

Chapter 26 The balance of payments

Answers to Knowledge checks

26.1 The overall balance of payments must always be zero, because the size of outflows must always equal the size of inflows. The 'net errors and omissions' item adjusts for inaccuracies in the actual recording of transactions.

26.2 This would be a credit item, as the sale is part of exports.

26.3 Data on the items that make up the balance of payments accounts are published in nominal terms only. By expressing the items as a percentage of GDP we get a clearer picture of the changes over time, as this is a way of abstracting from variations in prices over time.

26.4 The income from portfolio investment is an item on the current account. The purchase of equities (which would involve a change in ownership of assets) would be an item on the financial account.

26.5 The most obvious contributor to the smaller current account deficit in 2011 was primary income.

26.6 Foreign direct investment in the UK would be an item on the financial account in the present, but the income outflows in the future would be a debit on the current account.

Answers to Exercises and Case studies

Exercise 26.1

Table A26.1 The UK balance of payments, 2015 (£ billion at current prices)

Current account			
	Trade in goods	–118.6	
	Trade in services	+86.3	
	Investment income	–42.8	
	Compensation of employees	–0.1	
	Current transfers	–22.8	
		Current account balance	–98.0
Capital account			
	Capital transfers	–2.0	
		Capital account balance	–2.0
Financial account			
	Net direct investment	+76.1	
	Transactions in reserve assets	–21.1	
	Total net portfolio investment	+139.0	
	Other transactions	–103.1	

	in financial assets		
		Financial account balance	+90.9
Errors and omissions			+9.2
Overall balance of payments			0

Note: The overall balance of payments actually sums to 0.1, because of a rounding error.

Case study 26.1

The UK balance of trade

- a** The significance of having the trade balance measured in current prices is that the data do not take into account the effect of changing prices. As prices have risen during this period, the data shown in the graph overstate the extent to which the deficit has increased, as part of the increase is due to the higher prices.
- b** The changing economic structure is important. As manufacturing activity has declined and service sector activity has increased, it is natural that the trade in goods should have declined, whereas services have offset this effect.
- c** It is important to remember that the trade in goods is just one component in the overall balance of payments, albeit an important one. Of more concern to the authorities is the overall picture. You can get some feel for this by looking back at Figure 26.2 (*see* page 360 of the book), which shows how the overall deficit on the current account is balanced by the surplus on the financial account.

Answers to end-of-chapter questions

A Multiple-choice questions

- 1** c. Transfers of ownership of fixed assets
- 2** c. The balance of payments monitors transactions between the UK and the rest of the world
- 3** b. An export

B Knowledge and understanding questions

- 4** Primary income represents earnings accruing to domestic citizens on past investment abroad (less income earned by overseas residents who own assets in the UK).

A full explanation of primary income	2 marks
A vague or partial explanation of primary income	1 mark

- 5** Reasons may include:
 - To avoid leakages from the circular flow
 - To allow economic growth
 - To increase *AD* (or to reduce the effects of *AD* decreasing for another reason)
 - To monitor international competitiveness

Two reasons explained	4 marks
One reason explained AND one reason identified	3 marks
One reason explained OR two reasons identified	2 marks
One reason identified	1 mark

- 6** Causes may include:
 - Too high spending on imports
 - Inflationary

pressure, pushing up export prices and making them uncompetitive

- Domestic production is uncompetitive on the international market
- Poor domestic quality
- Lack of domestic production facilities
- Lack of domestic natural resources
- Rapid economic growth

Two causes explained	4 marks
One cause explained AND one cause identified	3 marks
One cause explained OR two causes identified	2 marks
One cause identified	1 mark

C Stimulus response question

- 7 a** The value of imports of visible products into a country exceeds the value of exports of visible goods out of a country.

A full explanation of a deficit in trade in goods	2 marks
A vague or partial explanation of a deficit in trade in goods	1 mark

b

AO1 Knowledge	1 mark
AO2 Application	1 mark
AO3 Analysis	5 marks
AO4 Evaluation	5 marks

Knowledge (1 mark) is likely to include:

- UK balance of payments

Application (1 mark) is likely to include:

- Application to the UK balance of payments position

Analysis (5 marks) is likely to include:

Analysis of possible consequences of a deficit in trade in goods/balance of payments overall, for example:

- Reduced *AD*
- Lower GDP
- Reduced pressure on the price level

Analysis of possible consequences of a surplus in trade in goods, for example:

- Increased *AD*
- Economic growth
- Increased pressure on price level

Evaluation (5 marks) is likely to include:

Evaluation that the consequences may not occur, for example:

- Depends upon the level of imports/exports
- Depends upon the size of the deficit/surplus

- Depends upon the state of the rest of the economy
- Depends upon the timescale
- Depends upon other factors influencing the economy

A judgement of the possible consequences of the UK balance of payments position