Balance of payment and what affect will a deficit have on the economy economics e...

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Balance of Payments is defined as “ a record of all the transactions that are made between the residents of one country with the residents of all other countries in the world over a given period of time”. The time period used to calculate the balance of payments of a country is usually one year; however some countries (those with seasonal, cyclical, or somewhat volatile economies) calculate their balance of payments on a monthly basis. The balance of payments account is divided into two main parts: the Current Account and the Capital Account. The Current Account measures the money flow, which is derived from the money gained and spent from the trade in goods and services and it is subdivided into three sections: balance of trade in goods, balance of trade in services and net income flows. The capital account measures all of the asset (property which is owned) related transactions (buying and selling) within a country. Examples of capital account include land, foreign currency, bank deposits, etc.

Even though the Balance of Payments account has to balance out overall, there may be imbalances in the components (either in the capital account or in the current account) that lead to surpluses or deficits. When there is a deficit in the current account there must be a surplus in the capital account to balance it out and vice versa. A balance of payments deficit is when the payments made by a country are greater than the payments received by the country. The opposite of a deficit is a surplus, where the payments received exceed the payments made by the country.

Most countries in the world have deficits in the current account. Moreover, most balance of payments problems arise in connection with a deficit in the current account, mainly because imports exceed exports over a long period

of time. A current account deficit is caused by the following factors: overvalued local currency, increasing economic growth, a decline in competitiveness, inflation, recession in other countries, and borrowing money. A current account deficit has to be balanced out by a surplus in the capital account. Most governments do this by using any available foreign currency reserves to increase the capital account. However, this solution is flawed in the long run as governments will eventually run out of these reserves. In the long run, there are quite a few problems that arise from a current account deficit. A current account deficit may be an indication of a wider structural economic problem; there may be inadequate investment in new capital, a change in comparative advantage towards other nations or a decline in competitiveness in markets abroad. A large trade deficit reflects an ‘ unbalanced economy’, which is usually the consequence of the consumer demand being at a high level contrasted with a weaker industrial sector. The government will need to address the imbalance in the economy. If consumers continue to spend beyond their means, the rise in the demand for imports will be accompanied by a large increase in household debt. Running a trade deficit also leads to an impending loss in the output and the employment. There is a net leakage in the circular flow of income and spending and workers whose jobs are lost as a result of the fall in net exports will find it difficult to find employment. Countries facing a current account deficit will not always be able to rely on inflows of financial capital to finance the deficit. Foreign investors may lose confidence and decide to withdraw their money out of the economy; they might also look towards increasing interest rates to persuade them to continue investing in the economy. Higher interest rates will cause a fall in the aggregate demand, and domestic

consumption and investment will fall. A large deficit in the balance of trade can also lead to a sharp fall in the value of the exchange rate; which in turn can push the central bank to raise interest rates. The rise in inflation and interest rates would result in a fall in demand, output and employment.

A current account can also run a surplus, which means that there will be a deficit in the capital account. A current account surplus can lead to a build up in the official currency reserves and the import of capital goods. However, the argument made against running a current account surplus is the " zero sum game", which basically means that if one party gains, another has to lose. Other countries may think that their current account deficits may have been caused by the country's current account surplus; it may cause problems in diplomacy and the other countries may seek to use protectionist revenge policies. A current account surplus also gives rise to an appreciation of the local currency, if the currency is floating. It will become more difficult to export, and imports will become cheaper; this may increase inflation inside the economy if it is dependent on imports for inputs or essentials, such as crude oil.

The government can either use Expenditure Switching Policies or Expenditure Reducing Policies to try and deal with persistent current account deficits.

Keynesian economists prefer expenditure switching policies. An expenditure switching policy is defined as " an economic policy that is designed to persuade consumers to buy fewer imported goods". These policies support " import substitution", where the government attempts to encourage domestic

production to replace the import of goods and services. The government can introduce protectionist measures such as tariffs, quotas, and embargoes in order to directly restrict imports. The government can also set up complex customs procedures, anti-dumping legislations and other administrative barriers to reduce the value of imports. By providing subsidies to local industries and encouraging and helping local industries to produce cheaper, better quality products, the government can reduce the reliance on foreign imports. The government can also decide to protect the ‘ infant industries’ until they are able to compete against the large foreign multinational companies by providing them assistance in the form of tax breaks, grants and subsidies. Depreciation of the currency can also help to improve the current account deficit. If the value of the currency falls, imports will become more expensive and the marginal propensity to import will fall. At the same time, exports will become cheaper to the foreigners, and as a result the country will be able to export more; thereby raising net exports, which in turn will have a positive impact on the balance of payments. However, a monetarist will argue that protectionist policies will reduce competition in the economy and it will make the economy less efficient. Monetarists prefer to use the expenditure reducing policies to solve the imbalance in the current account.

An expenditure reducing policy or an expenditure dampening policy is very different compared to an expenditure switching policy. These policies aim to reduce the aggregate demand in the economy and reduce the velocity of money in the circular flow of income. A monetarist would believe that a leftward shift in the aggregate demand would have an adverse effect on the

marginal propensity to import, thereby indirectly reducing the current account deficit. Keynesians disagree with this strategy, as they believe that reducing aggregate demand will only worsen the balance of payments condition, rather than improving it. Monetarists believe in using these policies to cut the public sector (privatization), and, if required, increase taxes, the rate of interest and reduce the money supply. The increase in interest rates will encourage foreign investors to take advantage of the higher interest rates and invest money in the economy; this will increase the capital account and can as a result offset the effects of the current account deficit. Even though Keynesians and Monetarist have different viewpoints on how to address the issue of current account deficits, they both agree that both the policies (expenditure switching and expenditure reducing) are painful, time consuming and can have adverse political effects.

As mentioned in the expenditure switching policies, devaluation of the currency will cause imports to be more expensive and exports to become cheaper and thereby improve the balance of payments condition. However, this will not always be the case. The Marshall Lerner Condition and the J-Curve (given below) can be used to explain the “ relationship between the exchange rate for a country’s currency and the country’s balance of trade”. It does not matter if a country is exporting more and importing less; what matters is whether or not the increase in income from exports exceeds the decrease in expenditures on imports. This is where the Marshall Lerner Condition comes into play. The Marshall Lerner Condition examines the PED (Price Elasticity of Demand) for imports and exports of a country and it states that “ If PEDx + PEDm > 1, then a depreciation or a devaluation of a nation’s

currency will shift the the balance on its current account towards surplus.” The J curve effect shows the effect of time on elasticity of imports and the elasticity of exports and in most cases as time passes by, goods tend to become more elastic because people have more time to adjust to the price change.

It is very important for economists to identify the reasons behind a balance of payments deficit and how it is being accounted for. A deficit can be looked at as either a sign that the country is enjoying economic welfare, or a sign that the country is on the road to experiencing economic problems. Governments should try and keep their balance of payments situation under control. Both Keynesians and Monetarists believe that governments should try to avoid getting into a huge balance of payments deficit in the first place by encouraging exports, promoting good diplomatic relations between countries, advertising national production and encouraging overseas trade missions between nations. The balance of payments account for Bangladesh is given below:

Bangladesh has been experiencing a trade deficit for several years, but slowly as the country is developing, the local industries are becoming more and more competitive and producing low-cost high quality products; the reliance on imports is slowly decreasing. If Bangladesh continues on its path of economic progress, it will eventually be able to improve its balance of payments condition.