestic goods, and away from imports. The govt. can the following TWO types of policies to reduce the demand for imports:

1. Devaluation/Depreciation of Currency
2. Protectionary Measures

1. Devaluation/Depreciation of Currency (Monetary Policy)

Definition: It can be defined as a deliberate policy used by government in reducing the par value of the country's currency in terms of other currencies. This results in imports becoming more expensive whereas exports become cheaper hence improving the BOP.

Note: When an economy faces both unemployment and a BOP deficit expenditure switching policies always prove to be more beneficial since they resolve both the problems.
1. Due to devaluation the local goods become cheaper as compared to imported ones hence lower imports. Hence consumers switch from imports to domestic goods.
2. Improvement in current account will cause an increase in expenditure on the local goods increasing their demand. This will result in lower unemployment.

Evaluation of Devaluation/Depreciation of Currency

1. This technique will only be beneficial when the PED of imports and exports combined is greater than 1 or elastic. (Marshal Lerner condition).

2. Other countries should not retaliate in any form otherwise the policy is useless.

3. Inflation is the country should be low because if it is high, even if the currency is devalued if the price of the goods are still high nobody will buy them.

2. Protectionary Measures (Fiscal Policy)

Definition: This policy restricts imports by imposing tariffs, quotas, embargos OR encouraging exports by giving local firms subsidies, increasing quality of exports, promotion etc. to promote domestic industries in order to give a competitive advantage to domestic industry. (The details of the measures and advantages and disadvantages were discussed under international trade).

3. EXCHANGE CONTROLS

Definition: This is when the govt. authorities regulate the amount of foreign currency available for domestic residents to import goods, services or assets from abroad. Under it, all the exporters are ordered to surrender their foreign exchange to the central bank of a country and it is then rationed out among the licensed importers. None else is allowed to import goods without a license. The balance of payments is thus rectified by keeping the imports within limits.

However this method reduces the confidence of individuals in the market and leads to the contraction of foreign trade and the world's welfare at large. Hence exchange control is an instant remedy to check disequilibrium in the balance of payments. But, in the long-run it results in the creation of basic disequilibrium which harms the economy at large.

4. SUPPLY SIDE POLICIES

Definition: Supply side policy measures may reduce a current account deficit and a financial account deficit by making domestic products more price competitive and by making domestic markets more attractive to invest in.

Methods	Description
1. Deregulation and Privatization	Privatization results in more competition which leads to put pressure on domestic firms to keep costs and prices low, to improve quality and to become more responsive to changes in consumer demand.
2. Increase spending on education and training	A more skilled labor force and better capital equipment may reduce the relative price of domestic output and raise its quality. A skillful labor force and good quality capital equipment may also attract foreign multinational companies to set up branches in the country in expectation they will be able to produce good quality products at low cost.
3. Increased investment	If the government invest on roads and infrastructure investors from abroad would be encouraged to invest. When the same quality of international goods would be produced in an economy people would tend to import less.
4. Trade union reform	Domestic firms to work with more flexibility and so be more responsive to changes in demand. A resulting fall in industrial action may, in addition, make multinational companies more willing to invest in the country.

Limitations of Supply Side Policies

Limitation	Description
1. Long-term solutions	These policies take time to be effective because privatization and education cannot result in immediate change. However in the long run they lead to the overall supply and quality which benefits for a longer period of time.
2. No effective sometimes	Providing more education and training may not be very effective if it is not of a high quality or it develops skills that will not be in demand in the longer term
3. External Costs	Privatization may not result in an increase in efficiency if the privatized industries become monopolies and do not take into account external costs and bene this. Deregulation and trade union reform may also result in increased in efficiency if there is market failure in the product and labor markets, which laws and trade union power initially countered.
4. Firms do not pass the subsidy benefit to consumers.	Firms may not pass on the subsidies to consumers and the payment of subsidies may make the firms less competent. There is also the risk that subsidies may provoke retaliation as foreign governments may see them as unfair competition.

Evaluation of Supply Side Polices

1. These policies will only work for economics that have a high budget and strong political systems to maintain spending on education and infrastructure.

2. Supply side policies need a stable economic and political environment before the policies can produce their result.

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