The uks balance of payments analysis economics essay

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Introduction

Balance of payments refers to a statistical record of a country's transactions with the rest of the world over a certain period of time and presented in the form of double-entry bookkeeping. A single country's international transactions consist with three main balance of payments accounts, the current account; the capital account and the official reserve account.

The UK's balance of payments is a statistical statement designed to provide a systematic record of the economic transactions with other countries, described as a system of consolidated accounts in which the accounting entity is the UK economy and the entries refer to economic transactions between residents in the UK and residents of the rest world (The Pink Book, 2010).

This paper presents the analysis of UK's balance of payments for the 10 year period; a comprehensive interpretation includes an examination from the current account balance and capital or financial account balance. Predict the trends of balance of payments in the UK, investigate the economic factors which might account for the changes and link in the balances. Evaluate the current accounts balance over time with examples, and also find solutions for current account deficits.

Current account balance over time

The current account is the most common and easy to understand the balance of payments, which includes all imports and exports of goods and services, other net income from abroad and current transfers to and from abroad, the data of current account provides the main material for economic

analysis. If the debits exceed the credits, then a country is running a trade deficit, by contrast, credits exceed the debits, then it means trade surplus.

The current account is divided into four categories: merchandise trade, services, factor income and unilateral transfers (Machiraju, 2009). Trade balance is sensitive to exchanges rates; changes in exchange rate influence the relative prices and change resources or consumption expenditures between the production nd consumption of tradable and non-tradable.

What are the factors caused swings of current account balance? One prominent school believes that the swings result from economic policy misalignments (Obstfeld and Rogoff 2005). Other approaches argue that the swings are caused by events such as differentials in productivity growth (Backus, Henriksen, Lambert and Telmer 2005).

According to Selen and Sarisoy (2005), the swings in current account balances are correlated with real depreciations in all developed and developing countries and transitional, the effect on exchange rate shocks as a factor or cause even stronger in the developed countries. Exchange rate fluctuations are the one factor of swings in current account balance. When a country’s currency depreciates in exchange rate will effect on trading partners, this country’s exports would rise and become more competitive, the trading prices are cheaper for major partner importers, and by contrast, imports tend to fall, due to the high price, should be improve the trade balance. For instance, Mexico had experienced deficits in trade balance in 1994, over U. S. $4. 5 billion per quarter throughout the whole year, due to

the peso depreciation. One year later, Mexico started to improve the trade balance, about $7 billion surplus in 1995.

The trade balance may deteriorate after depreciation in short term, however it will tend to improve over time. J curve effect shows that depreciation could worsen current account in short period, inelastic may cause negative swings. Positive swing or negative swing depends on price elasticity.

Another important factor impact on current account balance swings is the concept of economic growth and consumer spending (Michael R. Pakko, 2000); consumers could help economic grow, because consumers will have higher spending on imports, also higher import prices. If consumers choose cheaper local substitutes instead foreign imports, it takes time for local producers to replace import products. UK GDP was fast growing during late 1980s, which increased in domestic residents' consumption and inflation rate; these factors caused the current account deficit. In 1992, the recession of economic improved the current account to surplus. Since financial crisis overwhelmed whole world in 2008, the recession was temporarily rise the deficit in the UK due to domestic residents reduced spending and have huge impact on current account balances.

UK current account deficits

The current account deficit represents a country has been spending and earnings. Analysis the trends are important for economists to understand the domestic economic behaviour, they can evaluate the causes of deficits and find possible solutions.

The UK have been suffering current account deficit since 1984. During the period 1980 to 1983, the current account was surplus. In 1989, deficit reached to £24. 2 billion equivalent to 4. 6 per cent of Gross Domestic Product. The current account deficit decrease to £0. 8 billion in year 1997. 2006 was the most difficult time for the UK, deficits sharply rise to £39. 1 billion, and it was the highest record. The current account deficit showed the improvement in 2008, which reduced to £14. 4 billion. 2 years later, the deficit was twice higher than 2008, due to financial crisis. However, the current account deficit declined in year 2011 and equal to 1. 9 per cent of Gross Domestic Product.

UK current account balance

Source: pinkbook, 2012. £billion

Current account balance as a percentage of GDP

The graph presents the current account as a percentage of GDP, from year 1991 to 2011. In 1991, the deficit was equlevant to 1. 7 per cent of GDP, the current account deficit declined to 0. 2 percent in year 1998, then dramaticlly fell to 2. 7 percent in the following year. After 2000, the rate was fluctuate and sharply recovered in year 2008. It was equal to 1. 9 percent in 2011.

Reasons for a current account deficit

Domestic consumers have high demanding on experditure, which will increase in imports and break the balance of current account. Exchange rates may overvalued and the price of domestic products become less

attractive than imports products, consumers would spend money on cheaper oversea goods instead domestic goods, exporters become uncompetitive.

If an economy focus on consumer spending rather than exports and with low savings rate will have high current account deficit or negative swings overtime, such as America.

During the economic ression, overseas demand has fallen, and domestic market remains robust.

Solutions of current account deficit

import controls

increase triffs on various oversea goods, foreign products prices will higher then local producers's products, then the demand on foreign imports could decline and consumers would change consuptions to domestic products. Rise triffs lead to reduce the current account deficit and also protect home businesses. Multinational companies could add taxes in their goods, and remain the same selling price, total profits will be less to keep products competitative. However, this is not long term solution, protectionism decrease the exports.

Deflation

If the UK governemnt raises interest rates and taxes, domestic residents will reduce the shopping on overseas goods. Deflationary policies can lead to producers cut the costs and increase exports. But this solution could decline the economic growth and increase the rate of unemployment, the government unlikely to take the high risk on unemployment.

Supply Side Policies

Supply side economics is the branch of economics that how to achieve the productive capacity in the economy. These policies which can improve the current account position, and take competitve advantage on exports. Supply side policies which help the government raise the productivity and shift Aggregate Supply to the right direction.

There are advantages to apply supply side plicies, it will help to make the economy efficent and reduce cost to push inflation. Supply side policies can lower the rate of unemployment. Improve the trade and balance of payments which can make manufacturers increase productivity and exports.