

## Macro-economic objectives: Balance of Payments

The balance of payments records all incoming and exported goods, services and monies. When inflows are greater than outflows there is a net inflow in the economy this is called a surplus. When outflows are greater than inflows there is a net output in the economy this is called a deficit. The ideal is a balance – an equilibrium – where inflows are equal to outflows in the economy.

The 'visibles' balance is the trade is the net trade in goods, i.e. goods exported – goods imported. The 'invisibles' balance is the net trade in services, i.e. services exported – services imported. Most often this is the movement of money as a reward for a factor of production, either rent, interest or profits, generally not wages.

The balance of payments has four key sections; the current account, the capital balance, the financial account and a section for net errors and omissions.

The focus for AS level is on the current account. Briefly the capital balance involves transactions to and from EU countries. This is a minor part of the balance of payments. The financial account records investment and savings made in UK businesses and banks by individuals or companies overseas taken away from money invested overseas into foreign banks and businesses by UK consumers.

### Current account

An increase in GDP means that output has increased, so incomes have increased and expenditure has increased. This causes an increase in demand for goods with an elastic PED.

$$\text{Income elasticity of demand: } YED = \frac{\% \Delta Q_D}{\% \Delta Y}$$

$YED > 1$ : *Luxury* – more than proportional change in quantity demanded when income changes. Quantity demanded is very responsive to a change in income. For example a 1% increase in income would lead to a larger than 1% change in the quantity demanded.

$0 < YED \leq 1$ : *Normal* – when income increases there will be an increase in the quantity demanded but this increase will be proportionally less than the increase in income.

$YED < 0$ : *Inferior* – when income increases quantity demanded of this good decreases.

In the UK most of the luxury goods we demand are imports. So as growth increases imports increase, which means the balance of payments goes into a worsening deficit. As growth decreases imports decrease and so the balance of payments improves.

**1992:** Depreciation of the exchange rate caused an increase in exports and a decrease in imports. This causes the balance of payments to improve assuming overseas and domestic demand is price elastic. Domestic demand however is not elastic as we are very reliant on imports of food and fuel.

**1998:** Appreciation of the exchange rate caused a decrease in exports and an increase in imports and a decrease in exports as the price of UK output is less competitive on world

markets, again assuming both domestic and overseas demand is inelastic. This lack of competitive prices is one strong argument for joining the Euro.

When imports are greater than exports there is a deficit on the balance of payments.

- There is a net outflow of money. This needs financing:
  - Mostly on trade credit by overseas suppliers. The UK generally honours all debts.
  - Borrowed from overseas banks as imports must be paid for in a foreign currency.
  - Use money in the economy's foreign currency reserves.
- Unemployment could occur in the long run. Structural factors (such as the UK producing goods it is not competitive at exporting) cause lack of demand. Unemployment causes slower growth.
- Lower savings and investment lower future growth still further.

Yet a long term deficit is not necessarily a problem.

- The UK generally honours all debts.
- If GDP is growing faster than the Balance of Payments deficit, as a proportion of GDP the deficit is improving.
- If the deficit is a low percentage of GDP this is healthy.
- If imports are mainly consumer goods (not capital goods) this is sustainable only in the short run and will cause problems in the long run.
- If the UK is unable to adapt the structure of industry to produce competitive output the deficit is a problem.
  - This is true in goods, but not in services.
  - Although we are less efficient at producing some services now, for example call centres.