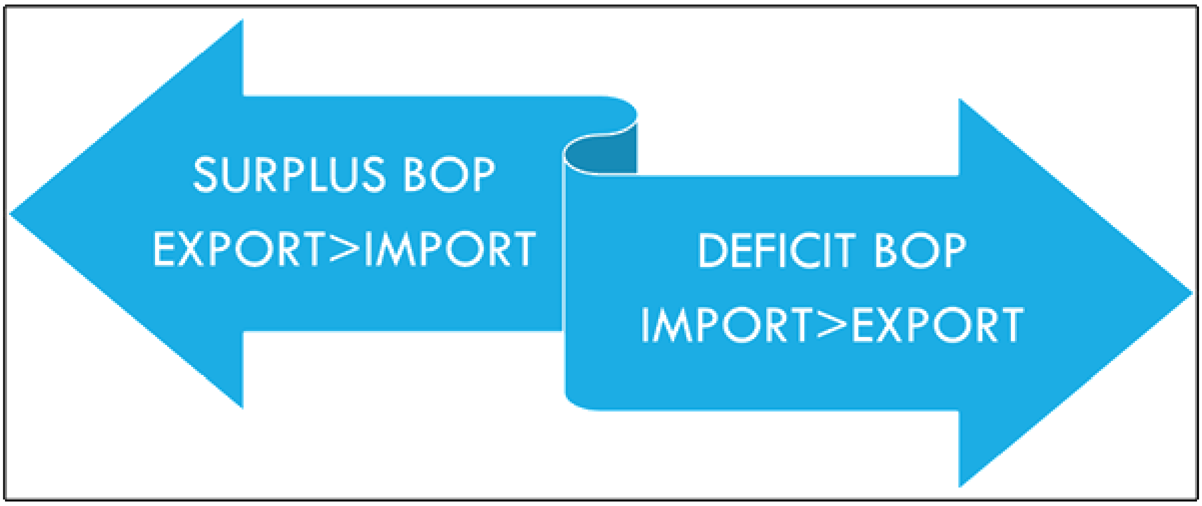
Balance of Payments: Deficits and Surplus, Current Account Deficit

Balance of Payment (Surplus/Deficit)

- Deficit or surplus can be there in Balance of payments. Exports and Imports determine it. Bop tells us whether the country has enough money finance its imports.
- **Surplus Bop**: Country exports more than it imports. So, country have sufficient outstanding reserves which can be used to finance domestically and lend internationally.
- Saving increases, domestic production increases, employment increase.
- **Deficit Bop**: the country imports more goods, services, and capital than they export. So, the government borrows to balance the deficit. i.e.. , to meet the cost of imports.
- So, the Country becomes prone to external shocks and becomes net consumer.
- Trade is said to be balanced if Bop is neither in surplus nor in deficit.



Current Account Deficit

- It measures the flow of goods, services, and investments into and out of the country. It represents a country's foreign transactions.
- Deficit can occur if the value of the goods and services imported exceeds the value of those exported.
- Current Account = Trade gap + Net current transfers + Net income abroad
- Higher CAD implies that economy is uncompetitive and so investment is very less. This leads to low output/employment.
- CAD can be reduced by boosting exports, stimulating manufacturing growth, linking global supply chain, and curbing non-essential imports.
- **Trade deficit**: When trade imbalance is there. If imports are more than exports than there is deficit.
- **Current Account Deficit**: It is wider than Trade deficit and includes transfer payments as well. It is broader component.

Financing of Deficits

- Market Borrowing both domestically and Foreign: Borrowing more from Central banks & other lending institutions, Treasury bonds, Foreign loans etc.
- Investments in domestic economy by investors through FII, FDI etc.

The Longer-Term Impact of CAD (Current Account Deficit)

- Higher borrowing and unsustainable loans leading to higher interest payments.
- If deficit is financed through FII (Foreign Institutional Investment) then markets become volatile as it can be withdrawn quickly. Also known as Hot Money.
- If deficit is financed through domestic borrowing, then less capital is available for domestic manufacturers.

Practice Question

Q. 1. If the Balance of Payment of a country is adverse, then which institution will help that country?

(A) World Bank

(B) World Trade Organization

(C) International Monetary Fund

(D) Asian Development Bank

Ans: (C)

Q. 2. How might a government attempt to reduce a medium-term balance of payments deficit?

(A) By reducing foreign exchange holdings

(B) By restructuring the macro economy

(C) By seeking a loan from the IMF

(D) By allowing overseas business to takeover certain sectors of the economy

Ans: (C)

Q. 3. Which of the following would be an appropriate policy to reduce a balance of payments deficit?

(A) An increase in government spending

(B) A cut in the level of indirect taxes

(C) An increase in interest rates

(D) A decrease in Interest rates.

Ans: (C)

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