**RWS10: BALANCE OF PAYMENTS (BoP) CRISIS’ AND SOLUTIONS**

TASK: Read these articles below and answer the questions – should take 2 hours 45 minutes MAX

**SECTION 1: Balance of Payments Overview**

The BoP is a record of a country’s transactions with the rest of the world. It shows the receipts from trade. It consists of the current and financial account

**BoP Accounts (see details from RWS3)**

**(A) The Current Account**

1. Trade (in visibles and invisibles): Exports would mean domestic firms in the economy selling to foreign buyers (importers). Imports are when domestic firms/consumers/Governments buy from foreign sellers (exports).
2. Investment Income: Income from foreign investments returning to the foreign country and investments abroad sending money back to the economy.
3. Transfers: workers abroad sending wages home to the domestic economy or immigrants within the domestic economy sending money home to their foreign homes

**(B) The Financial Account** (note the Financial Account used to be called the Capital Account)

1. Foreign Direct Investment: foreign companies setting up in the economy or domestic business setting up in foreign countries (e.g. A UK firm buying a factory in Japan would be a debit item. The profit from this factory would be a credit but appear under the current account and ‘investment income’)
2. Portfolio Investment: buying shares and/or bonds
3. Hot Money Flow: moving money in and out of banks within the economy. These are mainly short term monetary flows such as “hot money flows” to take advantage of exchange rate changes

**(C) The Capital Account:** This is a very minor account on the BoP which involves:

1. The transfer of assets when migrants change nationalities: For example, assuming Roman Abramovich changed his residency from Russia to the UK, then, automatically his assets are transferred and is money flowing into the capital account for the UK since he is officially resident in the UK.
2. Government transfers such as debt forgiveness to LEDCs: For example, the UK forgiving debt for Uganda would be money flowing out of the capital account for the UK but money flowing into Uganda’s capital account. Equally the UK’s EU membership fees are a debit as they goto the EU Government.

**(D) Foreign Reserves of the Central Bank**

* In the context of BoP and international monetary systems, the reserve asset is the currency or other store of value that is primarily used by nations for their foreign reserves. BoP imbalances tend to manifest as hoards of the reserve asset being amassed by surplus countries, with deficit countries building debts denominated in the reserve asset or at least depleting their supply. Under a gold standard, the reserve asset for all members of the standard is gold. In the Bretton Woods system, either gold or the U.S. dollar could serve as the reserve asset, though its smooth operation depended on countries apart from the US choosing to keep most of their holdings in dollars. Following the ending of Bretton Woods, there has been no official reserve asset (Gold etc.), but the US dollar has remained by far the principal reserve holding currency due to the strength of the US economy (and military!).

**(E) Balancing Item**

In practice when the statistics are compiled there are likely to be errors therefore the balancing item allows for these statistical discrepancies.

**BoP equilibrium**

In a floating exchange rate, the two components of the BoP should balance each other out. If the UK has a deficit on the current account of £38bn. Then in a floating exchange rate, the financial account should have a surplus of £38bn. This is because financial outflows must be matched by financial inflows. This is because under a floating exchange rate, the supply of currency will always equal the demand for currency, and the BoP must be zero. Therefore if there is a deficit on the current account there will be a surplus on the financial / capital account. For example if there was an increase in interest rates this would cause hot money flows to enter into the UK, therefore there would be a surplus on the financial account. The appreciation in the exchange rate would make exports less competitive and imports more competitive therefore with less exports and more imports there would be a deficit on the current account.

**BoP Disequilibrium**

This never refers to the overall BoP but normally to an ‘account’ of the BoP which then causes imbalances on other accounts. For example, if the UK imports more goods and services than we export – then we have a deficit on the current account. A significant deficit on the current account is generally referred to as disequilibrium. It will be matched by a surplus on the financial account.

When a country has a fixed exchange rate, there is more likely to be a BoP problem. For example, in 2011, several Euro countries (Portugal, Italy, Ireland, Greece, Spain) were relatively uncompetitive and therefore imported more than they exported causing a current account deficit. However, because they are in the Euro, it is not possible to devalue against other European countries as would normally happen. Therefore, they are stuck with exports which are too expensive which leads to a permanent imbalance (deficit) on the current account. Therefore Portugal and Greece both have a serious BoP disequilibrium caused by a decline in competitiveness. They rely on a surplus on the financial account which does not consist of FDI but more borrowing from other countries to pay for the deficit.

**Global Imbalances on the BoP**

BoP disequilibrium over time cause global imbalances e.g. Large flow of capital from China to US as US money heads to China to pay for imports. Some argue this was a factor in credit crunch of 2008. Large flows of capital from China to US kept yields (interest rates) on securities and bonds (loans) artificially low, creating a bubble in certain risky assets (packages of debt in risky house mortgages!). The current account can also be seen as an imbalance between domestic savings and domestic investment. If domestic saving is lower than domestic investment, then we will see a current account deficit. The excess domestic investment will be financed by capital inflows from abroad. A current account deficit could be caused by factors such as.

* High rate of consumer spending on imports (during economic boom)
* Decline in international competitiveness making countries exports less competitive
* Overvalued exchange rates which makes exports relatively more expensive
* Factors affecting current account deficit
* Cyclical nature of current account

In the UK, a current account deficit often increases after a period of economic growth. Higher economic growth leads to higher consumer spending and therefore more spending on imports. In an economic downturn, spending on imports usually declines leading to a smaller current account deficit.

**Reasons to Worry about a Current Account Deficit: The Case of the USA.**

**1.** In the US the current account deficit is to a large extent caused by excess spending in the economy. It is partly caused by government borrowing which increases Aggregate Demand in the economy and hence growing demand for imports. A large current account deficit is often a sign of an unbalanced economy. It could be a sign of structural weakness and an uncompetitive manufacturing sector. This leads to lower growth of the export sector. This is not necessarily an issue for the US as it can devalue its currency. But it is particularly a problem for countries in the Euro – who cannot devalue to restore competitiveness. It caused very large current account deficits and was a factor behind the EU recession of 2008-13

**2.** There could be problems financing the deficit in the long term. A short term deficit is not a problem, but if you have a deficit of over 6% of GDP then it is a problem if you rely on FDI or portfolio investment). If you run a current account deficit, it means you need to run a surplus on the financial / capital account. This means foreigners have an increasing claim on your assets which could reducing long term income as profits return to the foreign country and do not stay in the US. This problem can be compounded because, for example in the USA, In the beginning, a current account deficit could be just a deficit on buying goods. However over time the current account deficit also increased by income from the foreign investments leaving the country. Therefore the longer the deficit goes on and is financed by inward investment (FDI), the higher the level of investment income debits will be compounding the problem. This means that in the future the economy will need to attract capital flows just to pay off the investment income as well as the deficit on goods and services.

**3.** Once the possibilities of inward investment and portfolio investment start to dry up (foreigners own a large degree of your firms and land), a current account deficit will be financed through borrowing from foreign countries, firms, banks etc. (showing as a surplus on the financial account or ‘hot money’). it is then said to be even more unsustainable because countries will be burdened with high interest payments. E.g Russia was unable to pay its foreign debt back in 1998. Other developing countries have experienced similar repayment problems Brazil, African countries (3rd World debt) Countries with large interest payments have little left over to spend on domestic investment. This point does depend on the country in question however. A developing economy may be more vulnerable to a current account deficit. This is because investors may be quicker to fear an economic downturn and remove their capital. A factor behind the Asian crisis of 1997 was that weaker economies had run up large current account deficits by attracting capital flows (hot money) to finance the deficit. But, when confidence fell, these hot money flows dried up, leading to a rapid devaluation and crisis of confidence. A significant part of the current account deficit in US is now actually financed by Chinese investors, buying US securities (essentially loaning US citizens money) at relatively low interest rates. Most countries would not be able to borrow such large amounts at low interest rates however the US currently can because the it is seen as the World’s reserve currency. However if attitudes to the US economy change and investors lose their confidence in the US economy, they will stop buying US debt. This will cause 2 problems.

* US interest rates will need to rise to attract enough people to buy the debt. These higher interest rates will reduce demand in the economy. Higher interest rates will particularly hurt American consumers who have large amounts of debt at the moment.
* If capital flows can’t be attracted then the dollar will continue to devalue further. This could cause inflationary pressures, interest rates may need to rise to stabilise the dollar.

Basically to correct the deficit would be a painful experience for the US economy and result in a slowdown or possibly recession.

**4.** Ultimately a large, permanent BoP imbalance may cause a loss of confidence by foreign investors. Therefore, there is always a risk, that investors will remove their investments causing a big fall in the value of your currency (devaluation). This can lead to decline in living standards (less imports) and lower confidence for investment. At an extreme level, the currency could become worthless (like in Zimbabwe in 2008) and imports dry up. Shortages of food etc. leads to civil and social unrest.

**SECTION 2: What is a BALANCE OF PAYMENTS Crisis?**

While the BoP has to balance overall, surpluses or deficits on its individual elements can lead to imbalances between countries. In general there is concern over deficits in the current account. Countries with deficits in their current accounts will build up increasing debt or see increased foreign ownership of their assets to pay for the money leaving the BoP to pay for imports etc.

A BoP crisis, also called a currency crisis, occurs when a nation is unable to pay for essential imports or service its debt repayments. Typically, this is accompanied by a rapid devaluation of the affected nation's currency. Crises are generally preceded by large capital inflows, which are associated at first with rapid economic growth. These inflows could include more permanent FDI or ‘hot money flows’ as investors place their money into the banks of the country or lend money to firms and consumers in the country.

However a point is reached where overseas investors become concerned about the level of debt their inbound capital is generating, and decide to pull out their funds. The resulting outbound capital flows are associated with a rapid drop in the value of the affected nation's currency. This causes issues for firms of the affected nation who have received the inbound investments and loans, as the revenue of those firms is typically mostly comes from their domestic currency but their debts are often denominated in a reserve currency (like the dollar).

Once the nation's government has exhausted its foreign reserves trying to support the value of the domestic currency, its policy options are very limited. It can raise its interest rates to try to prevent further declines in the value of its currency, but while this can help those with debts denominated in foreign currencies, it generally further depresses the local economy, depressing aggregate demand further. Ultimately a rapidly devaluing currency may means that imports will cease althogether as consumers and firms are unable to afford foreign goods as their currency becomes almost worthless. This can lead to large drops in living standards and can lead to food shortages and civil unrest.

**East Asian Financial Crisis 1997**

The Asian financial crisis is an example of a BoP crisis that gripped much of East Asia beginning in July 1997 and raised fears of a worldwide economic meltdown due to financial contagion. One of the worst hit countries was Thailand. From 1985 to 1996, Thailand's economy grew at an average of over 9% per year, the highest economic growth rate of any country at the time. Inflation was kept reasonably low within a range of 3.4–5.7% and the Thai Government pegged the national currency, ‘the baht’ at 25 to the U.S. dollar in a fixed exchange rate scheme. On 14 May and 15 May 1997, the Thai baht was hit by massive speculative attacks as speculators were betting on the Baht falling as they knew the Thai Government would struggle to maintain the fixed exchange rate peg. On 30 June 1997, the PM of Thailand said that he would not devalue the baht. However, Thailand lacked the foreign reserves to support the USD–Baht currency peg. There were only so many dollars the Thai central bank could sell to buy up Baht and prop up the currency. Therefore the Thai government was eventually forced to float the Baht, on 2 July 1997, allowing the value of the Baht to be set by the currency market. This caused a chain reaction of events, eventually culminating into a region-wide crisis. At the time, Thailand had acquired a burden of foreign debt that made the country effectively bankrupt even before the collapse of its currency. As the crisis spread, most of Southeast Asia and Japan saw slumping currencies, devalued stock markets and other asset prices.

Indonesia, South Korea, and Thailand were the countries most affected by the crisis. Hong Kong, Laos, Malaysia and the Philippines were also hurt by the slump. Brunei, China, Singapore, Taiwan, and Vietnam were less affected, although all suffered from a loss of demand and confidence throughout the region. Foreign debt-to-GDP ratios rose from 100% to 167% in the four large Association of Southeast Asian Nations (ASEAN) economies in 1993–96, then shot up beyond 180% during the worst of the crisis. In South Korea, the ratios rose from 13% to 21% and then as high as 40%, while the other northern newly industrialized countries fared much better.

Thailand's booming economy came to a halt amid massive layoffs in finance, real estate, and construction that resulted in huge numbers of workers returning to their villages in the countryside and 600,000 foreign workers being sent back to their home countries. The baht devalued swiftly and lost more than half of its value. The baht reached its lowest point of 56 units to the U.S. dollar in January 1998. The Thai stock market dropped 75%. Living standards were threatened as imports dried up and civil unrest hit the streets. On 11 August 1997, the IMF unveiled a rescue package for Thailand with more than $17 billion, subject to conditions such as passing laws relating to bankruptcy (reorganizing and restructuring) procedures and establishing strong regulation frameworks for banks and other financial institutions. The IMF approved on 20 August 1997, another bailout package of $2.9 billion.

By 2001, Thailand's economy had recovered. The increasing tax revenues allowed the country to balance its budget and repay its debts to the IMF in 2003, four years ahead of schedule. The Thai baht continued to appreciate to 29 Baht to the U.S. dollar in October 2010.

**History of Global Issues with Balance of Payments**

**Pre-1820: mercantilism**

Up until the early 19th century, international trade was generally very small in comparison with national output, and was often heavily regulated. Power was associated with wealth, and with low levels of growth, nations were best able to accumulate funds either by running trade surpluses or by forcefully confiscating the wealth of others through warfare. Rulers sometimes strove to have their countries outsell competitors and so build up a "war chest" of gold.

This era saw low levels of economic growth; average global per capita income is not considered to have significantly risen in the whole 800 years leading up to 1820, and is estimated to have increased on average by less than 0.1% per year between 1700 and 1820. With very low levels of financial integration between nations and with international trade generally making up a low proportion of individual nations' GDP, BOP crises were very rare.

**1820–1914: free trade**

Gold was the primary reserve asset during this gold standard era. After victory in the Napoleonic wars Great Britain began promoting free trade, unilaterally reducing her trade tariffs (protectionism). Hoarding of gold was no longer encouraged, and in fact Britain exported more capital as a percentage of her national income than any other creditor nation has since, investing in other countries such as India and parts of the African continent. A gold standard enjoyed wide international participation especially from 1870, further contributing to close economic integration between nations. The period saw substantial global growth, in particular for the volume of international trade which grew tenfold between 1820 and 1870 and then by about 4% annually from 1870 to 1914. BoP crises began to occur, though less frequently than was to be the case for the remainder of the 20th century. From 1880 to 1914, there were approximately 8 BoP crises.

**1914–1945: deglobalisation**

The favorable economic conditions that had prevailed up until 1914 were shattered by the first world war, and efforts to re-establish them in the 1920s were not successful. Several countries rejoined the gold standard around 1925 but during the Great Depression most countries abandoned the gold standard. Imbalances remained an issue and international trade declined sharply. There was a return to countries competitively devaluing their exchange rates. There were approximately 16 BoP crises in this time.

**1945–1971: Bretton Woods**

Following World War II, the Bretton Woods institutions (the International Monetary Fund and World Bank) were set up to support an international monetary system designed to encourage free trade while also offering states options to correct imbalances without having to deflate their economies. Fixed but flexible exchange rates were established, with the system anchored by the dollar which alone remained convertible into gold. The Bretton Woods system ushered in a period of high global growth, known as the Golden Age of Capitalism, however it came under pressure due to the inability or unwillingness of governments to maintain their currencies between their bands at the expense of deflating their economies.

Imbalances caused gold to flow out of the US and a loss of confidence in the United States ability to supply gold for all future claims by dollar holders resulted in escalating demands to convert dollars, ultimately causing the US to end the convertibility of the dollar into gold, thus ending the Bretton Woods system. The 1945–71 era saw approximately 24 BoP crises for advanced economies, with emerging economies seeing 16 BoP crises.

**1971–2009: Transition, Washington Consensus, Bretton Woods II**

In the immediate aftermath of the Bretton Woods collapse, countries generally tried to retain some control over their exchange rate by independently managing it, or by intervening in the foreign exchange market such as the European Exchange Rate Mechanism (ERM) in 1979. From the mid-1970s however, and especially in the 1980s and early 1990s, many other countries followed the US in liberalising controls on both their capital and current accounts, in adopting a somewhat relaxed attitude to their balance of payments and in allowing the value of their currency to float relatively freely with exchange rates determined mostly by the market. This was based on ‘The Washington Consensus’ which was a policy theory out of the USA that markets should be allowed to be free without much (if any interference) from Government. Hence the attraction of a floating exchange rate scheme where Governments would not interfere with their currencies.

Developing countries in Africa and Latin America who chose to allow the market to determine their exchange rates would often develop sizeable current account deficits, financed by capital account inflows such as loans and investments, though this often ended in crises when investors lost confidence. The frequency of crises was especially high for developing economies in this era – from 1973 to 1997 emerging economies suffered 57 BoP crises and 30 for advanced economies.

In 1998, the U.S. current account deficit began to rise sharply whilst East Asian countries who traditionally had run deficits were now running surplus’. This new form of imbalance began to develop in part due to the increasing practice of emerging economies, principally China, in pegging their currency against the dollar, rather than allowing the value to freely float. The resulting state of affairs has been referred to as Bretton Woods II. Usually, a rising trade surplus leads to a rising value of the currency. A rising currency would make exports more expensive, imports less so, and push the trade surplus back towards balance. China circumvents the process by intervening in exchange markets and keeping the value of the yuan depressed. The result is a more permanent imbalance between countries like China (who are running a surplus) and the USA (who are running a deficit). Chinese foreign exchange reserves of dollars have therefore shot up as the Chinese sell their currency to buy up dollars (and thus devalue the Chinese currency to keep Chinese exports competitive). The Chinese have taken some of these dollars and loaned them back to firms and consumers in the USA so that they can then buy more Chinese products!

**2009 and later: post Washington Consensus**

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| Speaking after the 2009 G-20 London summit after the financial crisis of 2007 and 08, Gordon Brown announced "the Washington Consensus is over". There is now broad agreement that large imbalances between different countries do matter  In 2007, when the crises began, the global total of yearly BoP imbalances was $1680 billion. On the credit side, the biggest current account surplus was China with approx. $362 billion, followed by Japan at $213 billion and Germany at £185 billion, with oil producing countries such as Saudi Arabia also having large surpluses. On the debit side, the US had the biggest current account deficit at over $1100 billion, with the UK, Spain and Australia together accounting for close to a further $300 billion. |  |

China has been requested to allow the renminbi to appreciate but refused, the position expressed by her premier Wen Jiabao being that by keeping the value of the renmimbi stable against the dollar China has been helping the global recovery, and that calls to let her currency rise in value have been motivated by a desire to hold back China's development. Although the Chinese allowed their currency to appreciate a little until 2017, it has arguably allowed the likes of Donald Trump into power as he blames the Chinese for ‘taking American jobs’. Given these more permanent global imbalances, to some extent he might have a point.

**Current account imbalances today**

The Washington Consensus period (see history section above) saw a swing of opinion towards the view that there is no need to worry about imbalances. Opinion swung back in the opposite direction in the wake of financial crisis of 2007–2009. Mainstream opinion expressed by the leading financial press and economists, international bodies like the IMF – as well as leaders of surplus and deficit countries – has returned to the view that large current account imbalances do matter.

**QUESTIONS TO ANSWER from SECTIONS 1 and 2**

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| Due to the accounting nature of the BoP, it must always equal zero and be in ‘equilibrium’.  Therefore what does a BoP Deficit or Disequilibrium mean? |  |
| How might a BoP deficit or disequilibrium be financed and therefore persist for a long time? |  |
| How might exchange rates prevent a long run BoP deficit from occurring? |  |
| Why might certain “Eurozone countries” (Italy, Portugal, Spain, Ireland) running current account deficits face painful adjustments? |  |
| In these Eurozone countries, how would their economy adjust to restore their BoP equilibrium? |  |
| Why might developing countries be particularly vulnerable to a persistent BoP deficit? What is the worst that could happen?  Use examples from above to explain |  |

**Section 3: Is the UK at Risk of a Balance of Payments Crisis?**

**UK Current Account Deficit Falls to Lowest Level in Years as UK Exports Rise**

Saturday, 01 April 2017 11:43 Written by Gary Howes from the PoundSterling website

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| The UK's current account deficit - that millstone that hangs around the Pound’s neck - fell sharply in the final quarter of 2016 it has been revealed.  The news will take economists by surprise as it suggests the UK’s overall trade position with the rest of the world has improved markedly and it would appear the devaluation of the Pound following the EU referendum in June has played no small part.  The latest Balance of Payments data from the ONS, released at 09:30 on Friday, March 31, show that the UK’s current account deficit was £12.1 billion in Quarter 4. This represents a narrowing of £13.6 billion from a revised deficit of £25.7 billion in Quarter 3 2016.  Foreign exchange analysts have long pointed to the current account deficit as being the reason why Sterling must fall as the UK relies on foreign investor inflows to balance out the deficit created by the country’s reliance on imports. |  |

**Trade Deficit Narrows**

The ONS reports the total trade deficit narrowed to £4.8 billion in Quarter 4 2016, following a sharp widening of the deficit in Quarter 3 2016 (£14.8 billion). This narrowing was predominantly due to an increase in the exports of goods of £7.6 billion possiblys suggesting that the fall in value of Sterling has allowed exporters to ramp up business.

A cheaper Pound makes UK goods cheaper on the global market place and there were concerns that the impact was not actually being reflected in export books.

**EXERCISE: The UK’s Current Account Deficit – should we be worried about our own BoP imbalances?**

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| Read the following articles:   1. Telegraph (2016) - <http://www.telegraph.co.uk/business/2016/03/21/why-the-uks-current-account-deficit-has-economists-spooked/> 2. Telegraph (2016) - <http://www.telegraph.co.uk/business/2016/04/01/dont-be-fooled-by-uk-deficit--the-good-outweighs-the-gloom/> 3. Guardian (2015) - <https://www.theguardian.com/business/economics-blog/2015/jun/30/uk-current-account-deficit-the-forgotten-deficit> 4. Guardian (2016) - <https://www.theguardian.com/business/2016/jun/30/uk-current-account-deficit-deepens-brexit-fears> |  |
| Arguments why we should be worried (max of 3 bullet points) | Arguments as to why we shouldn’t be worried (max of 3 bullet points) |
| CONCLUSION | |