5.5 Balance of payments

Name: _____ Class: _____ Date: _____ **Total: 21 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

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**

exercises.lol exercises.com.cn

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.

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

2 Practice

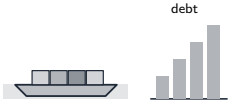
2.1 State **two** items recorded in the current account. [2]



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]



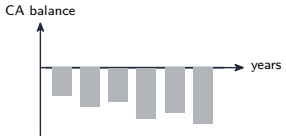
2.4 A country's data ($ bn): exports of goods 400, imports of goods 450, exports of services 120, imports of services 80, net primary income −20, net secondary income +10. Calculate the balance of trade in goods and the current account balance. [3]

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

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]



exercises.lol exercises.com.cn