The Balance of Payments

AQA A-Level Economics

Current Account · Capital Account · Financial Account · Deficits · Marshall-Lerner · J-Curve

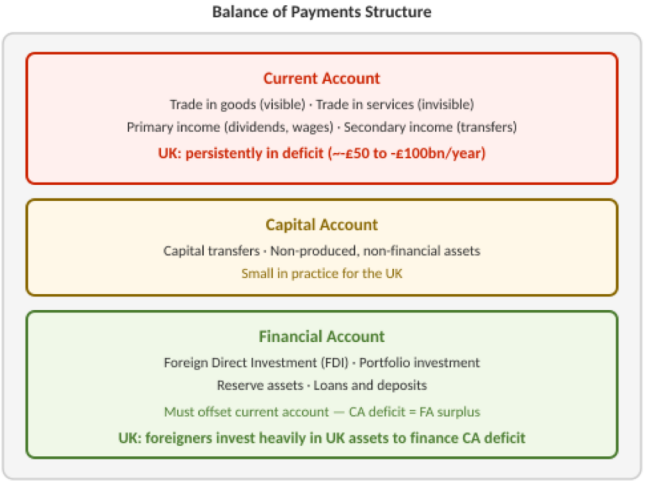
What is the Balance of Payments?

Definition:
The Balance of Payments (BoP) is a record of all financial transactions between a country's residents and the rest of the world over a given period. It records flows of money in (credits) and money out (debits).

Key principle — it always balances:
The BoP must always sum to zero. A deficit on one account must be offset by a surplus on another. For example, a current account deficit (more money leaving than entering through trade) must be financed by a surplus on the capital or financial account (e.g. foreigners investing in UK assets).

Three main accounts:

Current Account	Goods + services + primary income + secondary income. UK in persistent deficit.
Capital Account	Capital transfers and non-financial asset transactions. Small for the UK in practice.
Financial Account	FDI, portfolio investment, reserve assets, loans. Must offset current account — CA deficit = FA surplus.



🌍 Real-World Example

UK BoP always balances: a current account deficit of ~£80bn is offset by a financial account surplus — foreign investors buying UK gilts, property, and equities. London's role as a global financial centre generates the capital inflows needed to finance persistent trade deficits.

The Current Account in Detail

The current account is the most important and most discussed part of the BoP. It has four components:

Trade in Goods (Visible Balance)

Exports of physical goods minus imports of physical goods. UK consistently runs a visible deficit — we import far more manufactured goods than we export. Manufacturing decline (deindustrialisation) has widened this gap since the 1980s.

e.g. UK 2023: goods deficit ~£175bn. UK imports cars, electronics, clothing. Exports: pharmaceuticals, machinery, chemicals — but volume far less than imports.

Primary Income

Income flows: dividends and profits received from overseas investments (credit) minus dividends/profits paid to foreign investors in the UK (debit). Also includes wages of cross-border workers.

e.g. UK multinationals earning overseas profits repatriated to the UK are a credit. US tech giants' UK profits sent back to the USA are a debit — UK often runs a small primary income deficit.

Trade in Services (Invisible Balance)

Exports of services (financial services, legal, education, tourism) minus imports. UK runs a services surplus — London is a global hub for financial and professional services. Partially offsets the goods deficit.

e.g. UK 2023: services surplus ~£120bn. Financial services, insurance, management consulting, and education exports are the UK's key comparative advantages.

Secondary Income (Transfers)

One-way transfers of money with no exchange of goods/services. Includes foreign aid given and received, EU contributions (historically), remittances from migrant workers, and international organisation subscriptions.

e.g. UK foreign aid spending: ~£14bn/year (0.5% of GNI). UK net EU budget contributions were a debit pre-Brexit (~£9bn/year). Both are secondary income outflows.

Causes of a Current Account Deficit (1/2)

A current account deficit means a country is spending more on foreign goods/services/income than it is earning from abroad. Multiple factors explain persistent deficits:

Deindustrialisation

Decline of the manufacturing sector reduces export capacity. The UK lost large parts of its industrial base from the 1970s onwards — visible exports fell while import penetration of manufactured goods rose.

e.g. UK steel, textiles, car production all shrank dramatically from the 1970s–90s. Goods once exported are now imported — a structural driver of the visible deficit.

Strong Consumer Demand / High Incomes

Higher domestic income raises demand for imports — including imported goods and services. Fast economic growth tends to worsen the current account as consumers spend more on imports.

e.g. UK consumer spending consistently includes large import content — electronics (Asia), cars (Germany/Japan), clothing (Bangladesh). Each boom in consumer spending widens the goods deficit.

Overvalued Exchange Rate

A strong currency makes exports more expensive for foreigners and imports cheaper for domestic consumers. Both effects worsen the trade balance — export volumes fall, import volumes rise.

e.g. UK pound in the mid-1990s was considered overvalued — UK exports were uncompetitive. The 1992 ERM exit (Black Wednesday) depreciated sterling, temporarily improving trade competitiveness.

Causes of a Current Account Deficit (2/2)

Further factors that explain persistent current account deficits:

Uncompetitive Exports

If UK goods and services are more expensive or lower quality than foreign competitors, export volumes fall. This reflects low productivity growth, high unit labour costs, or lack of investment in quality and innovation.

e.g. UK productivity growth has lagged Germany and France consistently since 2010 — making UK exports relatively more expensive and contributing to the persistent goods deficit.

Low Savings Rate

By national income accounting identity: CA deficit = Investment − Savings (I > S). If domestic savings are low relative to investment, the shortfall must be funded from abroad — generating a CA deficit.

e.g. UK household savings ratio fell below 5% pre-pandemic — among the lowest in the OECD. Low savings implies high consumption, much of which leaks abroad via imports.

Financial Flows Generating Income Outflows

Large foreign ownership of UK assets (companies, property, gilts) means profits, dividends, and interest flow out of the UK as primary income debits — worsening the current account even without a trade problem.

e.g. US tech giants (Amazon, Google, Apple) operate large UK businesses. Profits repatriated to the USA represent primary income outflows that widen the UK current account deficit.

Consequences of a Current Account Deficit

Whether a current account deficit is problematic depends on its size, cause, and how it is financed:

Potential Problems

Debt accumulation: a CA deficit financed by borrowing builds up foreign debt. If confidence falls, foreign investors may demand higher yields — raising borrowing costs.

Downward pressure on the exchange rate: persistent deficits create excess demand for foreign currency and excess supply of domestic currency — tending to depreciate the exchange rate.

Loss of productive capacity: if deficit reflects deindustrialisation, the economy loses its ability to produce tradable goods — making future adjustment harder.

Unsustainability: very large deficits (above ~5% of GDP) may be unsustainable — foreign investors may suddenly withdraw funding, causing a balance of payments crisis.

e.g. UK 2022: CA deficit hit ~5.5% of GDP — raising sustainability concerns among economists and credit rating agencies.

Why It May Not Matter

If financed by FDI: foreign direct investment in UK businesses brings technology, jobs, and management know-how — a benign form of financing that does not create debt.

If the currency can adjust: a floating exchange rate automatically depreciates when there is a CA deficit, making exports cheaper and imports dearer — self-correcting mechanism.

If it reflects investment: a deficit caused by high investment ($I > S$) may generate future growth and export capacity — not necessarily a sign of weakness.

London's financial attractiveness: UK's deep financial markets attract vast foreign capital inflows voluntarily — the deficit is partly a sign of the UK's attractiveness as an investment destination.

e.g. USA has run persistent CA deficits for decades — yet the dollar remains the world's reserve currency and the deficit has not caused a crisis.

Correcting a Current Account Deficit

Policy options for reducing a current account deficit:
Governments and central banks have several tools — each with trade-offs:

Exchange Rate Depreciation

A weaker currency makes exports cheaper for foreigners and imports dearer for domestic consumers. Export volumes rise, import volumes fall → current account improves. But: only works if Marshall-Lerner condition holds.

Eval: J-Curve effect means the CA initially worsens before it improves (contracts are fixed in the short run). May also import inflation.

Supply-Side Policies (Expenditure-Switching)

Improving productivity, quality, and competitiveness of domestic goods shifts domestic and foreign spending toward UK output. Trade deficit narrows as UK goods become more competitive without requiring a recession.

Eval: Long time lags — supply-side effects take years or decades to materialise. Cannot provide rapid correction in a crisis.

Deflationary (Expenditure-Reducing) Policy

Raising interest rates or cutting government spending reduces domestic incomes → consumer spending falls → import spending falls → CA improves. A blunt instrument that also reduces GDP and raises unemployment.

Eval: Reduces the deficit by reducing living standards. The medicine may be worse than the disease — a recession to fix a trade deficit.

Protectionism

Tariffs, quotas, and subsidies can directly reduce imports or boost exports. Quick to implement. However, invite retaliation from trading partners, violate WTO rules, and reduce economic efficiency.

Eval: Beggar-thy-neighbour — may temporarily improve own deficit but worsens partners' positions. Global trade wars reduce everyone's welfare.

The Marshall-Lerner Condition

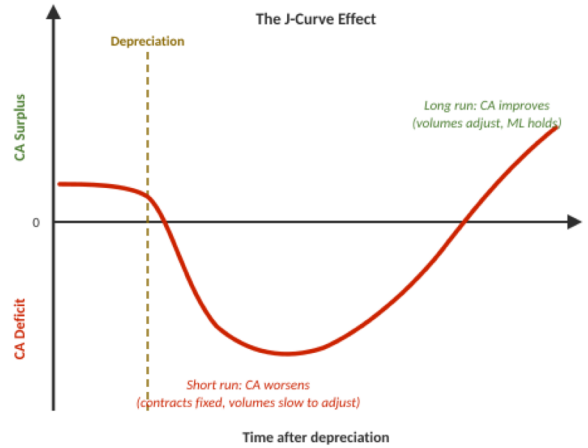
The condition:
A depreciation of the exchange rate will improve the current account only if the sum of the price elasticity of demand for exports (PEDx) and the price elasticity of demand for imports (PEDm) is greater than 1.

Marshall-Lerner Condition: |PEDx| + |PEDm| > 1

Why it matters:
A depreciation changes both prices and volumes. The value effect (export prices fall in foreign currency → export revenue may fall) must be overcome by the volume effect (more exports bought, fewer imports bought). This only happens if demand is sufficiently elastic.

If the condition is NOT met:
Depreciation makes imports more expensive but volumes don't fall much (inelastic). Export volumes rise little. The result: import bill rises more than export revenues → current account WORSENS.

Factors affecting elasticities:
Availability of substitutes (more substitutes → more elastic). Necessity vs luxury (necessities inelastic). Time period (long run: more elastic as firms/consumers adjust). Nature of the good (oil is inelastic; consumer goods more elastic).



Real-World Example

UK post-Brexit 2016: sterling fell ~15% — yet the current account deficit did not improve significantly in the short run. Contracts were fixed, and UK exports of services (inelastic) dominated. Only over several years did UK goods exports gain competitiveness — consistent with the J-Curve and Marshall-Lerner.

The J-Curve Effect

What is the J-Curve?

The J-Curve describes the typical time path of the current account following a currency depreciation. The current account initially worsens before it improves — tracing a path shaped like the letter 'J'.

Why does it initially worsen?

In the short run, trade volumes are relatively fixed — existing contracts have agreed prices and quantities. The immediate effect of depreciation is that imports become more expensive (in domestic currency) but the UK still buys the same quantity. The import bill rises. Meanwhile, exports are cheaper in foreign currency but foreigners don't immediately buy more.

Why does it eventually improve?

Over time — typically 12–24 months — volumes adjust. Foreign consumers buy more UK exports (cheaper). UK consumers switch from now-expensive imports to domestic substitutes. If Marshall-Lerner holds, the volume effects eventually outweigh the price effects and the current account improves.

Short Run (0–12 months)

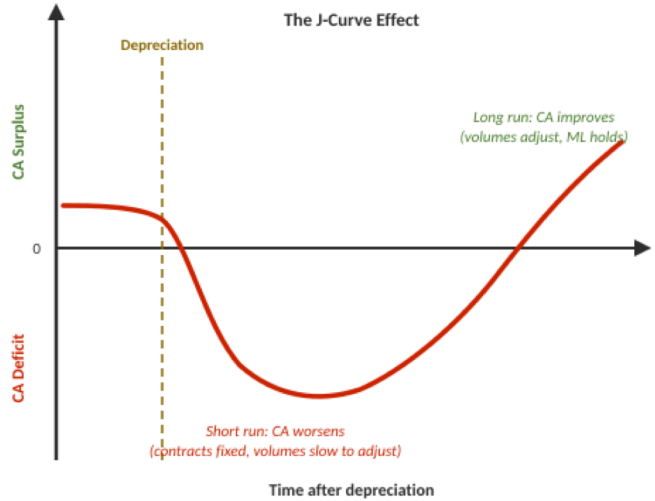
Import prices rise immediately (sterling worth less). UK import volumes fixed by existing contracts. Export volumes slow to respond. Net effect: import bill rises → CA worsens.

Long Run (12–24+ months)

Consumers switch from expensive imports to UK alternatives. Foreign consumers buy more (now-cheaper) UK exports. Volumes adjust. If ML condition holds → CA improves above pre-depreciation level.

The J-Curve: Evidence & Policy Implications

Implications for policy:
Policymakers who depreciate the currency to improve the trade balance must be patient — short-run deterioration is expected and should not prompt premature policy reversal. The J-Curve also means that if depreciation is the policy, it may worsen inflationary pressure before the trade balance improves.



Real-World Example

UK 2016 post-Brexit depreciation: sterling fell sharply. Initially the trade deficit widened as import costs rose. Only over subsequent years did UK goods exports gain some competitiveness. Tourism to the UK (a service export) did pick up quickly as the UK became cheaper for foreign visitors — one of the faster-adjusting sectors.

★ Bonus: Expenditure-Switching vs Expenditure-Reducing

Two approaches to correcting a current account deficit:

Economists distinguish between policies that reduce total spending in the economy (expenditure-reducing) and policies that switch spending from imports to domestic goods (expenditure-switching). Both can improve the current account but have very different effects on GDP and employment.

Expenditure-Reducing Policies

Reduce total domestic demand — deflating the economy so less income is spent on imports.

Tools: raising interest rates (monetary tightening); cutting government spending / raising taxes (fiscal austerity).

Effect: import spending falls as domestic income falls. CA improves BUT real GDP also falls and unemployment rises — the adjustment is painful.

e.g. IMF austerity programmes: countries receiving IMF support are typically required to run tight fiscal policy — reducing imports but also causing recessions.

Expenditure-Switching Policies

Switch domestic and foreign spending away from imports toward domestically produced goods — without necessarily reducing total spending.

Tools: exchange rate depreciation (makes domestic goods relatively cheaper); supply-side improvements (raising productivity/quality of domestic goods); protectionist tariffs and quotas.

Effect: consumption shifts toward domestic output. CA improves AND domestic output/employment may rise — less painful than expenditure-reducing.

e.g. China: deliberately kept yuan undervalued for years to make exports cheap — a classic expenditure-switching strategy that built its export manufacturing sector.

Summary: Key Terms & Relationships

Key Term	Meaning
Balance of Payments	Record of all financial transactions between a country and the rest of the world. Always sums to zero.
Current Account	Trade in goods + services + primary income + secondary income. UK persistently in deficit.
Visible balance	Trade in physical goods — exports minus imports. UK consistently in large deficit.
Invisible balance	Trade in services — exports minus imports. UK runs a surplus (financial services).
Capital Account	Capital transfers and non-produced assets. Small for UK in practice.
Financial Account	FDI, portfolio investment, reserve assets. Offsets the current account — CA deficit = FA surplus.
CA deficit	Spending more abroad than earning from abroad. Financed by capital/financial account surplus.
Marshall-Lerner condition	Depreciation improves CA only if $\|PED_x\| + \|PED_m\| > 1$ (demand is sufficiently elastic).
J-Curve	After depreciation, CA worsens first (volumes fixed) then improves as volumes adjust over time.
Expenditure-reducing	Deflationary policies (rate rises, austerity) reduce imports by reducing income. Painful — causes recession.
Expenditure-switching	Depreciation or protectionism shifts spending from imports to domestic goods without reducing total demand.
FDI	Foreign Direct Investment — buying physical assets abroad. A benign way to finance a CA deficit.