

# **A2 Macro: Balance of Payments**

# Balance of Payments in the context of a globalizing world



## Trade to GDP ratios are rising



## Expansion of Financial Capital



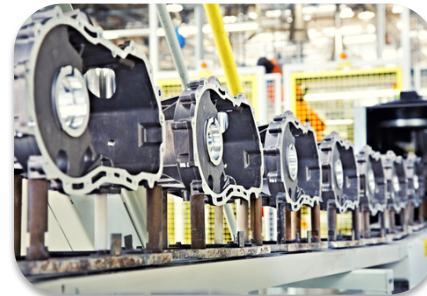
# FDI and Cross Border M&A



## Rise of truly global brands



## Deeper specialization



## Global supply chains & new trade routes

# Key components of the BoP

- The balance of payments is made up of:
  1. The current account
  2. The capital account
  3. Official financing account
- *(Note: You will need to understand all three for A2 exams, the AS course focused only on current account)*

# Current A/C of Balance of Payments

Trade Balance in Goods



```
graph TD; A[Trade Balance in Goods] --> B[Trade Balance in Services]; B --> C[Net Money Transfers]; C --> D[Net Investment Income from Overseas];
```

Trade Balance in Services

Net Money Transfers

Net Investment Income from Overseas

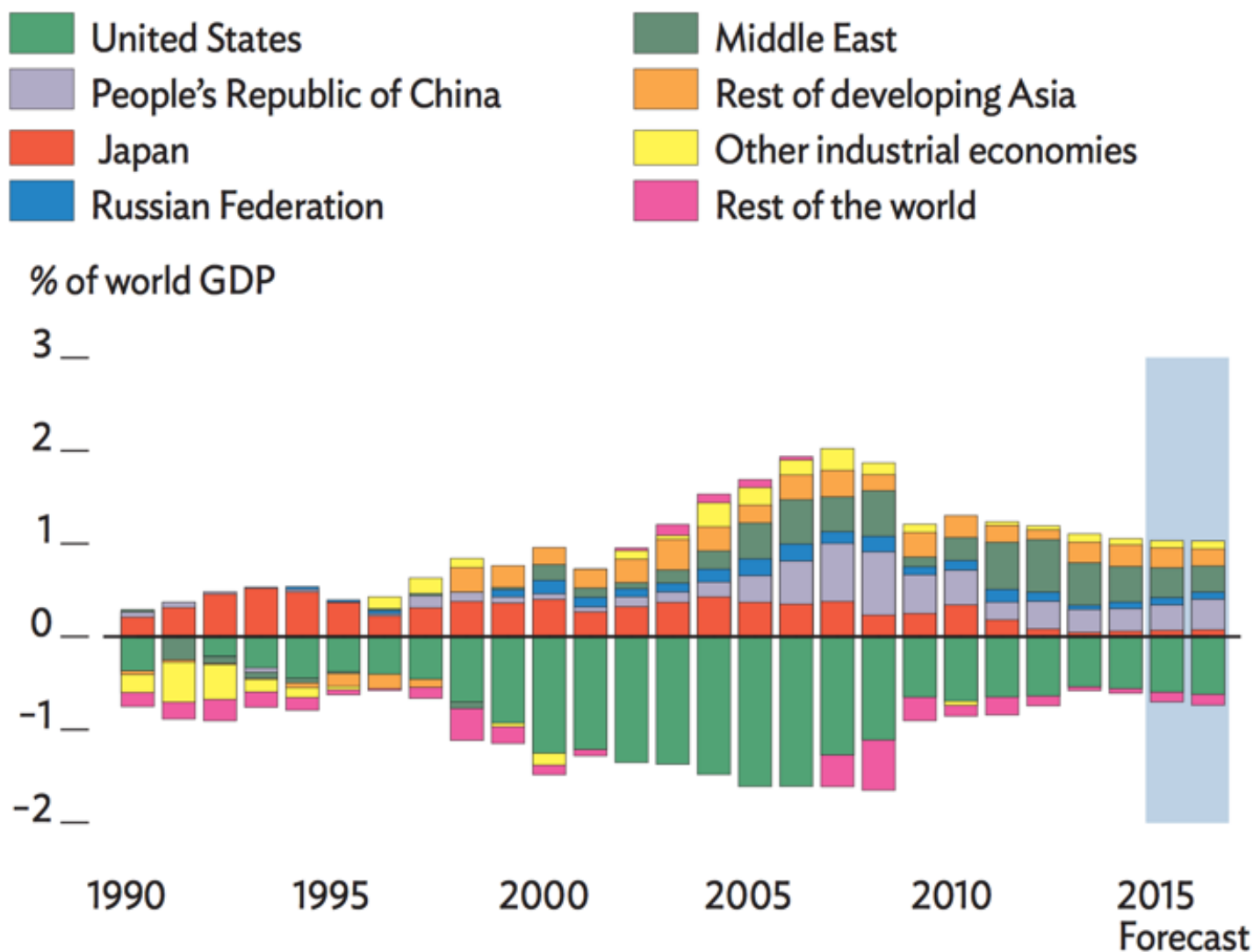
Item of the BoP	Net Balance \$ billion	Comment
<b>Current Account</b>		
(1) Balance of trade in goods	-25	A trade deficit
(2) Balance of trade in services	+10	A trade surplus
(3) Net investment income	-12	Net outflow of income i.e. due to profits of transnational corporations
(4) Net overseas transfers	+8	Net inflow of transfers perhaps from remittance payments from migrants
Sum of 1+2+3+4 = Current account balance	<b>-19</b>	Overall – this country runs a current account deficit
<b>Financial Account</b>		
Net balance of foreign direct investment flows	+5	Positive net inflow of FDI
Net balance of portfolio investment flows	+6	Positive net inflow into equity markets, property etc.
Net balance of short term banking flows	-2	Small net outflow of currency from country's banking system
Balancing item	+2	There to reflect errors and omissions in data calculations
Changes to reserves of gold and foreign currency	+8	+8 means that this country's gold and foreign currency reserves have been reduced
Overall balance of payments	0	

# Trade Imbalances



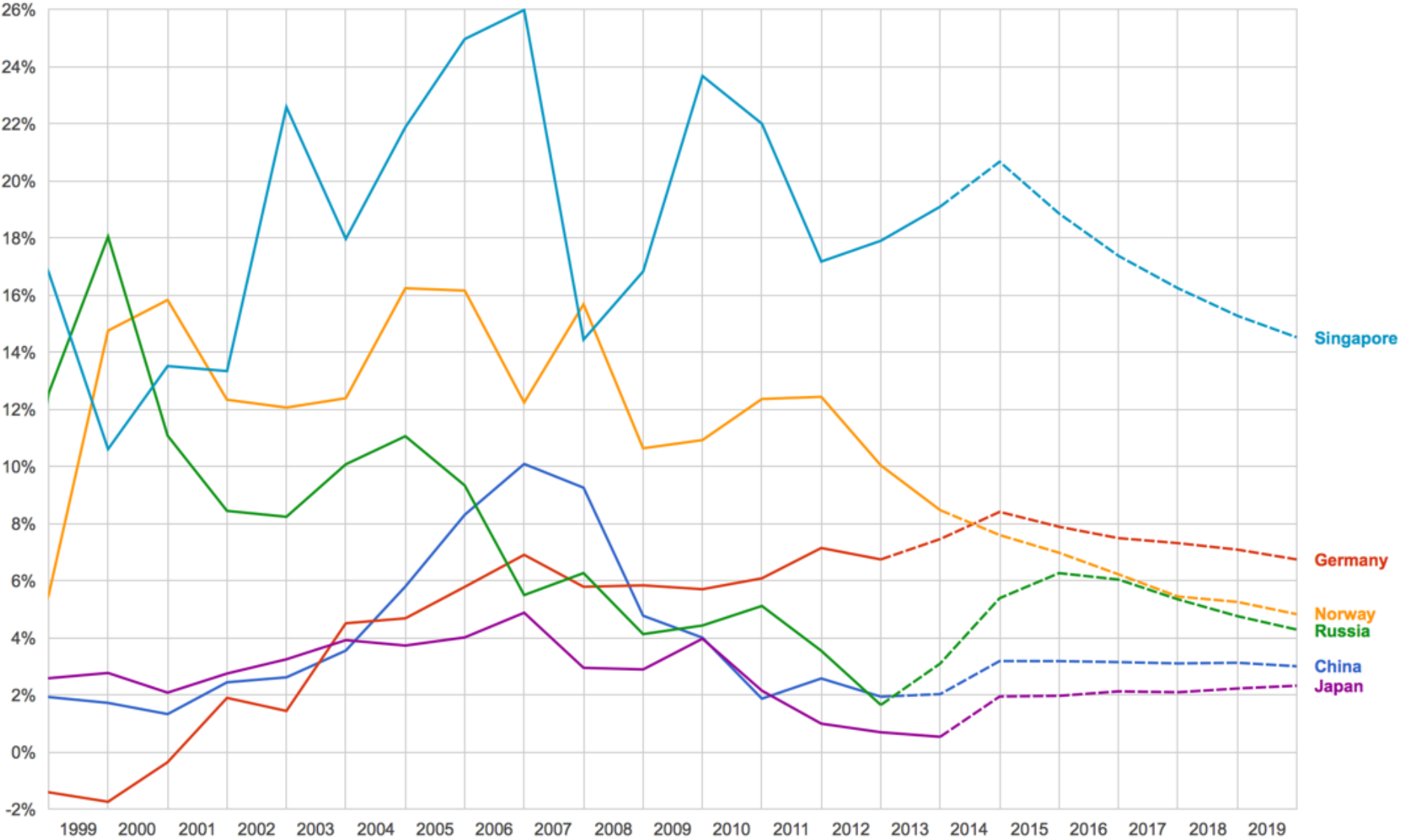
A key feature of globalisation in recent years has been rising **trade imbalances** which threatens a resurgence of protectionism

## 1.1.18 World current account balance



Sources: International Monetary Fund. 2015. World Economic Outlook Database.

Current account balance (%) ?





# Countries with External Surpluses

- If a country is running a **current account surplus**, this means there is a net inflow of foreign currency into their economic system.
- A surplus on the current account would allow a **deficit to be run on the capital account**.
- For example, surplus foreign currency can be used to fund investment in assets located overseas
- For example some current account surplus countries have large sovereign wealth funds
- **Current account surplus countries nearly always have fairly strong exchange rates as a result**

Country	Sovereign Wealth Fund Name	Assets \$Billion	Inception	Origin	<i>Linaburg-Maduell Transparency Index</i>
Norway	Government Pension Fund – Global	\$882	1990	Oil	10
UAE – Abu Dhabi	Abu Dhabi Investment Authority	\$773	1976	Oil	6
Saudi Arabia	SAMA Foreign Holdings	\$757.2	n/a	Oil	4
China	China Investment Corporation	\$652.7	2007	Non-Commodity	8
China	SAFE Investment Company	\$567.9**	1997	Non-Commodity	4
Kuwait	Kuwait Investment Authority	\$548	1953	Oil	6

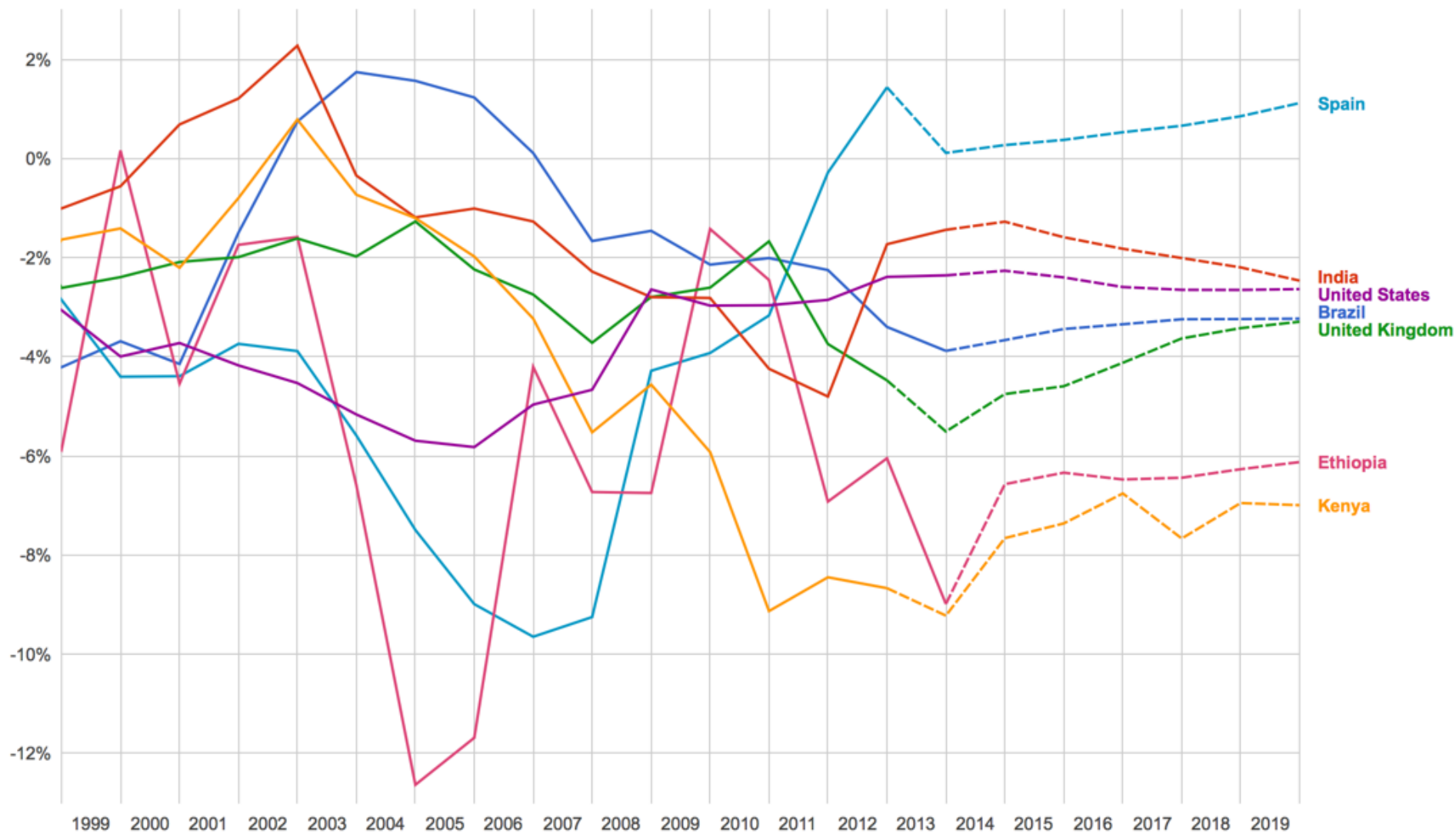
# External Deficits and (possible) Trouble Ahead

- Countries with current account deficits can run into financial difficulties.
- If the deficit is large and the economy is not able to attract enough inflows of foreign investment, then their foreign currency reserves will dwindle
- There may come a point when the country needs to seek emergency borrowing from institutions such as the International Monetary Fund
- Trade deficits and the resulting borrowing lead to a rise in external debt and rising debt service costs

Current account balance (%) ?







# Problems from Trade Gaps

Loss of aggregate demand and slower growth

In the long run, deficits undermine the standard of living

Loss of jobs in home-based industries

Can lead to currency weakness and higher inflation

Country may run short of vital foreign currency reserves

Trade deficit a reflection of lack of competitiveness

Can lead to capital flight / harder to attract inward FDI





The UK runs a deficit but has found it easy to attract capital to finance the gap.

# **Improving the Trade / Current Account Balance**

## **Expenditure - reducing policies**

- control demand and limit spending on imports - squeeze on demand, encouraging rising private sector saving

## **Expenditure-switching policies**

– e.g. through an exchange rate depreciation / devaluation

Improving Trade  
Performance in  
the Short and  
Long Run

**Improving the supply-side performance** of the economy -  
to boost competitiveness -  
economic reform is a long-run  
strategy

**Improving macroeconomic stability** to make a country  
more attractive to inward  
investment + raise productivity  
and increase a country's  
capacity for exporting



# Macro effects of a currency depreciation

When the pound depreciates against the US dollar

It makes UK import prices \_\_\_\_\_

It makes UK export prices \_\_\_\_\_



Changes in import and export prices will affect demand

Import volumes will \_\_\_\_\_

Export volumes will \_\_\_\_\_



This will have an effect on a number of key economic indicators

Domestic production \_\_\_\_\_

Trade deficit \_\_\_\_\_

Domestic employment  
\_\_\_\_\_

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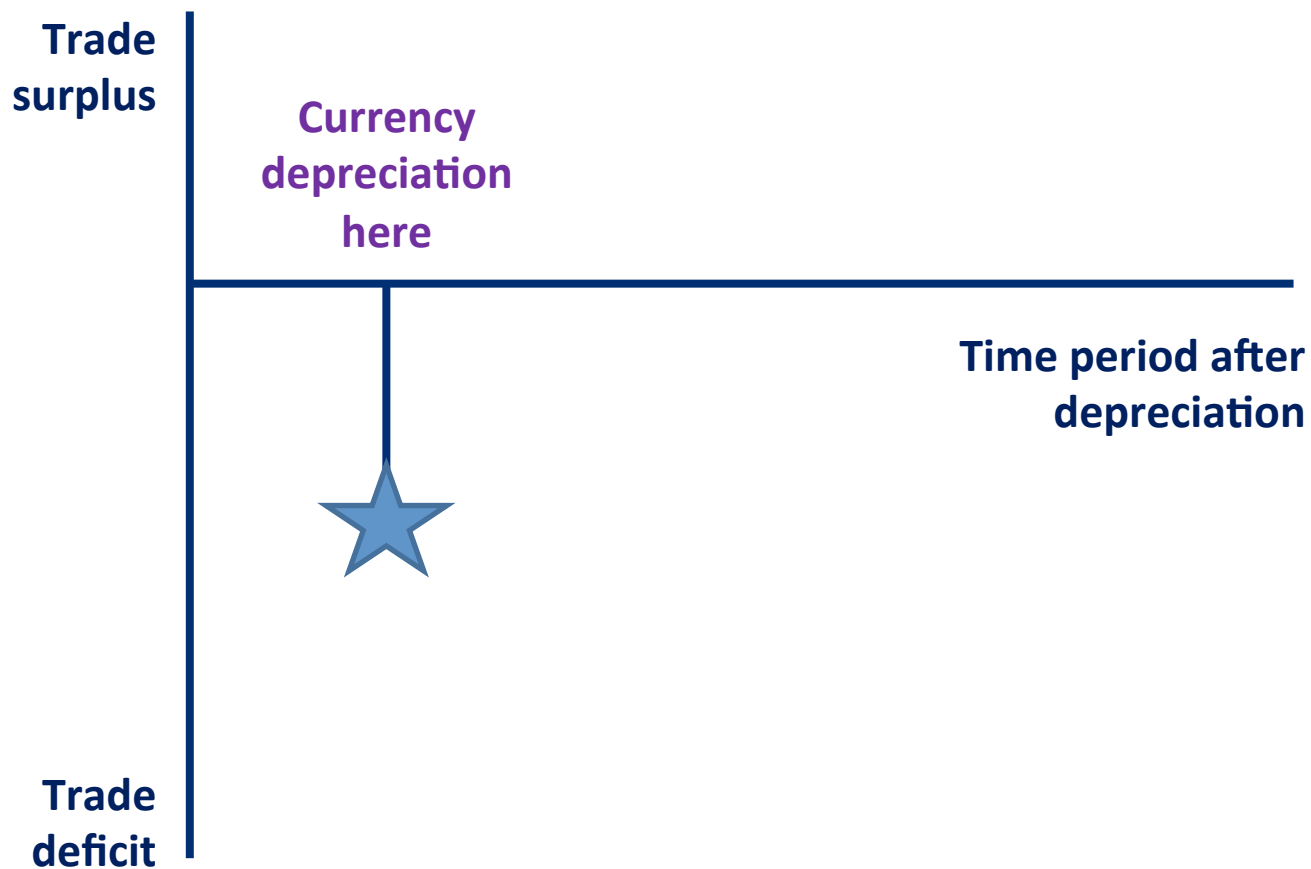
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Domestic production 

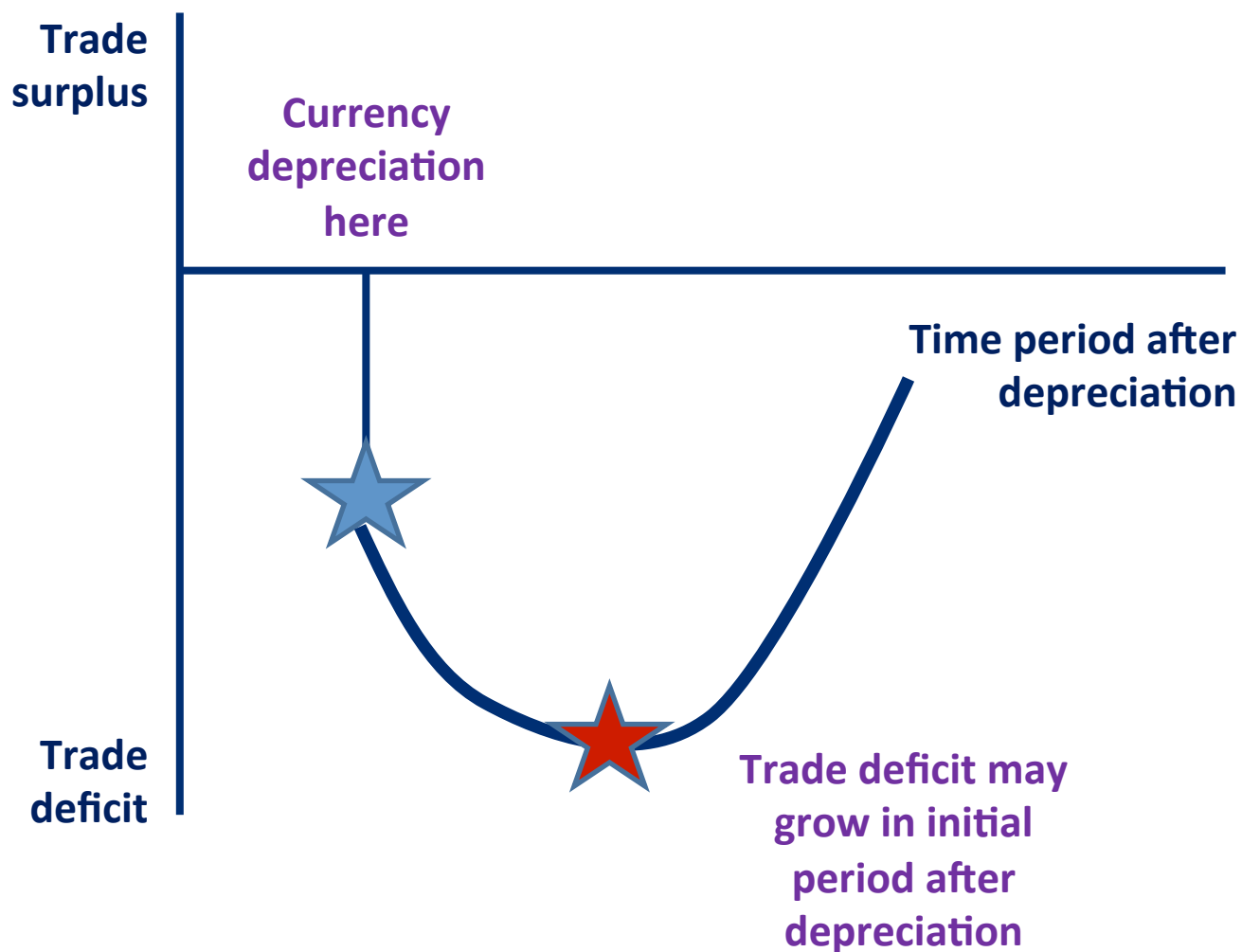
Trade deficit 

Domestic employment 

Will a depreciation of the currency bring about an improvement in the trade balance?

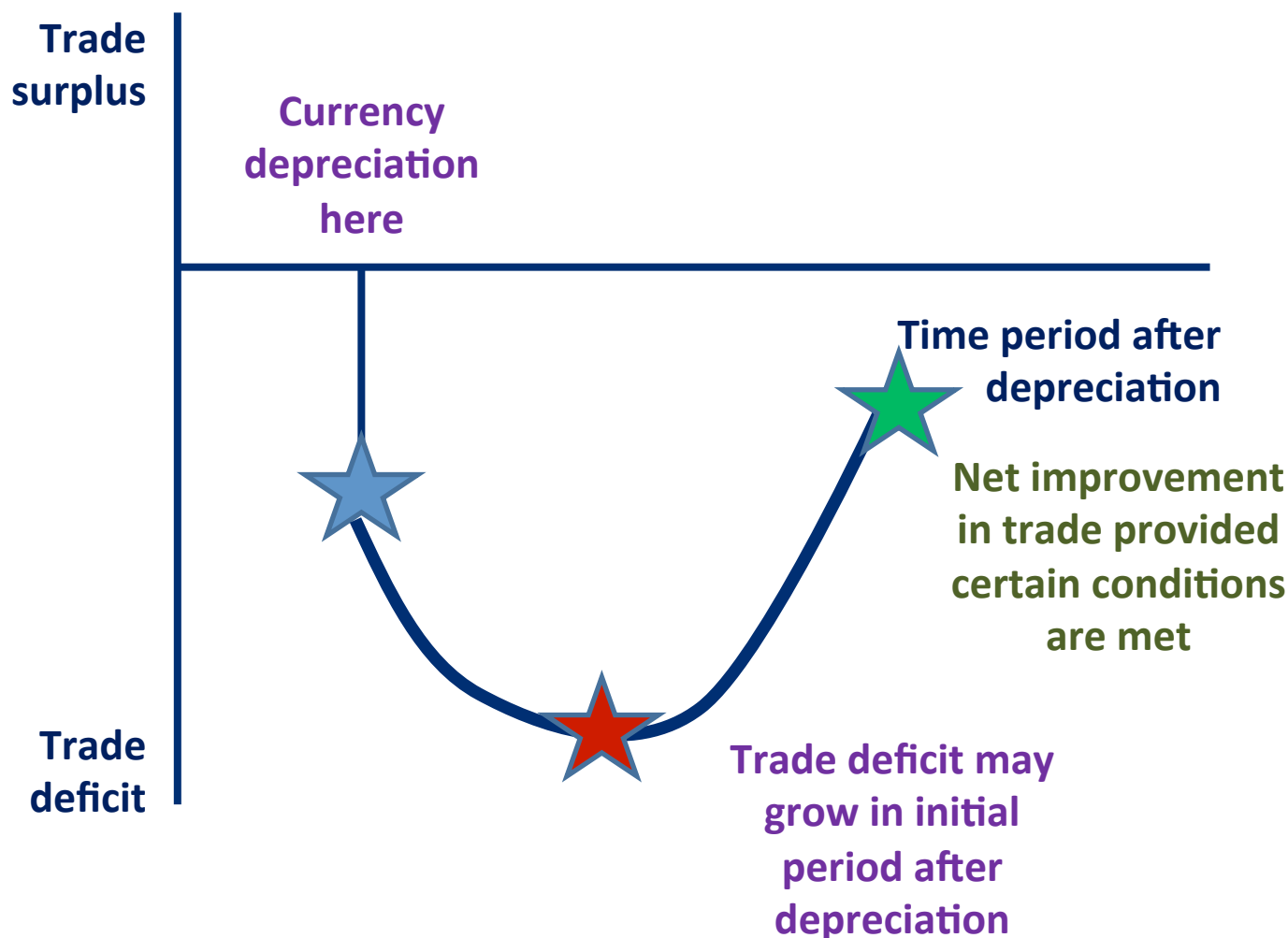


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# Reasons for a possible **J curve effect**

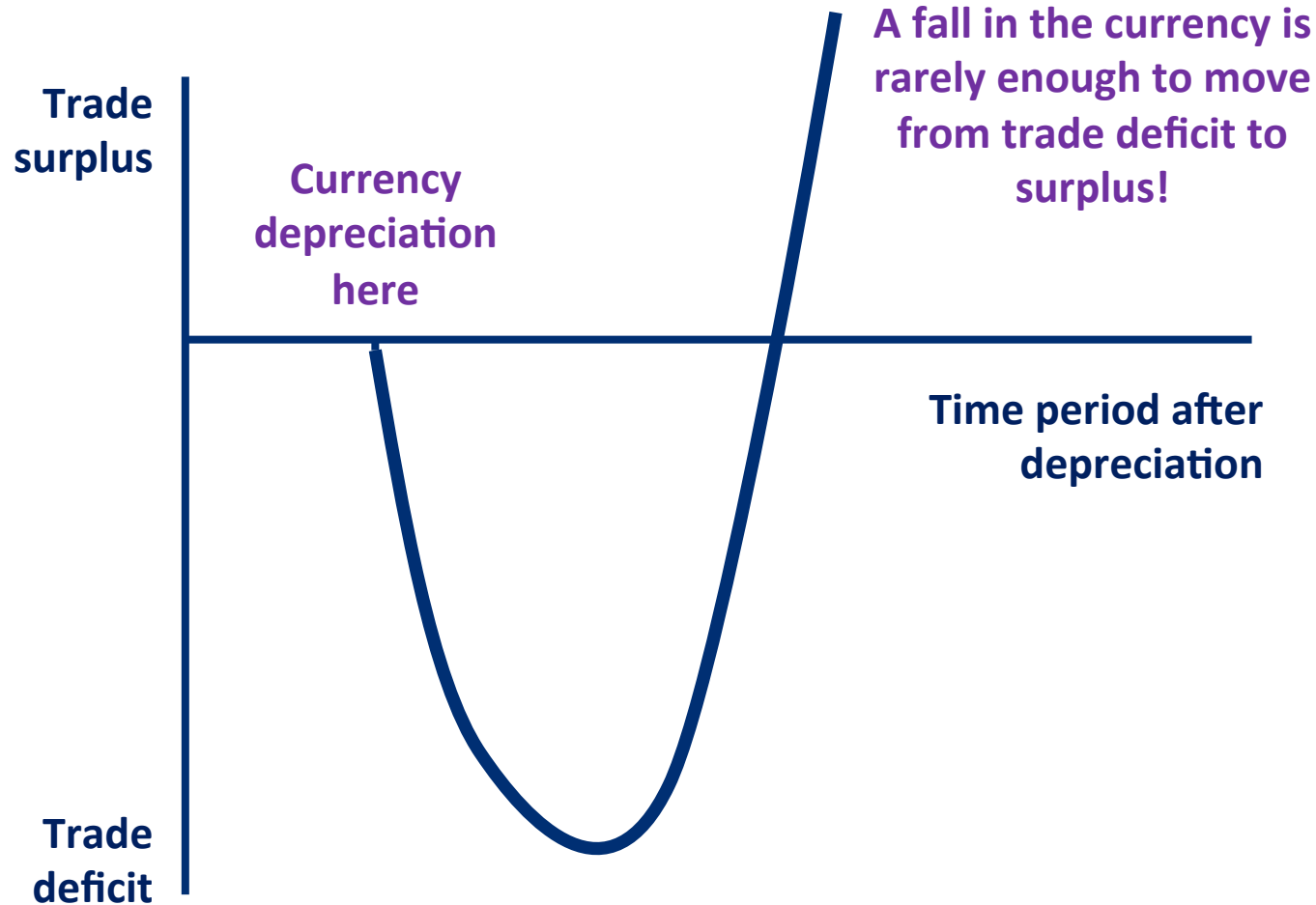
Low elasticity of demand for exports

Supply constraints for exporters

Low price elasticity for imports

Demand for wages to rise after falling XR

Please **do not draw it this way** in the exam if you are discussing the J curve!



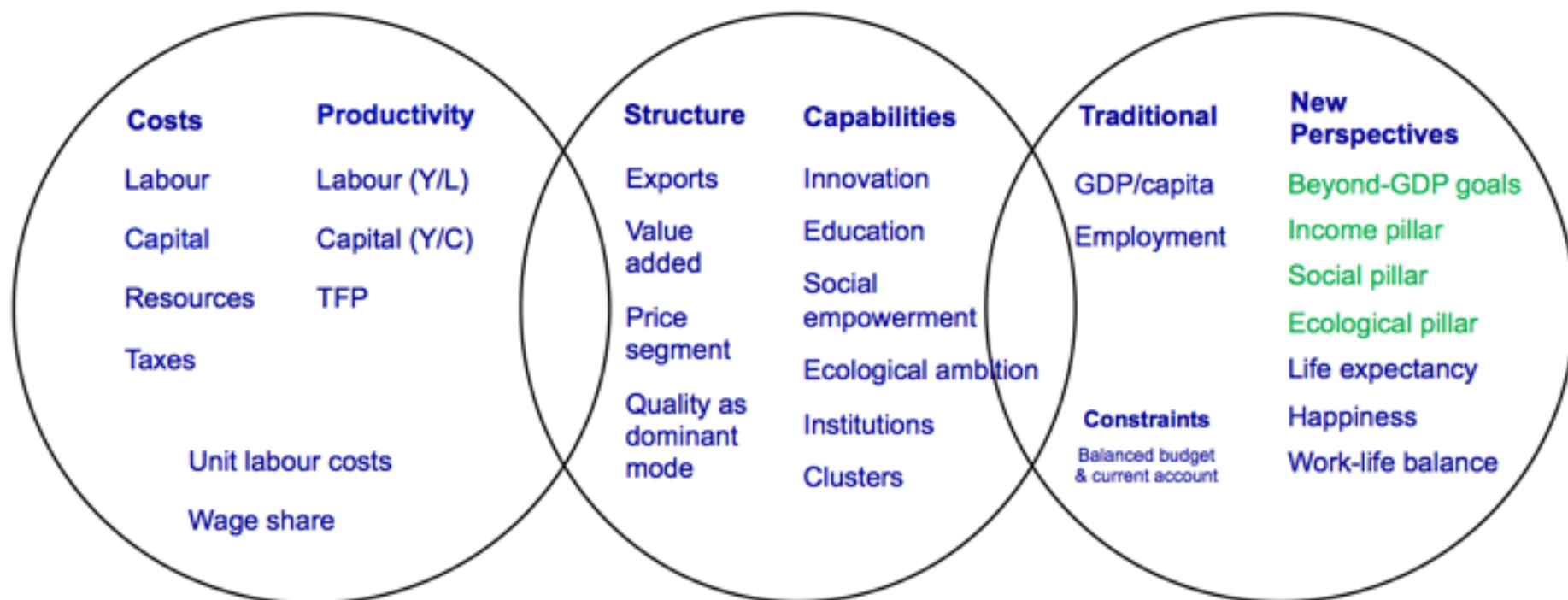
# Improving Competitiveness

# WWForEurope concept: Competitiveness in a nutshell

*Price competitiveness*

*Quality competitiveness*

*Outcomes competitiveness*



*Input-oriented evaluation*



*Outcomes-oriented evaluation*

# **A2 Macro: Balance of Payments**



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