6.5 Balance of payments

Name: _____ Class: _____ Date: _____ **Total: 30 marks**

KEY WORDS balance of payments • current account • financial account • remittances • expenditure switching • J-curve J

Objective

Build the skills to answer exam questions on the **balance of payments** : the current, capital and financial accounts, current account deficits and surpluses, and how they can be corrected.

You must be able to:

- outline the current, capital and financial accounts and how they relate
- calculate balances from balance-of-payments data
- explain the causes and consequences of persistent current account deficits and surpluses
- evaluate expenditure-switching and expenditure-reducing policies
- explain the Marshall–Lerner condition and the J-curve

1 Key knowledge and worked examples

The balance of payments

The **balance of payments** records all transactions between a country's residents and the rest of the world over a year. Money **coming in** is a credit (+); money **going out** is a debit (−).

account	what it records
current account	trade in **goods** and **services**; **primary income** (wages, interest, profits, dividends earned abroad); **secondary income** (transfers such as remittances and aid)
capital account	capital transfers (e.g. debt forgiveness) and buying or selling non-produced assets (e.g. patents, land for embassies)
financial account	**foreign direct investment** (FDI), **portfolio investment** (shares and bonds), other investment (loans, deposits) and **reserve assets**

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The accounts must balance: current account + capital account + financial account + errors and omissions = 0. So a **current account deficit** is matched by a **surplus** on the capital and financial accounts (the country borrows or sells assets abroad).

Causes of a current account deficit: low competitiveness (high costs, low productivity), a high exchange rate, fast growth that raises imports, high inflation compared with trading partners.

Consequences of a persistent deficit: rising foreign debt and interest payments; downward pressure on the currency; foreign ownership of domestic assets; possible need for higher interest rates. A **persistent surplus** may mean low domestic spending, pressure for the currency to appreciate and trade tensions with partners.

Correcting a deficit:

1. **expenditure-switching** (switch spending from imports to home goods): depreciation, protection;
2. **expenditure-reducing** (cut total spending, so fewer imports): contractionary fiscal or monetary policy, at the cost of growth and jobs;
3. **supply-side policies:** raise productivity and competitiveness in the long run.

AHL – Marshall–Lerner condition: a depreciation improves the current account only if $|\text{PED}_X| + |\text{PED}_M| > 1$. **J-curve:** in the short run, demand for exports and imports is inelastic (contracts already signed, slow to find new suppliers), so after a depreciation the deficit first gets **worse**; later, as demand becomes more elastic, it improves.

Answer shapes: identify the account → calculate the balance → explain the cause → evaluate the policy with its trade-offs.

2 Practice

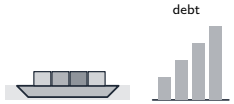
2.1 State **two** items recorded in the current account. [2]



2.2 Explain why a current account deficit must be matched by a surplus on the capital and financial accounts. [2]



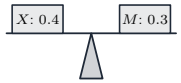
2.3 Explain **two** possible consequences of a persistent current account deficit. [4]



2.4 A country's data ($ bn): exports of goods 400, imports of goods 450, exports of services 120, imports of services 80, net primary income −20, net secondary income +10. Calculate the balance of trade in goods and the current account balance. [3]

	exports	imports
goods	400	450
services	120	80
net income	−20, +10	

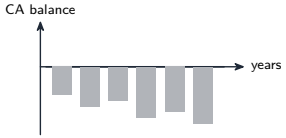
2.5 A country's PED for exports is 0.4 and its PED for imports is 0.3 (absolute values). Using the Marshall–Lerner condition, explain the likely effect of a depreciation on its current account. [3]



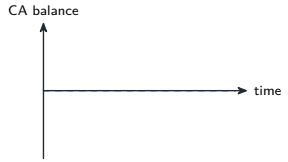
3 Exam-style questions

3.1 A country has had a large current account deficit for many years.

Evaluate the policies that the government could use to reduce the deficit. [10]



3.2 After its currency depreciated, a country's current account deficit grew for a year before it began to shrink.



Using a J-curve diagram, explain this pattern. [6]

[[drawlines:6]]

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Solutions

Marking: **M1** a correct method, **A1** the correct answer, **B1** an independent mark.

Each answer shows the steps, then the **result**.

2.1

any two: trade in goods; trade in services; primary income such as profits, interest or wages from abroad; secondary income such as remittances or aid

2.2

the balance of payments must sum to zero; a country paying out more on its current account must finance it by borrowing or selling assets abroad, which are inflows on the financial account

2.3

any two, explained: rising foreign debt, so more income goes on interest payments abroad; downward pressure on the exchange rate, which may raise import prices and inflation; more foreign ownership of domestic firms and assets; interest rates may have to rise to attract capital, slowing growth

2.4

trade in goods $= 400 - 450 = -\$\mathbf{50}$ bn; trade in services $= +40$; current account $= -50 + 40 - 20 + 10 = -\$\mathbf{20}$ bn

2.5

the condition needs $|\text{PED}_X| + |\text{PED}_M| > 1$; here $0.4 + 0.3 = 0.7 < 1$; so export and import volumes change too little to offset the price changes, and the current account worsens

3.1

award up to [10]: expenditure-switching: a depreciation makes exports cheaper and imports dearer; but imported inflation; and it depends on elasticities; protection reduces imports, but risks retaliation and inefficiency, and may break WTO rules; expenditure-reducing: higher taxes, lower government spending or higher interest rates cut AD and so imports; but they also cut growth and raise unemployment; supply-side policies (education, infrastructure, productivity) raise competitiveness; but they take a long time and are costly; a deficit may not be harmful if it finances investment that raises future exports; the best mix depends on the cause of the deficit; reasoned conclusion

3.2

diagram: current account balance against time, falling after the depreciation, then rising above the starting level; short run: export and import volumes respond slowly because of contracts and habits, so demand is inelastic; imports cost more in domestic currency and exports earn less foreign currency, so the deficit worsens; long run: buyers switch, demand becomes more elastic; once the Marshall–Lerner condition holds, the current account improves

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