Balance of Payments

- An economy's Balance of Payments (BOP) is official record of its all international transactions that took place during certain period of time (usually one year).
- Just like any other accounting statement, BOP has a particular format recommended by International Monetary Fund (IMF) which is used by all

countries which makes cross country comparison easier.

Balance of Payments

- Like World Bank, IMF is international development organization that provides financial and technical assistance to economies that experience persistent deficits on their BOPs.

Surplus and Deficit

- Any international transaction that results in Inflow of money is recorded as Credit Entry and it increases economy's stock of foreign currency reserves.
- Any international transaction that results in Outflow of money is recorded as Debit Entry and it reduces country's stock of foreign currency reserves.

Surplus and Deficit

- If economy's sum of credit entries is greater than sum of debit entries it is known as Surplus and if sum of debit entries is greater than sum of credit entries it is known as Deficit.

Balance of Payments

- An economy's BOP consists of 2 accounts namely Current Account and Capital Account –

which was previously known as Financial Account

1. Current Account

- Trade in Goods
- Trade in Services
- Income
- Current Transfer

2. Capital Account

- Records inflows and outflow of investments

Balance of Payments

3. Official Financing / Official Reserve Account

4. Net Errors and Omissions

Trade in Goods

- Trade in Goods or Visible Balance: records exports and imports of tangible goods for instance cars, electronics etc.
- Pakistan's exports of tangible products like wheat, fruits, textiles will be recorded as credit entries and imports like cars, consumer electronics will be recorded as debit entries.

Trade in Services

- Trade in Services or Invisible Balance: records exports and imports of services – intangible goods.
- Payment of tuition fees by a Pakistani student to a US university will be recorded as debit entry in Pakistan's Balance of Payments and as credit entry in Trade in Services section of US's Current Account.
- Similarly foreign tourists visiting Pakistan will be recorded as credit entry in Pakistan's BOP and so on.

Income

- Income: records all types of income earned by your nationals in foreign countries and by foreigners in your country.
- If a Pakistani earns dividends on his shares held in New York Stock Exchange it will be recorded as credit entry on Pakistan's BOP.
- Similarly if US national earns any income on his / her asset held in Pakistan like a restaurant or by working in US embassy etc that will be recorded as debit entry on Pakistan's BOP and as credit entry on

US BOP.

Current Transfers

- Current Transfers: records unilateral transfers which are one sided transfers and not as payment for goods / services.
- For instance countries receiving aid or grant. Remittances are also recorded in Current Transfer. The income sent back home by Pakistani nationals working abroad is known as remittance.

Current Transfers

- U.S government's grant to Pakistani government will be recorded as credit entry in Pakistan's BOP and as debit entry in US BOP.

Current Account Balance

- The sum of Trade in Goods, Trade in Services, Income and Current Transfers make up the Current Account Balance which can be a Surplus or a Deficit.

Current Account Balance

- If the sum of credit entries recorded is greater than the sum of debit entries recorded in Current Account there will be a Surplus on the country's Current Account and if opposite that would be defined as Deficit.

Capital Account

- All international investment transactions will be recorded in Capital Account.
- Investments can be classified in 2 categories namely:

Direct Investment and Portfolio Investment which is in financial instruments like bonds, shares etc.

Capital Account

- For instance if UK national investments in Pakistan's stock exchange then it will be recorded as credit entry in Pakistan's BOP for it is cash inflow for Pakistan and will be recorded as debit entry in UK's BOP as it is cash outflow for UK.
- Similarly if Pakistani national invests in a US company then it will be recorded as debit entry in Pakistan's BOP and as credit entry in US BOP.

Capital Account

- The income generated from these investment in the future are recorded in the Current Account's Income section.

Surplus and Deficit

- Balance of Current and Capital Account collectively determine any economy's overall position on its BOP (Surplus or Deficit).

Current Account + Financial Account = Change in Reserves

- If sum of Current Account and Capital Account balance is positive – meaning sum of all credit entries is greater than sum of all debit entries – it is defined as Surplus and it results in increase in the country's foreign currency reserves.

Surplus and Deficit

- Similarly if sum of Current Account and Capital Account balance is negative – meaning sum of all debit entries is greater than sum of all credit entries – it is defined as Deficit and results in depletion of a country's foreign currency reserves.

Net errors and Omissions

- Any missing information concerning that should have been recorded in the Balance of Payment that prevents Balance of Payments from getting balanced is written-off in the Net Errors and Omissions section.

Net errors and Omissions

- No matter how flawless a countries transaction recording system gets there will always be some missing information due to illegal activities.

Balance of Payments Disequilibrium

AS Economics

Balance of Payments Disequilibrium

- Balance of Payments is an official document that records all of an economy's international transactions.

- Balance of Payments disequilibrium refers to persistent surpluses or deficits on economies' Balance of Payments

Balance of Payments Disequilibrium

- Persistent deficits are indicative of economies' lack of competitiveness that require implementation of appropriate corrective actions which we will discuss in this lecture.

Balance of Payments Disequilibrium

- Similarly, economies experiencing consistent surpluses are likely to face substantial appreciation of their exchange rate which is very likely to reduce future demand of country's exports.

Relationship between Balance of Payments and Exchange Rates

- Exchange Rate being price of one currency in terms of another currency is affected by changes in demand and supply of currencies and so are affected by economies' international trade transactions.

- Exchange of currencies take place when economies engage in international transactions and this all is recorded on countries' Balance of Payments.

Relationship between Balance of Payments and Exchange Rates

- Surplus which shows net cash inflow in the country causes currency's demand to increase which causes the exchange rate to appreciate.

- Similarly deficit which shows net cash outflows causes currency's supply to increase which causes the exchange rate to depreciate.

Relationship between Balance of Payments and Exchange Rates

- Therefore economies facing persistent surpluses and deficits are likely to experience significant appreciation and depreciation of their exchange rates respectively.

Relationship between Balance of Payments and Exchange Rates

- Just like economies' position on their BOP affects their exchange rates, exchange rate changes can also significantly countries international trade transactions.

- Exchange Rate appreciation makes exports expensive and imports cheaper so economies are expected to experience deficit on BOP.

Relationship between Balance of Payments and Exchange Rates

- On the other hand, depreciation of exchange rates make exports cheaper and imports expensive and so economies are expected to experience surplus on BOP.

Macroeconomic Policies to Correct BOP Disequilibrium

- Expenditure Switching and Expenditure Dampening are the two popular macroeconomic strategies used to correct BOP disequilibrium.

Expenditure Switching Policy

- Expenditure Switching policies aim at redirecting domestic and international expenditure away from foreign to locally manufactured goods / services.

- This is achieved through imposition of different types of protectionist policies. Trade barriers including tariffs, quotas, exchange controls and export subsidies are all useful in this regard.

Expenditure Switching Policy

- Whereas tariffs, quotas and exchange control discourage imports, export subsidies artificially boost price competitiveness of local products increasing economy's export revenue.
- Unlike protectionist tools that are quick in achieving intended aims, export enhancing instruments are costly for economies and are more time consuming and therefore their results might only be evident in medium to longer term.

Limitations of Expenditure Switching Policy

- Price inelastic demand for imports will not reduce their quantity demanded by large extent for a given increase in their prices arising from imposition of tariffs and quotas. Hence in this case Expenditure Switching Policy won't be very effective.
- Similarly export subsidies might not be very effective in enhancing economies' exports because foreign products might be more competitive in terms of quality, durability etc.

Expenditure Dampening Policy

- Expenditure Dampening Policies aim to reduce local aggregate demand which is expected to also reduce demand for imports.

Expenditure Dampening Policy

- When countries maintain managed exchange rates, excessive imports relative to exports result in erosion of economies' precious foreign currency reserves which requires implementation of corrective actions. Hence constant deficits on economies' BOP is not economically feasible for countries.

Expenditure Dampening Policy

Use of contractionary fiscal and monetary policies are used as a strategy to implement Expenditure Dampening Policy.

- Government use of high tax rates and lower government spending to reduce aggregate demand is known as contractionary fiscal policy.

Expenditure Dampening Policy

- On the other hand, use of high interest rates by Central Banks to reduce economy's aggregate spending is known as deflationary monetary policy.

Expenditure Dampening Policy

- Lower aggregate spending will though adversely affect demand of locally manufactured goods/services but it will also reduce demand for foreign products which will limit economies' BOP deficits.

Strategies for sustainable improvements in BOP deficits

- Effective long term strategies for maintaining favorable position on BOP usually requires more than Expenditure Switching and Expenditure Dampening Policies.

- Choice of sustainable and more effective solutions for BOP deficits will be based on the actual cause of deficit meaning whether it is Current Account deficit or Capital Account Deficit.

Sustainable Solution for Capital Account Deficit

- Policymakers should be concerned about attracting more international investment. Capital account deficits are often representative of low investor confidence which results in net investment outflow. Improvement in economies' investment environment will positively affect their Capital Account balance.

Sustainable Solution for Capital Account Deficit

- Higher interest rates will also encourage portfolio investment in economy's financial assets which will further help improve its BOP balance.

Sustainable Solution for Capital Account Deficit

- Higher relative profits, lower cost of production through tax holidays and establishment of industrial zones will attract more FDI and will increase economies' capital account balance.

Sustainable Solution for Current Account Deficit

- On the other hand, countries suffering from negative balances on current account should try enhancing their exports' competitiveness.

Sustainable Solution for Current Account Deficit

- Unlike Expenditure Switching and Expenditure Dampening policies which are comparatively easier to implement and have short term impact, exports' competitiveness can be improved through supply-side policies and can only be expected to have medium to long term effect.

Sustainable Solution for Current Account Deficit

Supply-side policies are strategies
used to enhance economies' production potential.

- Improvement in economy's human resource through increased investment in education and professional trainings

- Interest free loans and grants for new start-ups
- Tax holidays and technical support for new start-ups