Chapter 5 – Balance of Payments

5.1 The Current Account of the Balance of Payments

- **Balance of Payments – Record of all international transactions between one country and the rest of the world**
- **Current Account – Measures the total value of export revenue and import expenditure of trade in goods & services, investment income and current transfers**

Demand Side Causes of a Current Account Deficit (Opposite for a Surplus)

1) **Strong domestic growth (higher incomes at home).** If real disposable incomes are high at home due to a boom for example, the marginal propensity to import will increase. There will be a greater 'sucking in' of imports effect, increasing demand and thus the expenditure on imports. Ceteris paribus, this will worsen the trade balance of the current account causing a current account deficit.

2) **Recession abroad (low incomes abroad).** If real disposable incomes fall abroad in the economies of major trading partners due to a recession for example, the demand for domestic exports will decrease, leading to a fall in the revenue generated from exports which ceteris paribus will worsen the trade balance of the current account causing a current account deficit.

3) **A strong exchange rate** makes exports dearer and imports cheaper. Economic theory suggests that the demand for imports and therefore the expenditure on imports will rise whereas the demand for exports and therefore the revenue generated by exports will decrease. Both effects will worsen the trade balance of the current account causing a current account deficit.

Supply Side Causes of a Current Account Deficit (Opposite for a Surplus)

1) **Low labour productivity**. Low labour productivity means output per hour worked is low relative to competitor countries around the world. This increases unit labour costs, a major cost of production for firms who will reflect such costs in higher prices charged, reducing the price competitiveness of a country's exports. This will reduce the demand and thus revenue generated from exports, worsening the trade balance of the current account causing a current account deficit.

2) **High minimum wages**. High minimum wages relative to competitor countries, who either do not have minimum wages or whose minimum wage is much lower, will increase unit labour costs; a major cost of production for firms, who will reflect such costs in higher prices charged reducing the price competitiveness of a country's exports. This will reduce the demand and thus revenue generated from exports, worsening the trade balance of the current account causing a current account deficit.

3) **Poor Investment**. Poor investment implies that capital machinery is out-dated, depreciating, inefficient and costly to maintain. This means that costs of production are relatively higher than competitor countries whose capital machinery is more productive, with firms reflecting higher costs in higher prices charged reducing the price competitiveness of a country's exports. Once more, non-price competitiveness of exports will fall as the final quality of goods produced is likely to be lower. These two factors will reduce the demand and thus revenue generated from exports, worsening the trade balance of the current account causing a current account deficit.

4) **Higher Relative Inflation.** If a country has higher inflation rates relative to competitor countries, the price competitiveness of exports will be lower. This will reduce the demand and thus revenue generated from exports, worsening the trade balance of the current account causing a current account deficit.

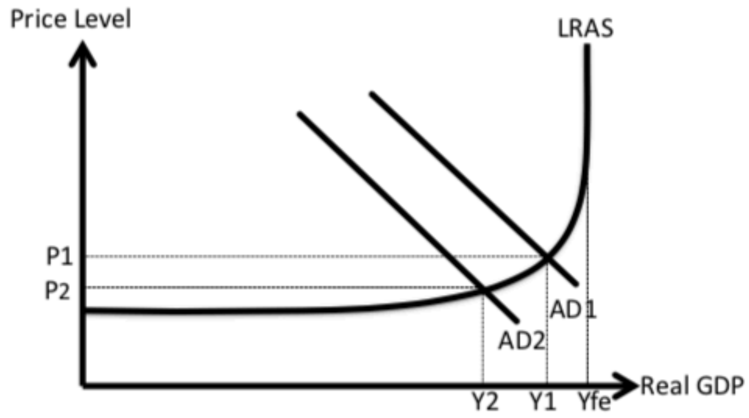
5) **Government restrictions on free trade.** If foreign governments increase or impose new trade barriers on domestic exports, such as tariffs, quotas and non-tariff barriers, it will be harder to access international markets. This will reduce the revenue generated by a country's exports worsening the trade balance of the current account causing a current account deficit.

6) **Loss of comparative advantage.** If one country loses their comparative advantage, perhaps due to skills improvements, lower wages or better access to raw materials in another country, industries will go into decline where large export revenues were previously being generated. Losing this export revenue will worsen the trade balance of the current account causing a current account deficit.

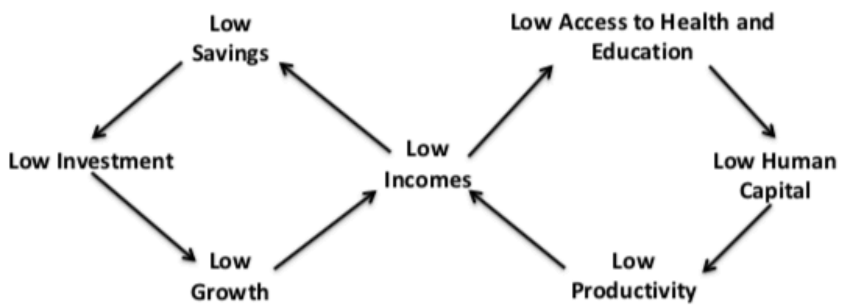
7) **Resource Depletion.** This is a strong argument in the case of developing countries in particular where extraction/mining laws and regulations do not exist or are not enforced. Self-interested, profit maximising firms will ignore the long term repercussions of their actions and continue to exploit natural resources eventually leading to depletion of the resource. Primary commodity export revenue is the major source of export revenue for these countries therefore depleting such resources will drastically reduce export revenue worsening the trade balance of the current account causing a current account deficit.

5.2 Consequences of a Current Account Deficit

1) A country with a current account deficit is very likely to have a trade deficit given that the trade balance accounts for a much greater share of the current account than the income balance. As a result, import expenditure on goods and services exceeds export revenue generated from goods and services which **reduces the value of (X-M) in the AD equation, causing AD to decrease from AD1 to AD2**:



Growth Poverty Cycle ***Development Poverty Cycle***



2) Microfinance can **alleviate poverty and create jobs for others**. This is because as profits and incomes rise for individual entrepreneurs, the need to hire more workers increases, a derived demand from the growth of their business. Therefore not only is income rising and poverty alleviated for the entrepreneur and their family but as jobs are given to others in the community, other family livelihoods improve and widespread poverty can be alleviated.

3) Microfinance provides a **means to finance** where official lenders may reject riskier small scale entrepreneurs allowing a road side stall for example to increase in size and use more capital machinery to boost productivity. Crucially however such loans are given **at low interest**, which can be paid back over a longer period of time. As a consequence, individuals can spend the money on capital (longer term investment) knowing that breathing space exists before a return needs to be made allowing for maximum profit and income growth without the pressure of having to pay back debts within a short space of time.

4) Microfinance schemes can **empower women**. This is because many small scale business ventures are fronted by women who need finance to grow and develop their business. Consequently by receiving these funds for business investment, women make profits and earn incomes becoming leaders in their community inspiring more women to do the same. Furthermore adding a second income into a family can rapidly improve the living standards of the whole family where improvements in schooling and health outcomes accelerate.

Microfinance and Development Cons/Evaluation

1) The presumption of microfinance schemes is that every business venture will be successful but this is certainly not the case. No matter how impressive the entrepreneur might be, **running a successful business is difficult and full of risk**. As a consequence if businesses do fail, individuals with very low incomes will have debts to repay which they cannot afford trapping themselves and their families in poverty.

Evaluation To overcome this issue, microfinance loans are usually issued with a **mentor or regular meetings with a specialist** to provide guidance and support to ensure that everything possible is done to make the business profitable enough where the loan can be paid back. Appropriate checks and talks are given to recipients to ensure the money is used appropriately for the growth of the business. Microfinance loans tend also to be given to groups of people rather than on an individual basis to again ensure correct use of the funds with a women to spearhead the business planning as women are deemed to be more likely to repay the debt.

2) There is a large risk that **microfinance institutions become profit motivated** rather than their motives being rooted in promoting development and alleviating poverty. Consequently, interest rates charged could become exorbitant and repayment time periods become shorter putting extra pressure on entrepreneurs to earn returns and repay loans, which may be unrealistic. As a consequence recipients who are not able to pay this money back quickly enough or at all face losing assets such as land and material possessions reducing their standards of living and causing absolute poverty.

3) There is a large temptation for individuals on low incomes who receive microfinance loans to **use the money to better the living standards of their family rather than invest in their business venture**. This is understandable especially if the family is living in extreme poverty where food, water and access to health may be limited but such expenditure will only improve short term living standards and worsen their long term position if the loan cannot be paid back. Having said this, the checks performed by better microfinance institutions can prevent this from happening and reduce the nature of this problem.

9.6 Trade and Development

Trade and Development Pros

1) Trade, growth and living standards. Trade allows developing countries to specialise in the extraction and production of primary commodities. Developing countries can exploit a comparative advantage in primary commodities, where they have an opportunity cost advantage, using the revenues generated from these sales to purchase capital imports. By specialising and exporting primary commodities like oil, gas, copper, cotton etc. net exports in these economies will increase thus increasing aggregate demand leading to economic growth. Consequently, GNI/capita will rise making basic life-sustaining goods and services more affordable, lifting people out of poverty. Simultaneously, job prospects in the economy will rise as this increase in demand will encourage domestic firms to increase their output, thus increasing their demand for labour, reducing unemployment and encouraging economic development.

2) Trade, growth and the fiscal dividend. Exporting and depending on the revenues from primary commodities can also produce a fiscal dividend for governments resulting from higher economic growth. An increase in net exports, allows incomes, output and expenditure in domestic economies to rise, increasing the receipts from income tax, corporation tax and expenditure taxes like VAT. Consequently, these revenues can be spent by the government to enhance health and education, improving literacy rates and life expectancy levels, two areas of development that Michael Todaro features as the most significant development factors. Crucially the government will also be able to spend on developing infrastructure like roads and bridges, bringing down transport costs for firms to operate efficiently with lower costs and higher productivity and allowing families to access schools and hospitals more easily, achieving sustainable development.