The balance of payments

Balance of payments: a record of a country's economic transactions with the rest of the world over a year.

- consists of
  - the current account
  - the capital account
  - the financial account
  - net errors and omissions (also sometimes known as the balancing item).

Money coming into the country creates credit items (+).Money going out of the country gives rise to debit items (-).

Components of the balance of payments

- **The current account** within the balance of payments, a record of the trade in goods, trade in services, investment income and current transfers.
  - Trade in goods (aka the balance of trade, the visible balance and the merchandise balance) export-import. A trade in goods surplus arises when export revenue is greater than import expenditure.
  - Trade in services

Components of the balance of payments

The current account

- Income includes income in the form of profits, interest and dividends earned on direct investment abroad and foreign earnings on investment in the country.
- Current transfers government transfers such as payments to and receipts from international organisations and foreign aid.

Components of the balance of payments

- **<u>Capital account</u>**: within the balance of payments, a record of capital transfers and the acquisition and disposal of nonproduced, non-financial assets.
  - Includes:
    - government debt forgiveness
    - money brought into and taken out of the country by migrants
    - the sales and purchases of

    copyrights, patents and trademark

Components of the balance of payments

- **<u>Financial account</u>**: within the balance of payments, a record of the transfer of financial assets between the country and the rest of the world.

1. <u>Direct investment</u>: the building of a factory 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. <u>Portfolio investment</u>: the purchase and sale of government bonds and shares that do not involve legal control of a firm.

Components of the balance of payments

<u>Financial account</u>:

3. <u>Other investments</u>: shorter-term movements of financial investment including bank loans and inter-government loans.

4. <u>Reserve assets</u>: the government's holdings of gold, foreign exchange reserves, Special Drawing Rights and changes in the country's reserve position in the IMF

Components of the balance of payments

- **<u>Net errors and omissions</u>**: a figure included to ensure the balance of payments balances.
  - Aka the balancing item
  - Some mistakes are likely to be made and some transactions may not be included. To compensate for this, a net errors and omissions figure is included.

Balance of payments disequilibria

Causes of a current account deficit:

A growing domestic economy: ➔ not a problem

- When firms are increasing their output, they may buy more raw materials and capital goods from abroad. they are likely to sell more products both abroad and at home.

Declining economic activity in trading partners: ➔no prob aka cyclical deficit the countries that buy this country's imports experience recessions or slowdowns in economic growth

Structural problems: ➔ a problem

lack of international competitiveness. (an overvalued exchange rate, a relatively high inflation rate, low labour and capital productivity.).

Balance of payments disequilibria

- **A financial account deficit**
  - it will give rise to an inflow of profits, interest and dividends in future years.
  - 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.

Not a problem

  - long-term lack of confidence in the country’s economic prospects
  - capital flight> reduces tax revenue and employment> recession

Problem !!!

Balance of payments disequilibria

Consequences of a current account deficit and a current account surplus

A current account deficit	A current account surplus
have to finance the deficit by attracting investment or borrowing.	the country's residents are not enjoying as high a standard of living as possible
reduce aggregate demand> slower economic growth> unemployment.	high level of demand>inflationary pressure
	May be pressured to change its policies by other countries experiencing current account deficit


THE
END