

# Balance of Payments

AS Economics Presentation  
2005

# What is the Balance of Payments?

- The balance of payments records the UK's overseas financial transactions
- The balance of payments accounts include:
  - (a) Trade in goods (tangible goods)
  - (b) Trade in services
  - (c) The net flow of investment income from UK overseas assets (e.g. UK businesses with investments in other countries)
  - (d) Transfers of money between people and governments
- (a) – (d) comprises the Current Account
- This is all that is required for your AS Economics course

# Importance of Exports for UK

- Export earnings are an injection of AD
  - A rise in exports boosts national income
  - Multiplier effects should also be considered – a rise in exports will lead to a bigger final increase in national income which may then affect investment demand
  - Exports are important for UK manufacturing industry (where exports are a high % of total industrial production)
  - Exports can help to ‘dampen’ or ‘cushion’ the volatility of our economic cycle – e.g. if there is a domestic economic slowdown / recession

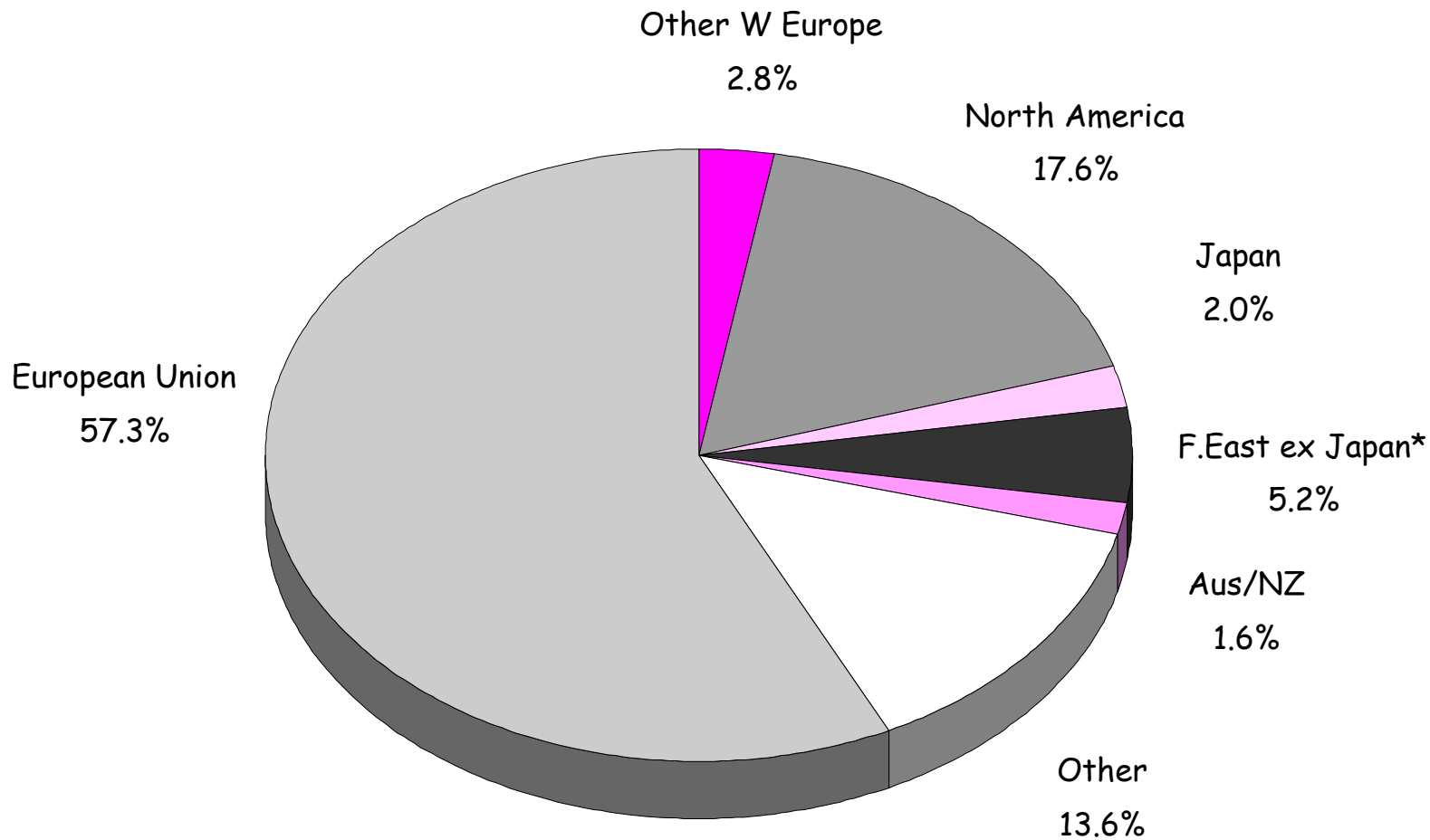
# Importance of Exports for UK

- Employment effects from exports
  - Many thousands of jobs depend directly and indirectly on the export sector
  - Changes in export demand have effects in other sectors further down the supply chain (e.g. component suppliers for manufacturers and also the distribution and marketing industries)
- Regional economy and exports
  - Some regions are more dependent on exports than others (e.g. the North east and Wales)

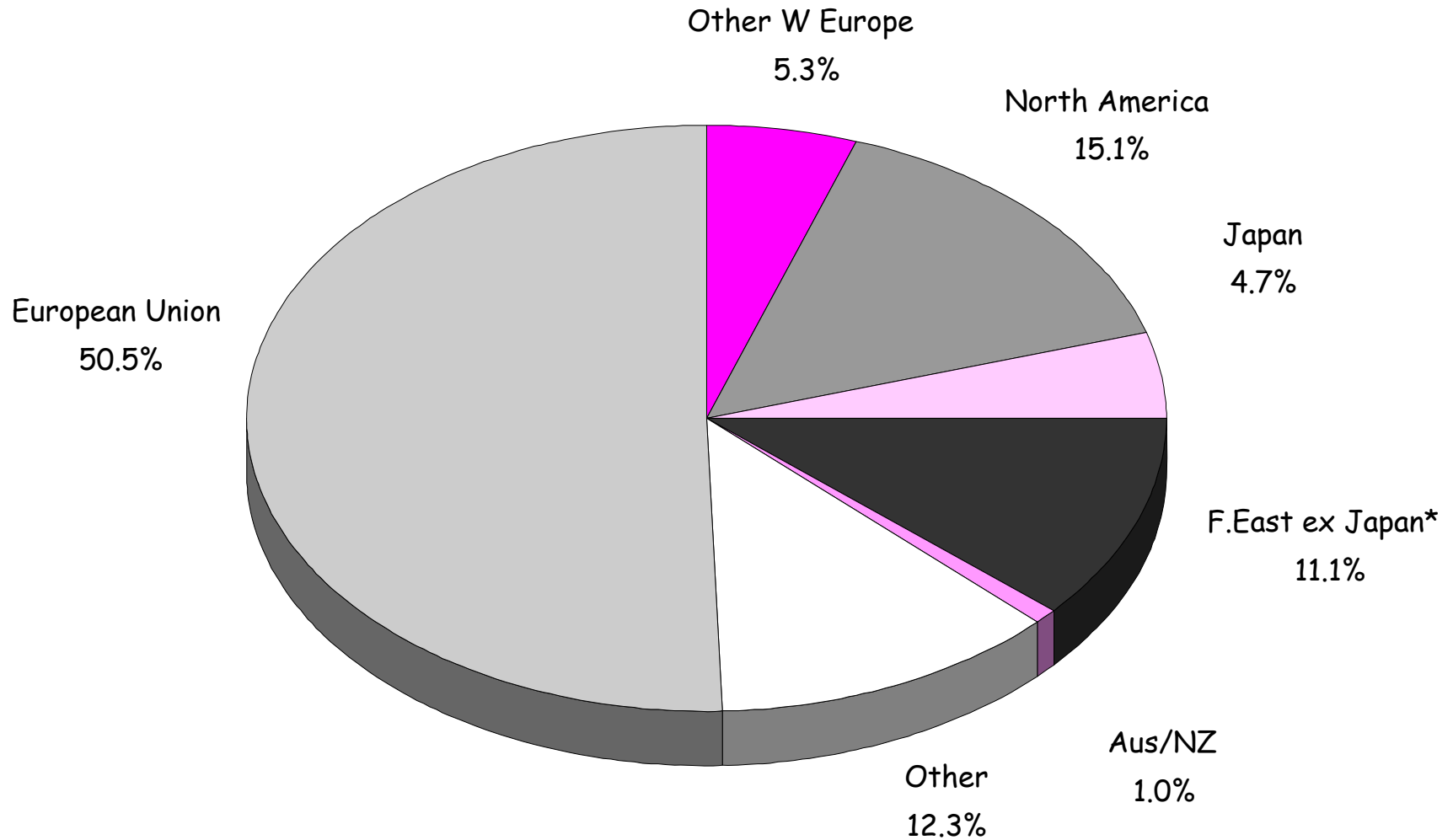
# Trade in Goods

- Consumer durables
  - Household goods (audio visual equipment, furniture etc)
  - Motor vehicles
  - Personal computers
- Capital goods / technology /software
- Commodities (including oil and other fuels)
- Components & basic raw materials (plastics, rubber, semi-conductors)
- Foodstuffs and Beverages

# UK Exports of Goods by Region (in 2000)

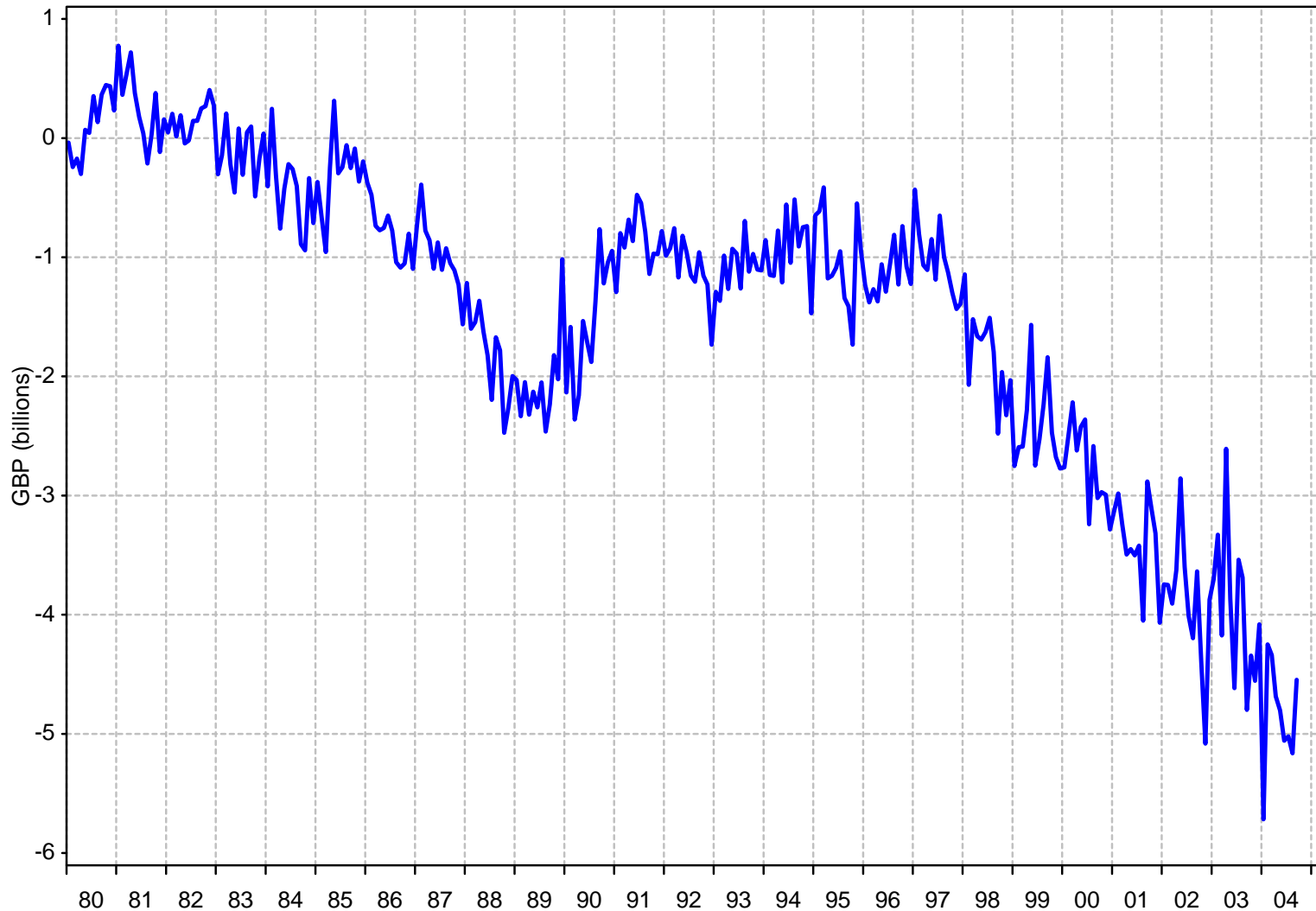


# UK Imports of Goods by Region (in 2000)



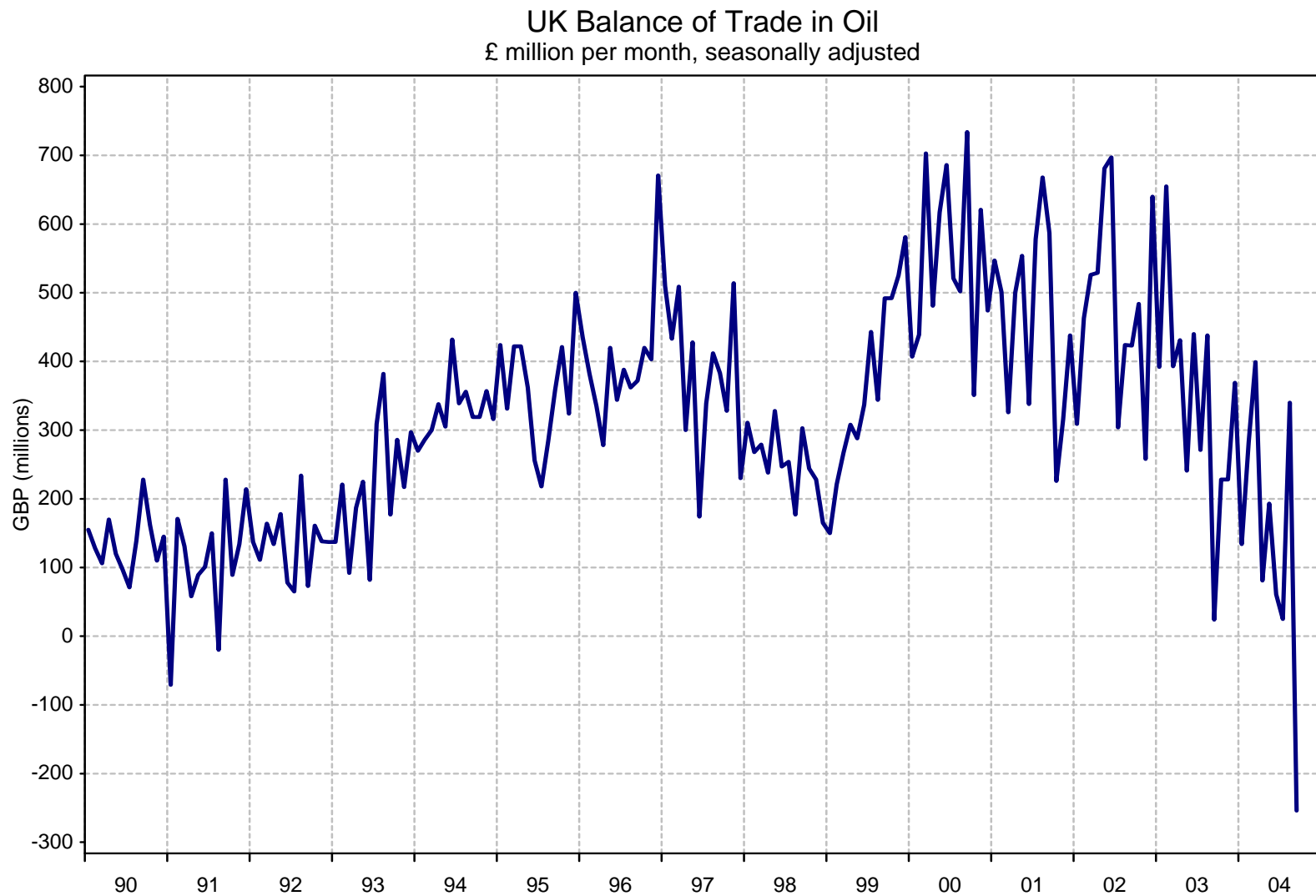
# Trade Balance in Goods

UK Balance of Trade in Goods  
Value of exports - value of imports, £billion





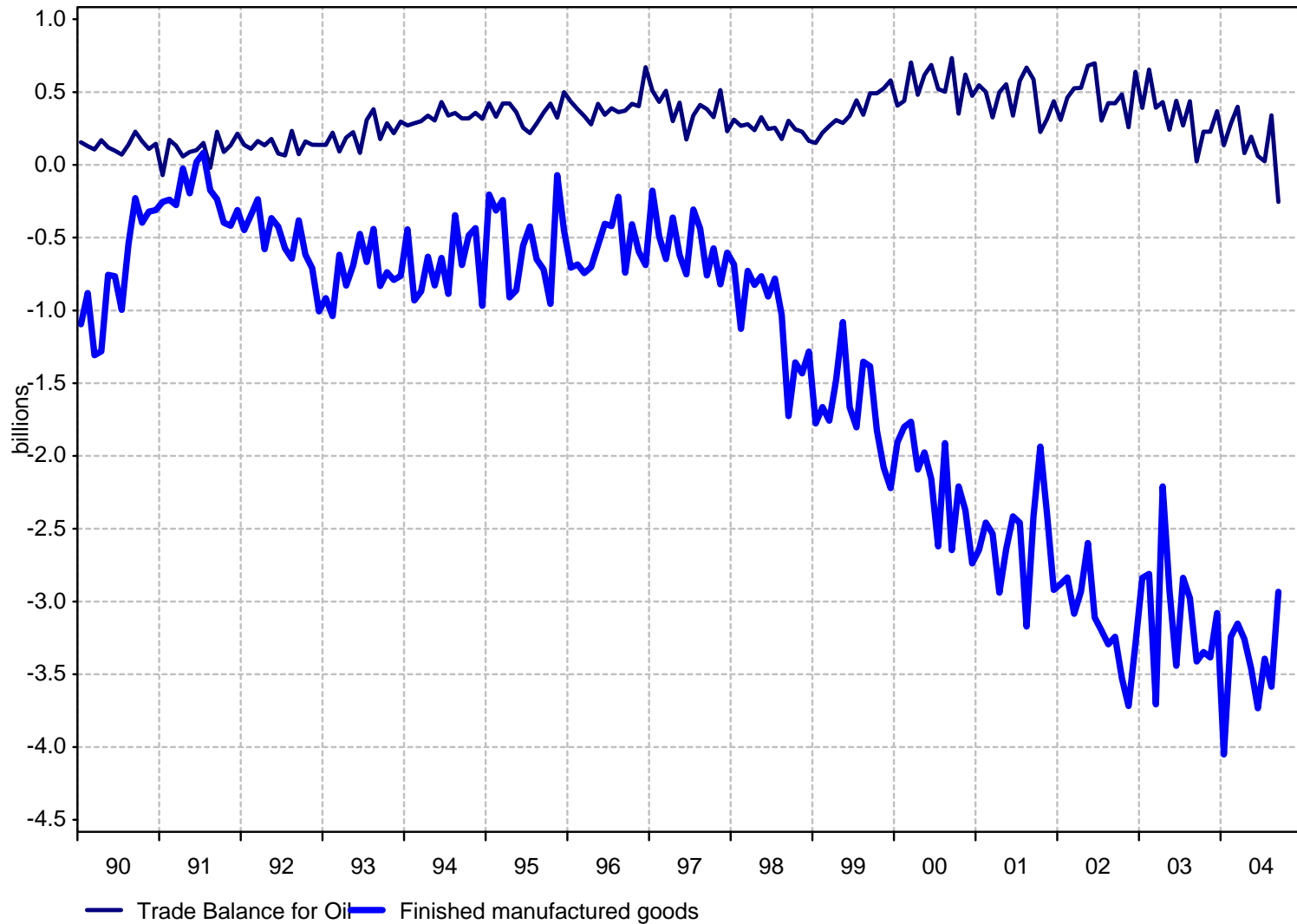
# Our balance of trade in oil



Source: EcoWin

# Oil and Manufactured Goods

UK Balance of Trade in Oil and Finished Manufactured Goods  
£ million per month, seasonally adjusted



Source: EcoWin

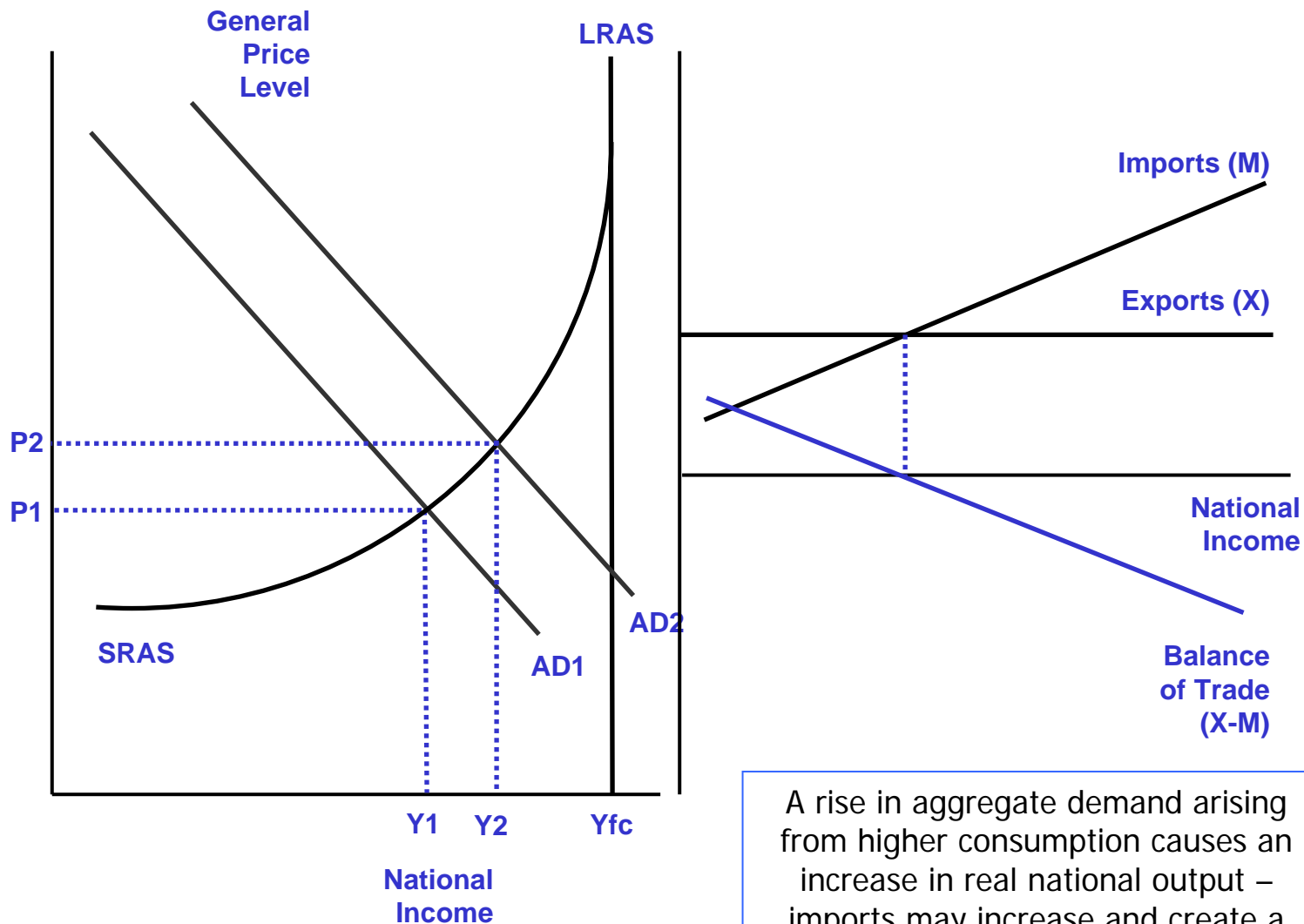
# Explaining the Trade Deficit in Goods

- Demand Side Explanations
  - (these are focused on AD factors i.e. the cyclical causes of a deficit – these are mainly short term)
  - Sustained growth of AD – leading to an increased demand for essential inputs (e.g. steel, glass, rubber, plastics)
  - Strong growth of consumer spending (UK consumers have a preference for imports!)
    - Economy cannot satisfy total demand from consumers
    - Imports come in to meet the excess demand (acting as a safety valve)
  - The effects of the strong exchange rate in recent years – leading to a slower growth of exports and faster growth of imports

# Explaining The Trade Deficit in Goods

- Supply Side Explanations
  - (These focus on LRAS – they are seen as structural causes of a deficit – i.e. mainly long term)
    - Insufficient productive capacity from British suppliers - Linked to a relatively low rate of capital investment in the longer term
    - The productivity gap with businesses in export sectors
    - Inadequate non-price competitiveness
    - A research and development gap – the UK has a smaller share of global patents than comparable countries
    - Changing comparative advantage in the global economy - emergence of new lower-cost competition for the UK

# Aggregate Demand and the Trade Balance



A rise in aggregate demand arising from higher consumption causes an increase in real national output – imports may increase and create a wider trade deficit

# Trade in Services

- Tourism and Travel including Civil Aviation
- Insurance and Business Consultancy Services
- Banking and Accountancy services
- Data processing and other information services
- Music & Entertainment
- Shipping

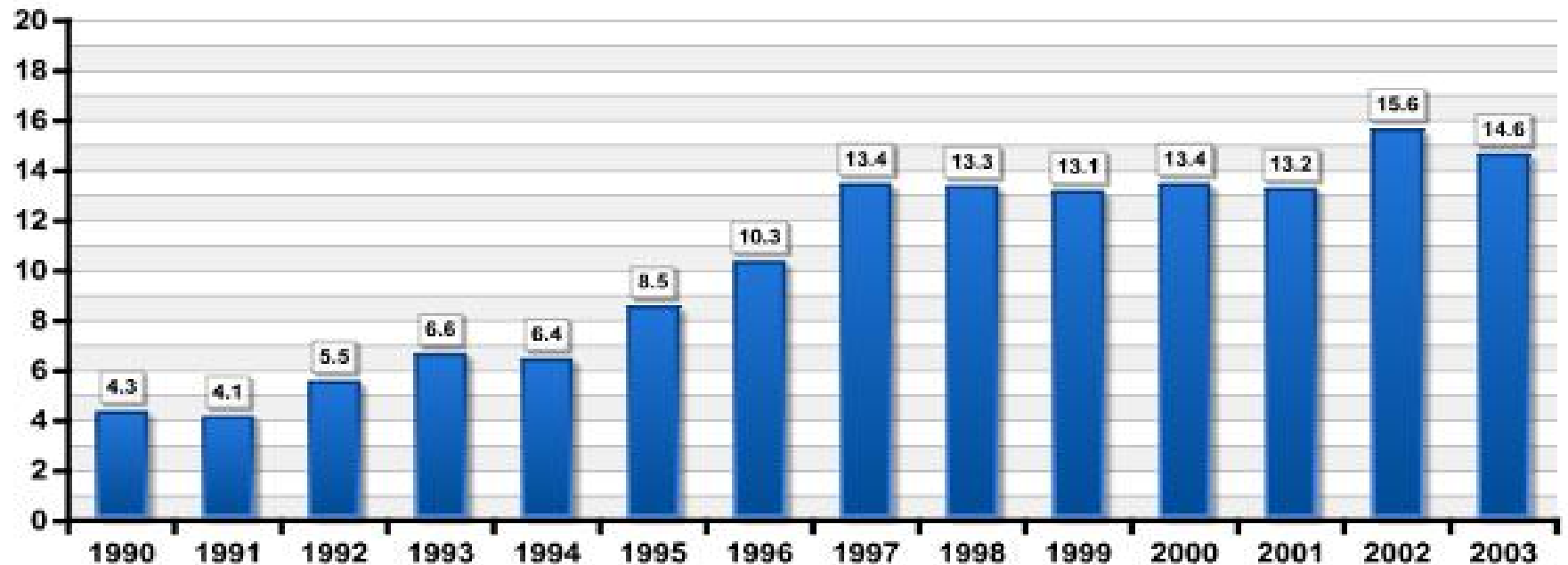
# Trade in Services

- Recent Data
  - United Kingdom was the world's second largest exporter of services in 2001
  - The UK accounts for almost 8 per cent of global exports and 6 per cent of the world's imports, making it also the fourth largest importer of services
  - We run strong annual surpluses in trade in services

# Balance of Trade in Services

## Trade Balance in Services

£ billion

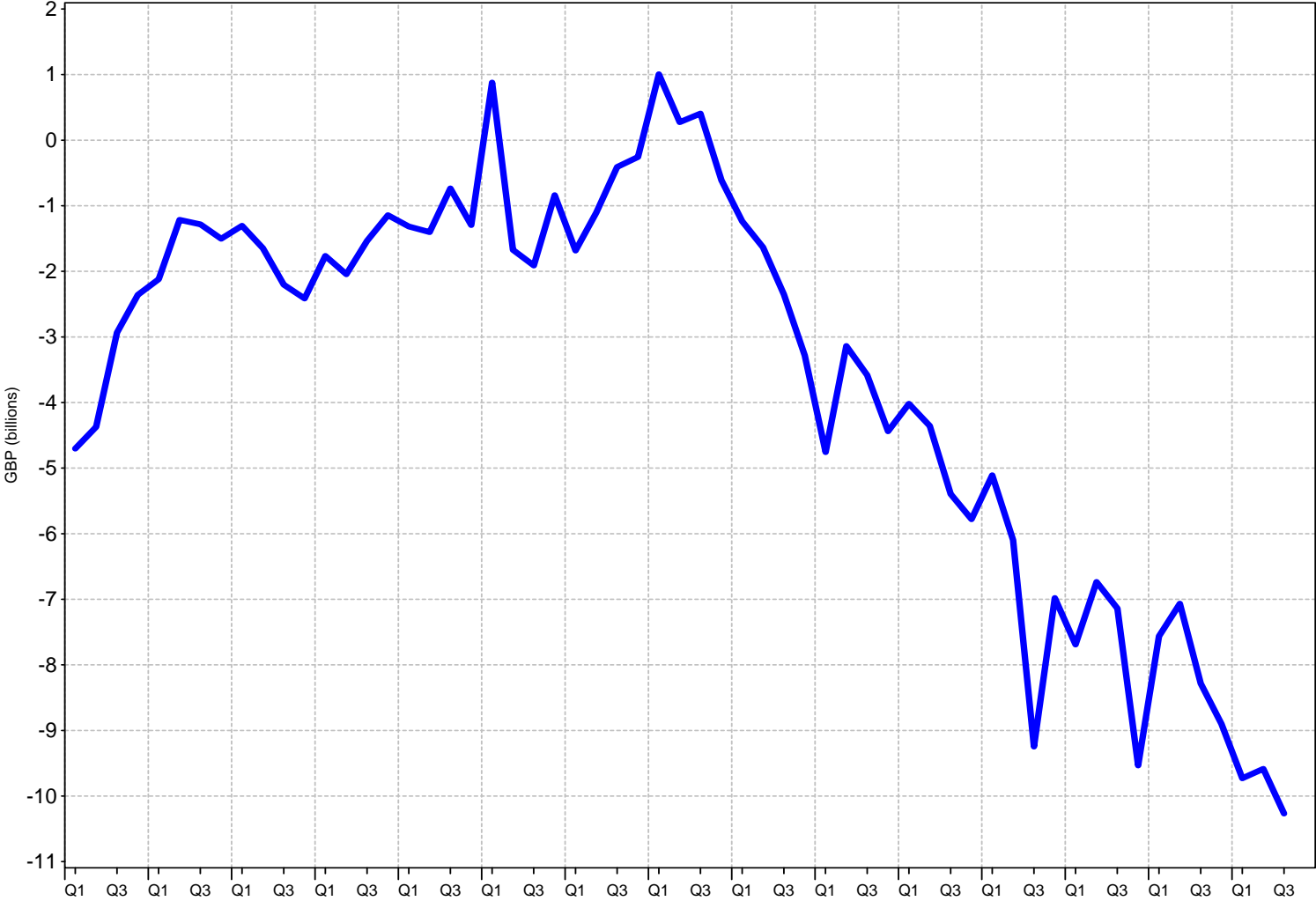




# Balance of Trade in Goods and Services

## UK Balance of Trade in Goods and Services

Seasonally adjusted, quarterly balance, £ billion

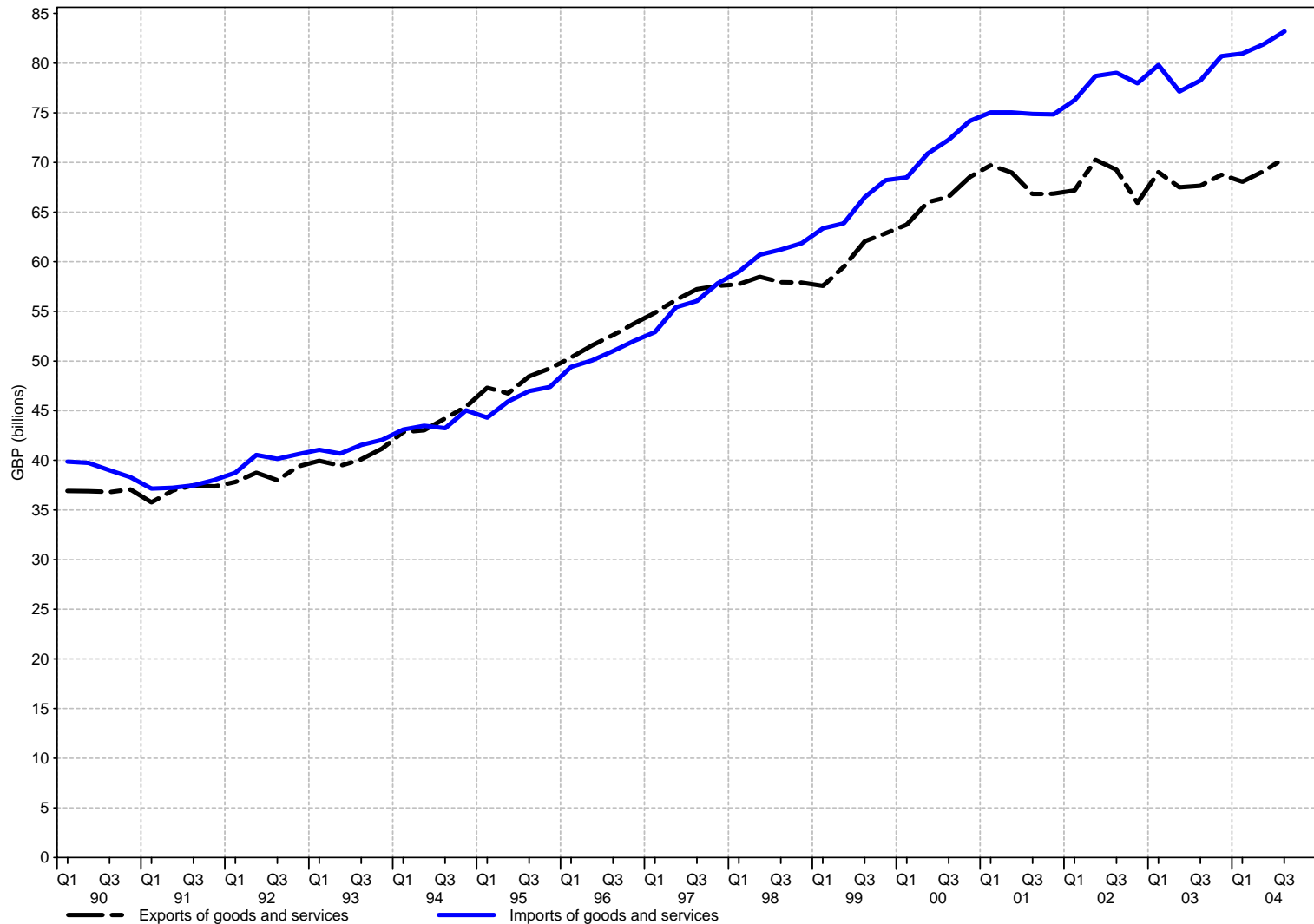


Source: EcoWin

# Long term trends in exports and imports

## Exports and Imports of Goods and Services for the UK

Quarterly values, Constant Prices, seasonally adjusted, £ billion



Source: EcoWin

# Economic Effects of a Fall in Exports

- Possible effects of a fall in demand for exports in overseas markets
  - Negative impact on aggregate demand
    - $C+I+G+(X-M)$
    - Fall in national output – multiplier effect on incomes and spending
    - Might trigger an economic slowdown / recession
    - Actual GDP will fall below potential GDP (negative output gap)

# Economic Effects of a Fall in Exports

- Negative effect on company profits and business confidence
  - Less demand implies less capital investment
  - Can lead to plant closures / job losses / cyclical unemployment
- Government finances will be affected
  - Slower growth hits tax revenues + extra welfare spending
- Some regions are more dependent on exports than others (e.g. manufacturing industry)- might worsen the “north-south divide”

# Economic Policies to Reduce a Trade Gap

- The cyclical element of the deficit tends to be self-correcting
- A lower exchange rate improves the trade balance after a time lag - but this depends on the elasticity of demand and supply for UK output

# Economic Policies to Reduce a Trade Gap

- Corrective policies for BOP normally focus on
- (1) Expenditure-reduction
  - Reducing aggregate demand for goods and services
- (2) Expenditure-switching
  - Changing the relative prices of UK and overseas output so that more resources are devoted to exporting

# Economic Policies to Reduce a Trade Gap

- In the long run, there is a need to improve the supply-side performance of the economy to achieve a BOP equilibrium
  - Businesses need to become more competitive in domestic and overseas markets
  - There needs to be more investment in industries with large export potential
  - The productivity gap with other countries needs to close

# Expenditure Reduction and Switching

- Expenditure reduction
  - Higher direct taxes – leads to lower real disposable incomes
  - Increased interest rates – to dampen consumer confidence and consumption and take away some of the excess AD in the economy
  - Reducing the growth of domestic demand may encourage UK businesses to switch their production towards export markets



# Expenditure Reduction and Switching

- Structural change
  - Supply-side economic reforms designed to raise productivity and reduce unit labour costs
  - A better supply-side performance is a long-term strategy to improve the trade figures
  - Improved non-price competition
    - Research and development and more innovation
    - Investment in new growth sectors
  - Export promotion

# Expenditure-switching Policies

- Depreciation of exchange rate
  - Raises sterling price of imports
  - Higher profitability of exporting
  - But impact of lower exchange rate depends on elasticity of overseas demand for UK exports

# Expenditure-switching Policies

- Achieving a period of low relative inflation
  - This helps to provide the British economy with macroeconomic stability - important for our long term competitiveness
- Tariffs and non-tariff barriers not really an option – because of UK commitments to the World Trade Organisation

# Evaluation on Balance of Payments Policies

- Effective policies to reduce a trade deficit focus on underlying causes
- Some of the trade deficit is cyclical – i.e. reflecting high AD – this may unwind if the economy goes into a slowdown or a recession
- The exchange rate also plays a part – but there is little that the government and the Bank of England can do to manipulate the exchange rate – they prefer a floating currency

# Evaluation on Balance of Payments Policies

- Eventually – a trade deficit puts downward pressure on the exchange rate (because of the outflow of currency to pay for imports)
- In the medium to long term – improving the trade position requires:
  - (i) Improved productivity for UK businesses facing global competition
  - (ii) Investment in new capital, research and development
  - (iii) Investment in human capital to boost our competitiveness in high value and high knowledge manufacturing and service industries

# Overall Current Account

## The Current Account of the UK Balance of Payments

Annual balances, source: UK balance of payments statistics

