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

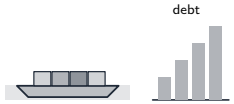
2.1 State **two** items recorded in the current account. [2]



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



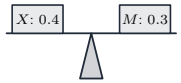
2.3 Explain **two** possible consequences of a persistent current account deficit. [4]



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	

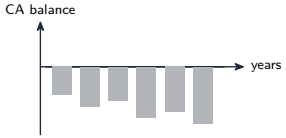
2.5 A country's PED for exports is 0.4 and its PED for imports is 0.3 (absolute values). Using the Marshall–Lerner condition, explain the likely effect of a depreciation on its current account. [3]



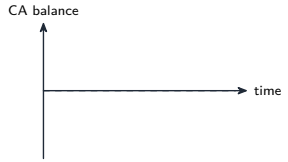
3 Exam-style questions

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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