Balance of payments issues

Chapter 68 – February, 2017

Components of the balance of payments

- Balance of payements is composed of 2 parts:
  1. current account
  2. capital and financial account
     - foreign direct investment (FDI): flows of money to buy *foreign shares* ($> 10\%$)
     - portfolio investment: flows of money to buy *foreign shares* ($< 10\%$)
     - other investments (i.e., trade credit, loans, purchases of currency, bank deposits)
- **Note**: The *negative sign* in the table shows *disinvestments*.

Table 1 UK current account, capital and financial accounts and the balancing item 2013, £ billions

£ billions	Credits	Debits	Balance
Current account	+690.7	+763.1	-72.4
Capital and financial accounts	-138.6	-201.7	+63.1
Balancing item			+9.3
Balance			0

Source: adapted from www.ons.gov.uk.

Table 2 UK capital and financial accounts

£ billions	Net inflow	Net outflow	Balance
Capital account	+1.8	+1.3	+0.5
Financial account	-140.4	-203.0	+62.6
of which			
Direct investment	+27.4	-12.7	+40.1
Portfolio investment	+30.7	+1.2	+29.5
Other investment	+198.5	-210.5	+11.9

Source: adapted from www.ons.gov.uk.

Reasons for international capital flows

Globalisation has increased international capital flows

- *speculators*: buy/sell debt and shares, currencies in order to make *quick profits*
- *financing of trade*: cross-border loans may be taken out to finance trade activities
- *transfer funds abroad* (i.e., buying a holiday house, tax evasion)
- *foreign direct investment* (FDI): firms can make profits by investing in firms abroad
- *portfolio investment*: same motivation as FDI, but of more speculative nature
- investment in *government bonds*

Advantages and disadvantages of international capital flows

- Advantages:
  - helps to *finance* the growth in world trade
  - helps to secure finance in countries that could not rely on financing from *inside their own country*
  - FDI leads to *transfer of technology and information* between countries
- Disadvantages:
  - crisis in one part of the world economy will *quickly spread* to other parts (i.e., 2007-08 financial crisis)
  - FDI can lead to *exploitation* of countries by multinational companies
  - availability of international funds may encourage governments, firms and individuals to *overborrow* (i.e., African countries struggling to repay debt fro decades)

Causes of surpluses and deficits on the current account

- 3 categories of countries:
  1. current account is *in balance* (i.e., France, Chile)
  2. current account is in *surplus* (i.e., Norway, China, Germany, Switzerland)
  3. current account is in *deficit* (i.e., UK, US, Turkey, Poland, Australia)

CAUSES OF SURPLUSES AND DEFICITS ON THE CURRENT ACCOUNT

- Reasons of these states of the current account:
  - *natural resources*: exporting energy (i.e., oil) $\rightarrow$ likely to have current account surplus
  - underlying *competitiveness*: strong competitiveness $\rightarrow$ likely to have current account surplus
  - *exchange rates*: low exchange rates will stimulate exports (i.e., *exchange rate manipulation*)
  - *inflation*: high inflation will make domestic products less competitive wrt foreign (for a given exchange rate)
  - *investment* and *long-term economic growth*: inward $ outward investment is a sign of strong economic growth (i.e., Victorian UK $\rightarrow$ investments abroad, US $\rightarrow$ investments in US)
  - spending by consumers and government: deficits $\rightarrow$ consumers & government are overspending (i.e., Greece, Portugal, Argentina)

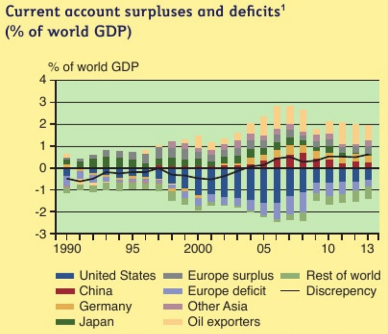
Measures to reduce imbalances on the current account ★

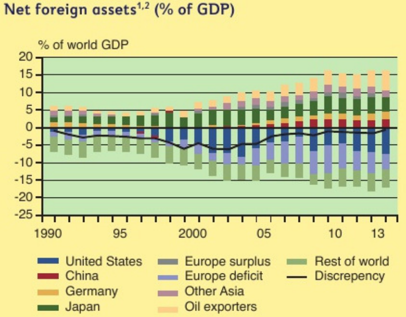
How can governments affect the current account?

- *exchange rate changes* (expenditure switching policies): currency devaluation or depreciation → exports ↑ and imports ↓ (explain mechanism!, chapter 69, 70)
- *deflationary policies* (expenditure reducing policies): ↑ interest or ↑ taxes → imports ↓ (explain mechanism!)
- *supply-side policies* (long-term tool!): aim at ↓ unit labour costs, ↑ investment, ↑ skills of labour force. This will ↑ exports and ↓ imports.
- *protectionism*: imposing tariffs, quotas or other protectionist measures
- *currency controls*: controls on the purchase of foreign currency by domestic citizens and firms (i.e., Pakistan, Russia, Venezuela)

Global trade imbalances

- Global imbalances are measured in 2 ways:
  1. imbalances on the *current account*
  2. imbalances in *assets owned abroad* or *borrowing from abroad* (graph: difference between foreign assets owned and what is owed to foreigners)





Financial crisis

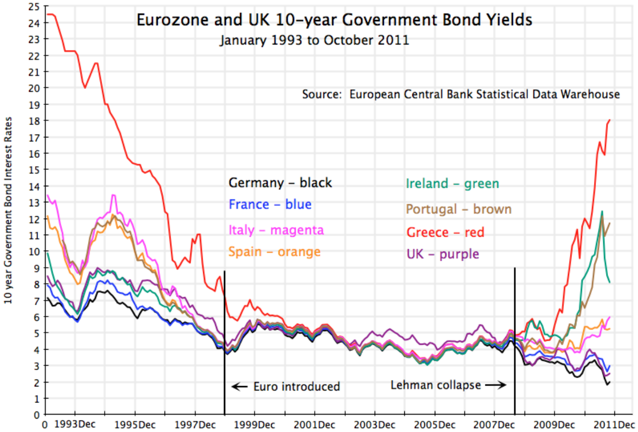
- foreign investors may suddenly refuse to lend to a country (i.e., Asian countries in 1997, Greece, Italy, Spain, Portugal after 2008)
- loans are given to individuals or institutions, not to countries! (i.e., government, banks, firms, individuals)
- *fear of contagion*
- in case there is such a refusal of lending:
    - central banks lend money to banks (*lender of last resort*)
    - governments may step in and rescue insolvent banks (i.e., financial crisis 2017-08)
    - local governments can be *bailed out* by central government
    - governments can borrow money from the IMF or the ESM

Default

- failure of a government to repay its debt $\rightarrow$ government will not be able to borrow money on international markets
- creditors will start legal action against the government that is not paying
- firms may refuse to supply governments with goods and services (i.e., shortage of medecine)
- international creditors may refuse to lend money to cover for *day-to-day imports*
- it is likely that it will come to a *debt-restructuring* agreement between creditors and the government
- countries default $\rightarrow$ reduce debt but pay heavy price

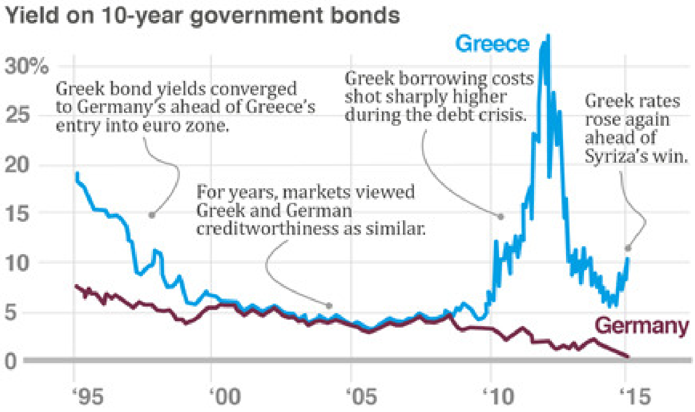
DEFAULT

10-YEAR GOVERNMENT BOND YIELDS



Default

10-year government bond yields



Extract 1: The problem of the UK current account balance

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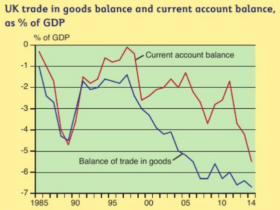

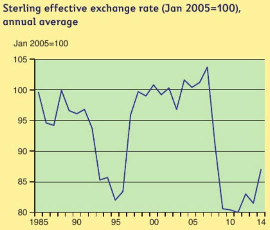

Extract 2: France, a deteriorating current account position

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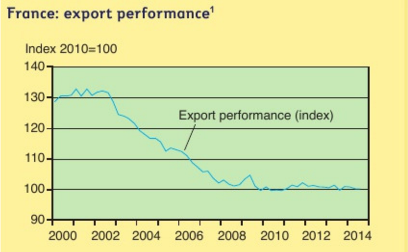

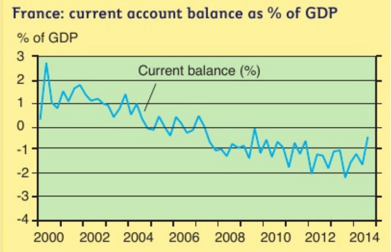

KEYTERMS

- Expenditure reducing:
- Expenditure switching:
- Foreign direct investment (FDI):
- Portfolio investment:

Keyterms

Revision (Chapter 6)

- command or planned or centrally planned economy:
- economic system:
- free market economy or free enterprise economy or capitalist economy or market economy:
- mixed economy:

KEYTERMS

REVISION (CHAPTER 7)

- economic welfare:
- macroeconomics:
- microeconomics:
- neo-classical theory:
- utility or economic welfare:

KEYTERMS

REVISION (CHAPTER 8)

- conditions of demand:
- consumer surplus:
- contraction of demand:
- demand curve:
- demand or effective demand:
- extension of demand:
- law of diminishing marginal utility:
- shift in the demand curve:

Keyterms

Revision (Chapter 9)

- elastic demand:
- inelastic demand:
- price elasticity of demand or own price elasticity of demand:
- unitary elasticity:
- total expenditure:
- total revenue:

Keyterms

Revision (Chapter 10)

- complement:
- cross elasticity or cross-price elasticity of demand:
- income elasticity of demand:
- inferior good:
- normal good:
- substitute: