The World Economy: Trade Theory

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BALANCE OF PAYMENTS

- Balance of Payments (BOP) is a record of the country's cross-border transactions.
- The balance-of-payments accounts of a country record the payments and receipts of the residents of the country in their transactions with residents of other countries.
- Balance of payments (BoP) accounts are an accounting record of all monetary transactions between a country and the rest of the world.
- Datasets:
  - http://www.tradingeconomics.com
  - http://www.ons.gov.uk/ons/taxonomy/index.html?nscl=Balance+of+

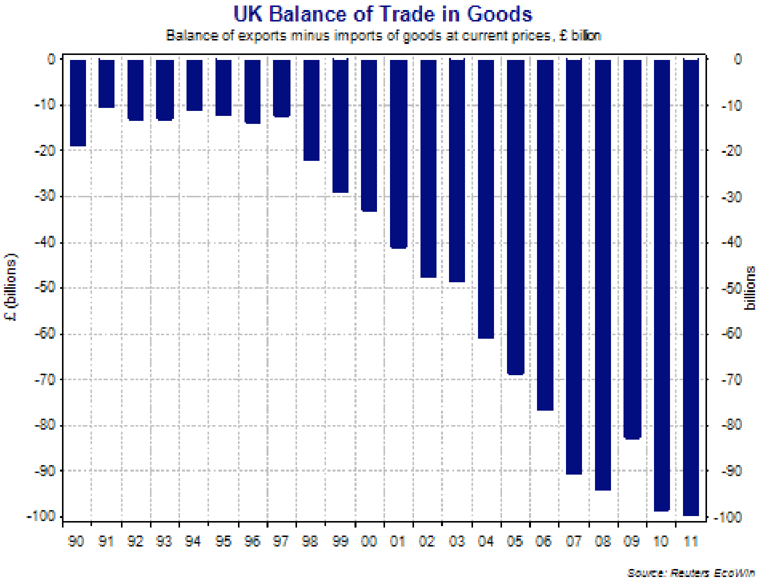
BALANCE OF PAYMENTS

Current Account **Trans-boundary flow of income earned in current year.**	**Financial & Capital Account** **Trans-boundary flow of savings (funds set aside from income earned in previous years).**
Merchandise trade Services trade Investment income Unilateral transfers	Direct investment Portfolio investment Change in reserves (central bank) Capital account (debt forgiveness)

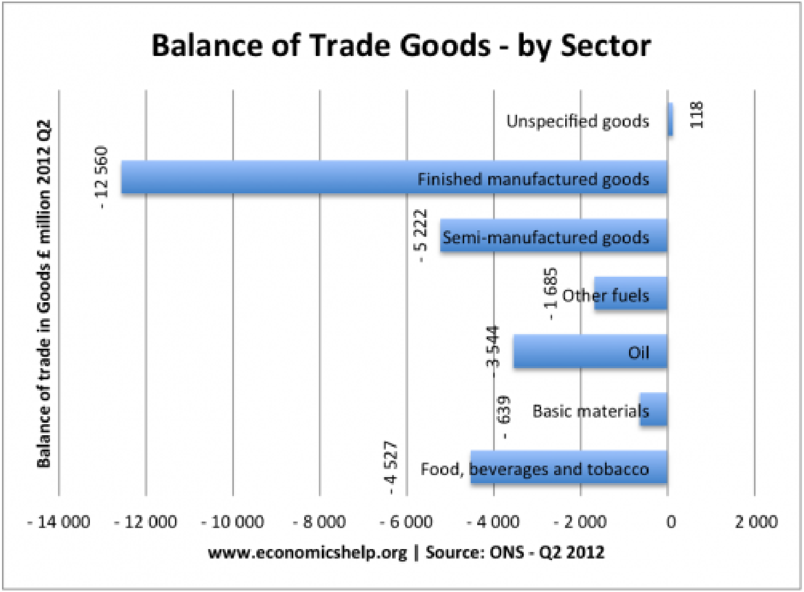
Current account

- Imports and exports of goods.
- Receives money from exports.
- Pays money for imports.
- UK has large trade in goods deficit in the last 30 years.
- Deficit with China has been growing.
- Develops high value manufacturing industries.

Current account



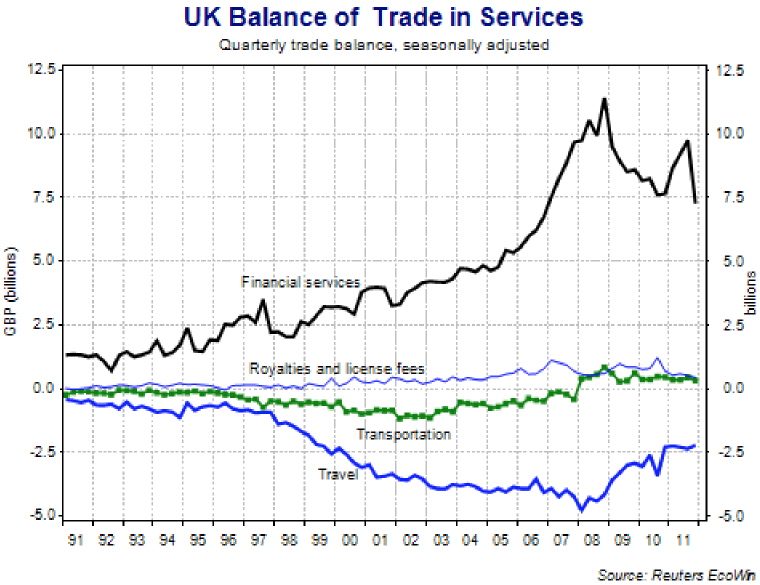
Current account



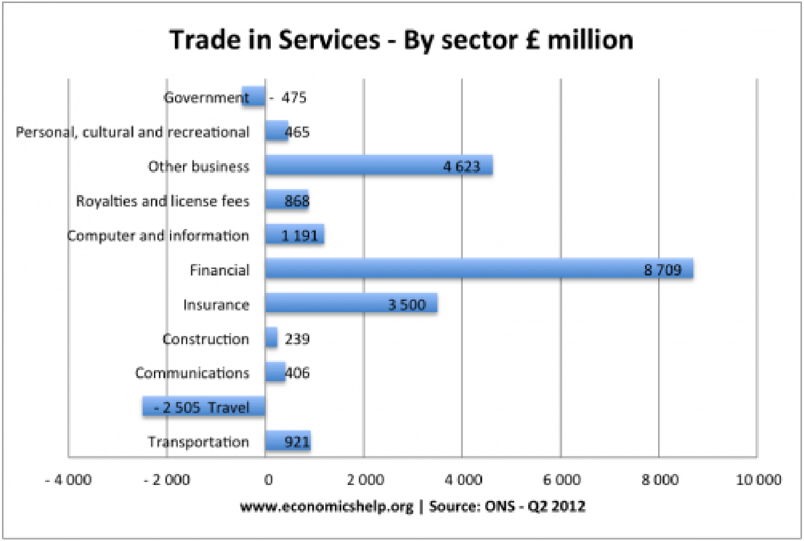
Current account –Trade in service

- Imports and exports of services.
- Travel, financial, IT, education, transportation...
- UK traditionally has been in surplus
- Financial services have been growing for 20 years.
- Royalty and license fee: Harry Potter - J.K Rowling
- Culture and recreation services: movie

Current account –Trade in service



Current account –Trade in service



Current account – Income

- Direct investment income – profits earned by UK companies from overseas.
- Portfolio investment income – interest on bonds and dividends held abroad by UK companies and residents.

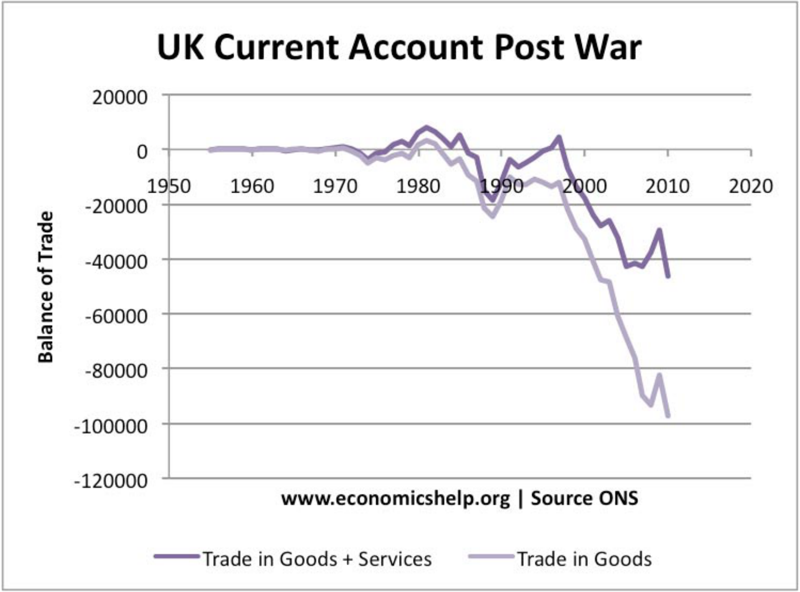
Current account – current transfer

- Payments and receipts where there is no corresponding exchange of goods or services
- May include income remittance from overseas, and payments to the EU

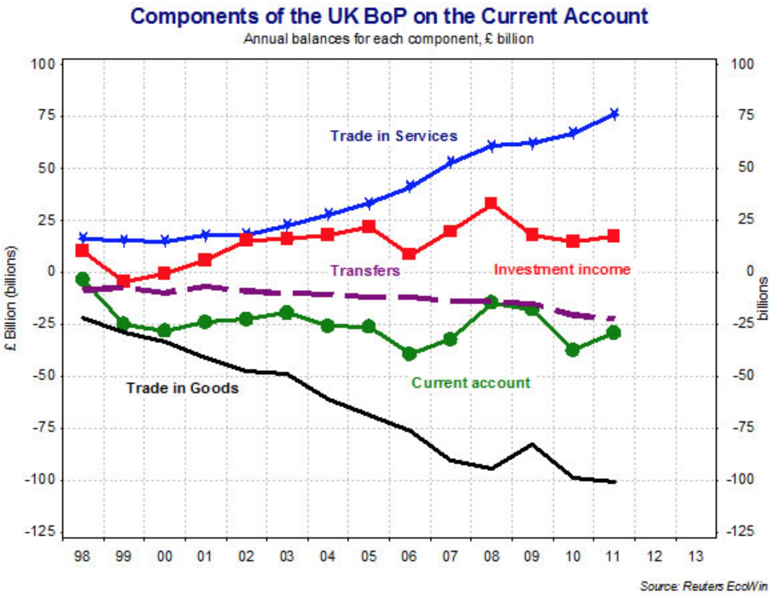
Current account

	(A) Trade in goods	(B) Trade in services	(C) Total trade in goods and services	(D) Total net investment income	(E) Current transfers	Current balance = A+B+D+E
	£ billion	£ billion	£ billion	£ billion	£ billion	£ billion
2005	-68.7	33.2	-35.4	21.4	-11.8	-25.9
2006	-76.4	41.4	-35.0	7.8	-11.9	-39.1
2007	-90.5	52.9	-37.6	19.0	-13.5	-32.2
2008	-94.1	61.0	-33.1	32.4	-13.8	-14.4
2009	-82.8	62.2	-20.6	18.0	-15.1	-17.7
2010	-98.5	67.0	-31.5	14.6	-20.4	-37.3
2011	-100.3	76.4	-24.0	17.1	-22.2	-29.0

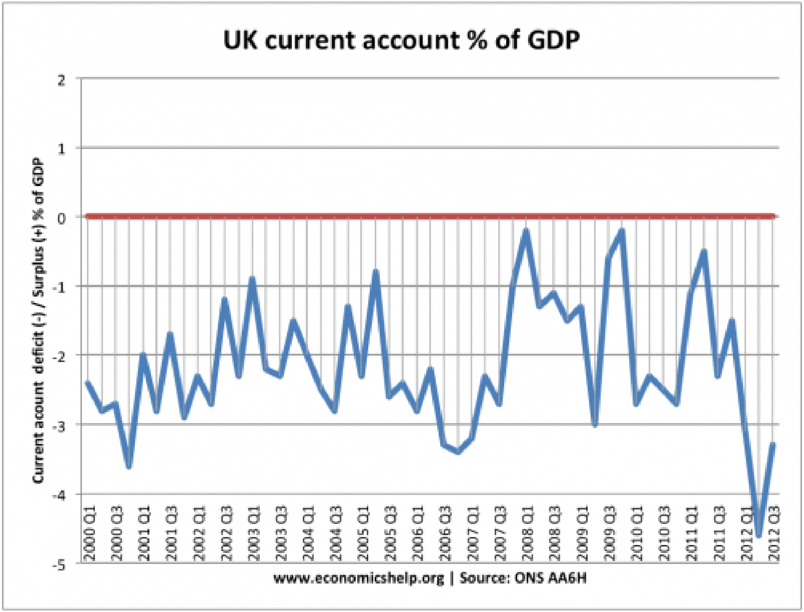
Current account



Current account



Current account



Capital account

- Capital transfers – debt forgiveness
- Acquisition/disposal of non-produced/non-financial assets –purchase or sale of land by foreign embassy or patents, copyrights, trade marks, franchises and leases

Financial account

- Foreign direct investment (FDI) or large enough amount of stock/ stake (>10%) which has managerial influence
- Portfolio flows - stock/bond, hot money
- Other investments – credits, loans, currency and deposits
- Change in official reserves - gold & foreign exchange

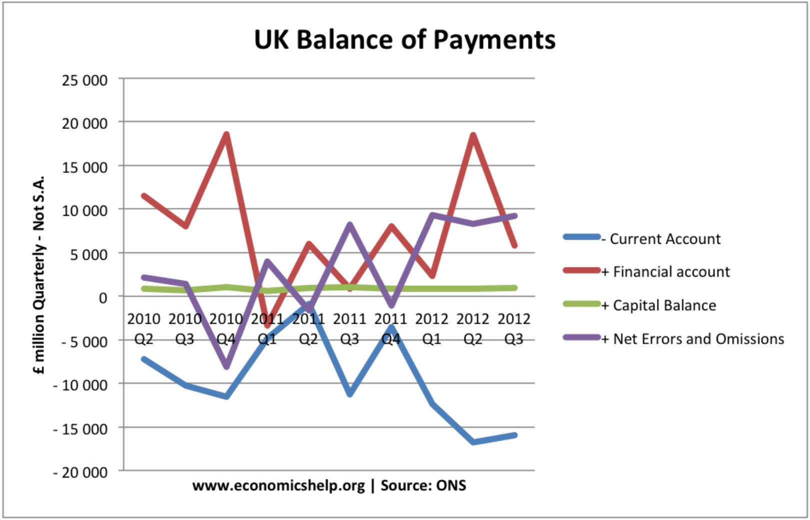
Net Errors and omissions

- Not all accurate information available
- Delayed or temporarily lost payments
- Fluctuation of exchange rate
- Unintentional errors
- Statistical discrepancy

Net Errors and omissions

Merchandise trade balance
+ Services trade balance
= **Balance on goods and services**
+ Net investment income
+ Net unilateral transfers
= **Current account balance**
+ Net direct investment
= **Basic balance**
+ Net portfolio investment
+ Statistical discrepancy
= **Overall balance**
+ Change in official reserves
= Zero

BoP


UK Balance of Payments
25 000
20 000
15 000
10 000
5 000
0
- 5 000
- 10 000
- 15 000
- 20 000
£ million Quarterly - Not S.A.
2010 Q2
2010 Q3
2010 Q4
2011 Q1
2011 Q2
2011 Q3
2011 Q4
2012 Q1
2012 Q2
2012 Q3
- Current Account
+ Financial account
+ Capital Balance
+ Net Errors and Omissions
www.economicshelp.org | Source: ONS

Main causes of a current account deficit

- High income elasticity of demand for imports
- An overvalued currency
- Non price factors, such as poor design, quality, and reputation
- Long-term decline in the capacity of manufacturing industry (low cost countries/outsource)
- Vulnerable to the fluctuation of raw material price
- Ability to attract foreign financial flows (portfolio flows)

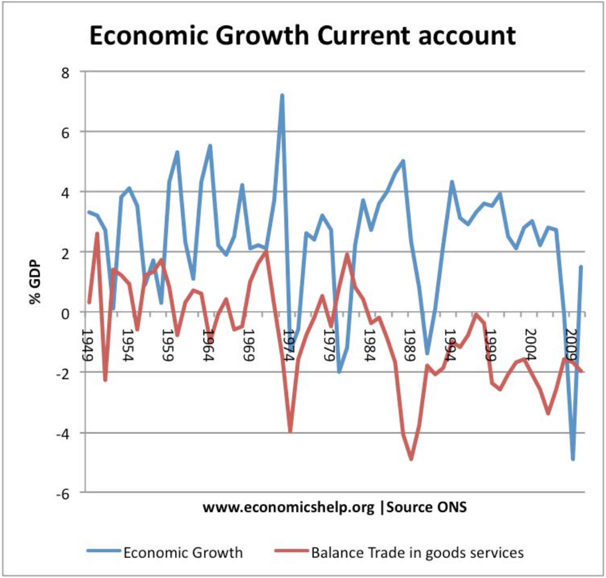
A CA deficit can be a problem if

- It is persistent.
- It forms a large share of GDP.
- There are no compensating inflows of investment income or inward capital account flows.
- The Central Bank has low reserves.
- The economy has a poor record of repaying debt.

The BoP and the standard of living

- The perception is that current account deficits are always bad for the economy.
- Current account deficits means that a country must rely on foreign direct investment or borrow money to make up the difference.
- In the short term, this is an increase in living standards because consumers are buy more than producing.

The BoP and the standard of living



Does a Current Account Deficit Matter?

- Yes, we should worry
  - It is a sign of uncompetitiveness, which will lead to lower economic growth and poorer prospects in the long run.
  - If capital / financial flows dry up, it could lead to depreciation in the exchange rate and a fall in living standards
  - It is a sign of an unbalanced economy.

Does a Current Account Deficit Matter?

- No, we shouldn't be concerned
  - The UK has had a persistent deficit since the mid 1980s.
  - Countries with large current account surplus have not necessarily done better, e.g. Japan had a long period of stagnation.
  - In era of globalization, financial flows are easier to attract and therefore the deficit is financed by these capital inflows.
  - If the current account deficit was too large, there should be a depreciation in the exchange rate to restore the balance.
  - A current account deficit is a bigger concern in a fixed exchange rate (like Euro) because there is no option of depreciation.

Does a Current Account Deficit Matter?