Topic 24: balance of payments

The balance of payments account is a record of the value of all the transactions between the residents of one country and the residents of all other countries in the world over a given period of time, usually a year.

- Credit item: any transaction that leads to money entering the country
- Debit item: any transaction that leads to money leaving the country

The current account is a measure of the flow of funds from the trade of goods and services, plus other income flows.

- Balance of trade in goods and services
- Net factor income
  - Movement of profit, interest and dividends
- Net unilateral transfers
  - Payments made without transaction of goods or service

The capital account is a relatively small part of the balance of payments accounts

- Capital transfers
- Transactions in non-produced, non-financial assets

The financial account measures the net change in foreign ownership of domestic financial assets.

- Foreign direct investment
- Portfolio investment
- Reserve assets

Current account and financial account imbalances

- Deficit
  - Foreign exchange reserves have to be used to pay the deficit. If deficit occurs in the long run, the reserves will be depleted
  - Too much foreign ownership of domestic property may be a threat to economic sovereignty
  - The deficit may be financed by high levels of lending from abroad and high interest rates have to be paid; the lenders may withdraw their money and place it elsewhere leading to a massive selling of currency and fall in exchange rate
- Surplus
  - May lead to protectionism in other countries (one country's surplus is another's deficit)
  - Build official reserve
  - Appreciation of currency – make imports cheaper and reduce inflationary pressure; exports more expensive, less competitive

Methods to correct BOP deficit

- Expenditure switching
  - Protectionism (tariff, quota) – restricting the number of imports and make their prices higher so local consumers will switch to domestic products
  - Depreciation – exports become less expensive and imports become more expensive
  - However this may lead to retaliation from other countries and WTO
- Expenditure reducing policies
  - Shifting the AD to the left (deflationary demand side policies – monetary/ fiscal)
  - However this may lead to unemployment within the domestic economy and fall in economic growth

The Marshall-Lerner condition is a rule that shows how successful a depreciation or devaluation of a currency's exchange rate will be.

$$PED_{exports} + PED_{imports} > 1$$

If the government decides to depreciate its currency and it satisfies the Marshall-Lerner condition, it should improve the current account deficit. However in the short run there will be a worsening of the current account before it gets better, this is due to lack of perfect information, causing exports to be inelastic in the short run. The J curve shows what happens to a current account deficit over time when the exchange rate is devalued.