

## **WEEK 13: BALANCE OF PAYMENTS**

The balance of payments is a statistical 'accounting' record of a country's international trade transactions (the purchase and sale of goods and services) and capital transactions (the acquisition and disposal of assets and liabilities) with other countries during a period of time.

The broad classifications of transactions are:

a. **Current account**

The purchase and sale of goods and services. Current account transactions can be sub-divided into:

- i. Visible trade            the export and import of goods
- ii. Invisible trade        the sale and purchase of services e.g. transport, tourism, financial (banking, insurance, brokerage), share

b. **Capital account**

Transactions in external assets and liabilities. This involves the movement of capital (money) rather than goods and services, i.e. it is concerned with international loans and investment e.g. shares, long term loans.

***Balance of trade = Balance of the current account***

## **BALANCE OF TRADE**

Types of balance of trade

- a. Equilibrium    Money flows in from exports is equal to money flows out on imports. Money neither flowing in nor out.
- b. Deficit        Export more than import which cause the money that flows out from the country more than the money that flows into the country.
- c. Surplus        Import more than export; money that flows into the country is more than the money flows out from the country.

**It is important to distinguish between balance of trade and balance of payments. Balance of trade is only a part of the balance of payments. Deficit trade balance does not necessarily mean that the balance of payments is also deficit. Conversely, surplus trade balance also does not mean that the balance of payments is surplus, because deficit trade balance may be covered by the surplus in capital account. The**

**deficit balance in capital account may reduce by the same amount as the surplus in trade balance.**

### DEFICIT PROBLEMS

Measures to rectify a deficit can be categorized into two main categories:

#### **Expenditure Reducing Policy**

These are measures such as domestic deflation, which aim to rectify deficit by cutting expenditure.

#### **Expenditure Switching Policy**

This refers to measures such as import controls designed to switch expenditure from imports to domestically produced goods.

The two types of measures need not be regarded as alternatives but rather as complementary. For example, a government might reduce expenditure to create spare capacity in the economy prior to creating through expenditure switching policies.

a. **Deflation**

The demand for imports could be restrained (expenditure reducing) by restricting the total level of demand in the country through fiscal and monetary policies.  
**Deflation will cause unemployment.**

Fiscal or monetary policy

Increase government expenditure (subsidies), or increase interest rates or

increase tax  $\Rightarrow$  income decreases  $\Rightarrow$  consumption decreases or demand decreases  
 $\Rightarrow$  price decreases ( $dd < ss$ )  $\Rightarrow$  output decreases  $\Rightarrow$  factors of production decrease  
 $\Rightarrow$  unemployment increases

b. **Protectionism**

The several methods of protecting home market from foreign competition are as follows:

1. Tariffs / Import duties
2. Import Quotas
3. Embargoes
4. Import restrictions

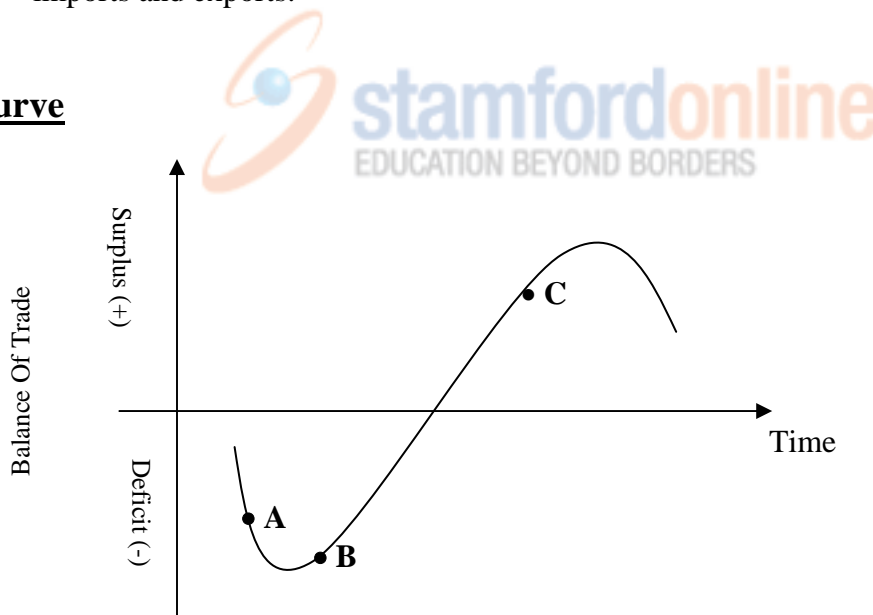
5. Hidden export subsidies
6. Depreciation / Devaluation of currency

We may note here that they are aimed at expenditure switching. If tariffs are used to reduce imports, their efficiency will be determined by the elasticity of demand for imports. For tariffs to reduce expenditure, it is necessary for demand to be elastic.

c. **Devaluation Or Depreciation Of Currency**

When the country's exchange rates changed from  $\text{£}1 = \$2.80$  to  $\text{£}1 = \$2.40$ , this is referred to as devaluation. If a country has a floating exchange rate and it allows the external value of its currency to decrease, this is referred to as depreciation. Both of these actions have the same effect, i.e., exports will appear cheaper to foreigners, imports will appear more expensive to domestic consumers. These measures are thus expenditure switching. In order to access devaluation and depreciation as a method, we need to consider the elasticities of demand for imports and exports.

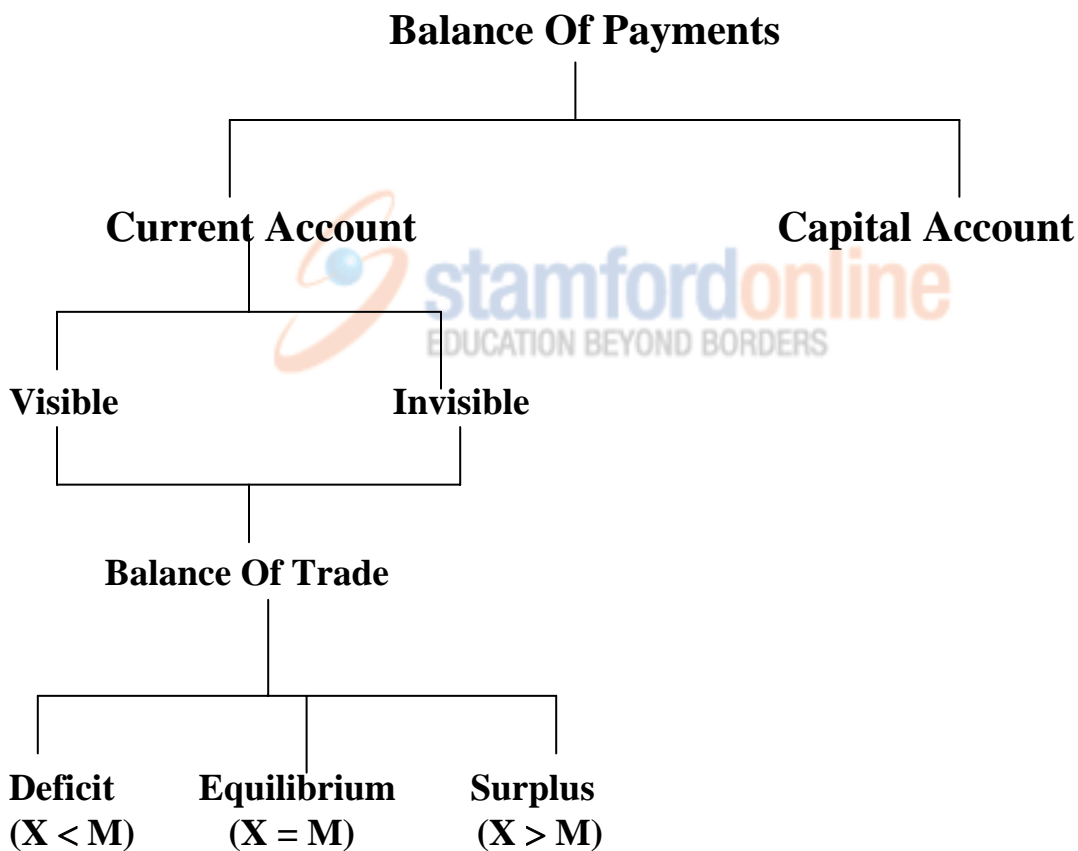
**J Curve**



In response to a trade deficit at point A, the government depreciates the currency. Initially this causes a further deterioration to point B before moving the balance of trade into surplus (point C).

Measures taken to rectify a balance of payments deficit have often led to an immediate deterioration in the payment position before it improves. This may be caused by:

- i. **Crises of Confidence**  
Measures taken to rectify a deficit may have the initial effect of creating anxiety, thus leading to an outflow of money, which initially leads to a deterioration in the payments position before the recovery.
- ii. **Insufficient Capacity**  
If the economy is at, or near, capacity, then expenditure switching policy is unlikely to be successful immediately until capacity can be increased.



## **TERMS OF TRADE**

The terms of trade is a measure of the relative prices of imports and exports. The terms of trade is an export : import price ratio which measures the relative prices of country's exports to the prices paid for its imports. The terms of trade for a country continually changes as export prices and import prices change. The ratio of export to import ratio – **the terms of trade** – determines the volume of exports necessary to pay for a given volume of imports or the volume of imports that can be purchased with the proceeds of a given volume of exports.

The terms of trade is measured as:

$$\text{Terms of trade} = \frac{\text{Unit value of exports}}{\text{Unit value of imports}} \times \frac{100}{1}$$

Other things being equal, if the price of exports falls relative to that of imports (a fall in the terms of trade), the trade balance will deteriorate, or vice versa.

Note that the trade balance depends not just on the physical volume of exports and imports, but on the price at which they are traded.

If the index increases, this is said to be a **favourable** movement in the terms of trade, while if it falls, it is termed as **unfavourable**. A favourable movement in the terms of trade means that a given quantity of exports will buy more imports.

### **Learning Outcomes:**

Students should be able to:

- Identify and examine different accounts in Balance of Payments (BOP)
- Interpret the statistical data

### **Main Reference**

Case, K. E., & Fair, R. C. (2007). *Principles of Economics* (8<sup>th</sup> ed.). Prentice Hall, Chapter 34.

### **Other Reference**

Sloman, J. (1993). *Economics* (3<sup>rd</sup> ed.). Prentice Hall, Chapter 24.

**Review Questions**

1. What are terms of trade and balance of trade?
2. Analyse the effects of unfavourable balance of payments on an economy.
3. Describe the corrective measures that a government can take in order to improve an unfavourable balance of payments.

