Balance of Payments Notes

Definitions:

- A country's BOP is a record of the receipts[1] and payments[2] arising from all economic transaction between residents of one country and the rest of the world over a period of time, usually a year. The BOP records the international inflows and outflow of a country's currency.

- The current account records payments for exports and imports of g/s, net income flows and net current transfers into and out of the country in a year.
  1. Trade in goods account: difference in value of exports and imports of **goods** (BOT in gds)
  2. Trade in services: difference in value of exports and imports of **services** (BOT in services)
  3. Net income flows: factor incomes earned by Singaporeans from aboard and factor income earned by foreigners in SG (**WRIP and dividents**)
  4. Net current transfers: flow of currency from individuals/ firms/ government of one country to another for which there is **no** corresponding flow of g/s

- The financial account records the international transactions in financial assets and liabilities both short term and long term.
  1. FDI: cross border, long term capital investment. It involves the acquisition of a lasting management interest which implies a significant degree of influence and control over the management of the enterprise (long-term capital flows)
  2. Portfolio investment: transaction in equity securities such as stocks and shares, and debt securities like bonds (long-term capital flows)
  3. Other investment: short-term capital flows
  4. Financial derivatives: financial instruments whose values are derived from other financial instruments (e.g. equities and debt securities), indicators or commodities (e.g. options, future, forwards, swaps)

Government Objective:

To avoid persistent BOT surplus or deficit (wld mean favorable position of BOT),

BOT deficit has -ve consequences and BOT surplus wld mean trading partners are experiencing BOT deficit. They may resort to undertaking protectionist measures to decrease trade deficit.

Terms:

- BOT value is 0
- BOT (is in) surplus/ deficit
- BOT deficit has increased/ decreased
- BOT has improved/ deteriorated

[1] recorded as **credit** items: (**+**) and constitutes currency **inflow**

[2] recorded as **debit** items: (**-**) and constitutes currency **outflow**

Exception to the sign convention: Capital and financial account

Causes of BOT deficit:
1. Loss of Comparative Advantage (int trade)
2. Appreciation of DC (e/r policy)
3. Relatively higher domestic inflation (e/r policy)
4. Relatively faster domestic EG

Explanation for a large and persistent current account deficit:

Persistently high prices of X

Make use of assumptions for DD and MLC

1. Permanent loss in CA
   e.g. lose CA in pdtn of goods to ctries like India, Vietnam with lower labour cost → x/p is more expensive and m/p is cheaper
   - Assuming **DD for x/p is price elastic** → increase in px of x/p leads to more than proportionate fall in Qd → x/p revenue falls
   - Assuming **DD for m/ps is price elastic** → decrease in px of m/p leads to more than proportionate rise in Qd → m/p expenditure rises

   ∴ Current account worsens, leading to deficit

2. Persistent appreciation of DC/ persistent depreciation of major trading partners
   Higher X price in FC and lower M price in DC → assuming MLC (quote) holds → NX falls

   ∴ Current account worsens, leading to deficit

3. Persistently higher rate of domestic inflation compared to trading partners
   X will be relatively more expensive than M
   - If **DD for x/p is price elastic** → increase in px of x/p leads to more than proportionate fall in Qd → x/p revenue falls
   - M is relatively cheaper → increase Qd → increase M expenditure

   ∴ Current account worsens, leading to deficit

Persistently high prices of M

1. Persistently depreciating DC/ persistent appreciation of major trading partners
   M will be relatively more expensive than X

2. Persistently higher inflation overseas
   M into dom eco will be relatively more expensive

For the cases above, assuming **demand for m/ps is price inelastic** (e.g. ctry is reliant on m/p raw materials and necessities) → Qd for m/p will fall less then proportionately → increase in m/p expenditure → persistent current account deficit assuming X revenue remain unchanged

In fact, the more px inelastic the DD for m/ps, the larger the current account deficit. Also, higher price of m/ps → higher cop → decrease X revenue and worsen current account deficit

N.B. Typically the above factors will cause NX to increase and BOP to improve, but here we are trying to explain otherwise for EQ1a.

Changes in DD for X and M

1. Persistently higher dom EG than trading partners
   A relatively faster rate of EG → NY of ctry increase faster than that of other ctries → residents have greater increase in PP → DD for m/p tend to rise faster as **m/ps is a function of income** → decrease NX → persistent current account deficit

2. Consistently ambitious development program
   Mainly applies to LDC for ambitious industrialization program over a prolonged period of time → large scale m/p of FOPs like machinery, equipment, raw materials, technology → large increase in m/p expenditure → persistent and large current account deficit

Consequences of BOT deficit:

Consumers and Producers	- Severe and persistent BOT deficit → consumer and investor confidence fall → consumption and investment fall → fall in AD → fall in NY ① → fall in DD labour → fall in employment ② → decrease PP → decrease material SOL
Government	- Persistent BOT deficit → ctry living beyond its means → if deficit financed through increase in borrowing ① → debt has to be repaid in future with high interest burden → **decrease future SOL** ② → if amt of foreign debt high → lending agencies will impose conditions for future borrowing (e.g. CMP/ CFP) → govt **lose autonomy of running economy** - Persistent BOT deficit → greater outflow of currency → increase SS of DC as cr sell DC to buy FC → decrease e/r (i.e. depreciation)→ increase P of M in DC → inflationary pressure → **decrease competitiveness of M-reliant ctries** - If fixed e/r system →CB sell FR to buy excess supply of DC to prevent e/r from falling → **depletion of FR** → if run down too quickly, crisis of **confidence in currency**

Factors affecting severity of BOT deficit:

1. Type of exchange rate regime

- **More problematic** for fixed/ managed float than freely floating exchange rate regime

Floating EER	Fixed EER
Given a BOT deficit	
E/r ill adjust according to mkt forces → BOT deficit due to fall in DD for X → fall in DD of SGD → fall in exchange rate (i.e. SGD depreciate) → increase P of M in DC, decrease P of X in FC → MLC holds → increase NX → **correct the deficit** in BOT, restoring it to eqm	Fall in e/r is not allowed when demand for ctry's X falls → sell reserves to buy DC to keep e/r at pre-determined rate → such action, if done continuously depletes ctry's foreign reserves in LR → any govt intervention to maintain fixed e/r wld lead to ctry's **currency becoming overvalued and increase deficit**

2. Persistency of Problem/ Cause of disequilibrium

- **SR run- not serious**
  → may arise as ctry is industrializing and need to import machinery and raw material for pdtn
- **LR- serious**
  → there is a limit on ability of the ctry to sustain such chronic deficits

Polices to tackle BOT deficit:
Aim of policies: **Increase X revenue and/or decrease M expenditure**

1. Expenditure Reducing Policies
   Aim: **Decrease AD**
   Means: CFP (Increase T and/or decrease G), CMP (Increase i/r, decrease Ms)
   Explanation:
   - Decrease AD → decrease NY → decrease DD of M → decrease M expd
   - Decrease AD → decrease competition for resources → decrease P of FOP → decrease GPL → X more competitive (P of X fall) → more than proportionate increase in Qd if $PED_x > 1$ → increase X revenue (can discuss as EV)

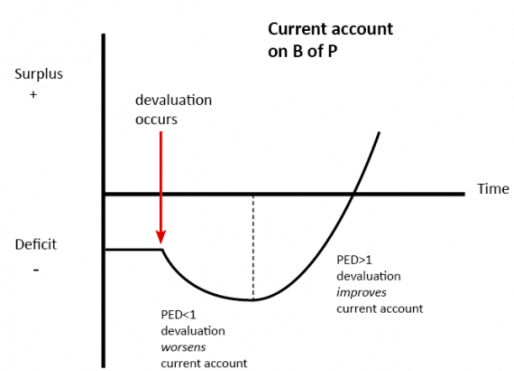
   Taken together, decrease BOT deficit

   Limitations:

Ineffective	Damaging
Time lags - FP: Implementation lag → debate and pass cuts in G and increase in T in parliament - Impact lag → time for HH to respond - MP: Impact lag esp long when economic outlook is good → negligible fall in C, I, NY and M expd **M expd may not fall to a large extent** If $0 < YED < 1$, DD is income inelastic (e.g. necessities/ m/p reliant ctries). Given fall in Y → DD for M decrease less than proportionately → less than proportionate fall in M expd → decrease effectiveness of policy	**Might worsen current account** Higher i/r → hot money inflow → increase DD for DC → DC appreciates → … → worsen current account **Possibly slowdown in EG/ economic contraction** CFP/ CMP → decrease AD → decrease NY → decrease DD lbr → increase cyclical Une → damaging as it leads to: lower SOL, loss of skills, greater fiscal cost (less taxes collected, more UnE paid out)

EV: If you talked about the points in blue: Effectiveness of expenditure reducing policies depends on ①**State of the economy** ②W**hether the government can prevent currency from appreciating** e.g. by limiting hot money flow temporarily or suppressing ext value of currency. If the latter can be done and current account deficit is due to DD pull infln (fall in AD → fall in GPL → X more competitive → Qd for X rise more than proportionately if DD for X is price elastic), can be beneficial.

2. Expenditure Switching Policies (also covered in International Trade: Protectionist Measures)
   Aim: **Switch expd from import to dom pd gds and to switch foreigner's expd towards purchase of ctry's X**

	Manipulation of e/r (Depreciation/ Devaluation)	Protectionist measures	SSP to increase dom pdtvy and promote x/p
Explanation	Depreciation/ devaluation → decrease P of X in FC + increase P of M in DC → assuming MLC holds, increase NX → decrease BOT deficit  [Limitation: J-shape effect]	- Trade restriction (decrease M expd) ▪ Tariff → increase P of M ① → if PED imports price elastic → more than prop decrease Qd of M ② → dom pd gds relatively cheaper → buy more domestically produced gds ▪ Import quota → limit on qty and consumption of M → increase DD for domestically produced gds ∴Overall Effect: Fall in M expd. - Subsidies/ tax rebates for export industries (increase X revenue) → decrease px → increase X revenue assuming DD for x/p px elastic	R&D and tech improvements → increase domestic pdtvy → reduction in unit COP → improve X competitiveness → improvement in BOT
Limitations, cost-benefit	- Effectiveness **depends on the price elasticity of demand for X and M** ▪ Devaluation is only effective in improving BOT position if MLC holds ▪ J curve effect: In SR, PED of X and m tends to be highly px inelastic → domestic and foreign importers often bound by contracts → require time to respond to price changes → **devaluation may cause BOT in current account to worsen in SR, only leading to improvement in LR when MLC holds** - **Ineffective if trading partners devalue currency as well** - Might lead to inflation ▪ Devaluation → increase NX → if economy at Yf → no spare capacity to meet increase in DD for ctry's gds → DD pull infln ▪ For M reliant ctries, devaluation → increase P of m/ped FOP → increase COP → cost-push infln In both cases, **inflation eliminate price advantage gained through devaluation**.	Disadvantages: - Curb progress of international trade - **Invite retaliation** from ctries whose X are adversely affected - Decrease income of trading partners → **decrease DD for ctry's X** - Domestic firms may become **complacent and inefficient** → decrease price, qly, variety of gds + drain government resources - **Does not address root cause** of BOT deficit- loss of X competitiveness	Advantages: - Don't unfairly disadvantage other ctries, **unlikely to invite retaliation** - Translate to improvement in pdtvy capacity and **encourage EG** Disadvantages: - Long term policy - Results not guaranteed - Structural UnE

EV:

- **Devaluation vs Protectionism**
  The benefit reaped in the LR from devaluation could possibly outweight the damage in SR. On the other hand, protectionist measures are more damaging if implemented for prolonged period of time.

- **SSP will be the wisest approach**
  Disadvantages are likely to be short lived especially when proper training programmed are in place to equip workers with new skills to take on new jobs created. The long-term gains in terms of improved current account and a more competitive economy, where consumers enjoy cheaper and better pdts is likely to outweigh ST damage.

Glossary of EQs attempted

(1) The UK has run a large deficit on the current account if its balance of payments for several years.

(a) Explain what might cause a persistent and large deficit on a country's BOP on current account (10m).

Require 3 main points. Refer to pg 2-3.

N.B. Qns wont ask you to explain for financial account ☺

(b) Discuss the view that government policies to deal with such a deficit can be potentially damaging and ineffective (15m).

worsen current account/ -ve impact on other macro-goals

unable to reduce current account deficit

Structure (x3):
Explain how policy work
Explain how policy can be potentially damaging
Explain how policy can be potentially ineffective

Limitations should ideally address both aspects

Refer to pg 4-6