

MACROECONOMICS - Current account of balance of payments

By Kru P'Da and Kru P'Eve Knockout.Economics

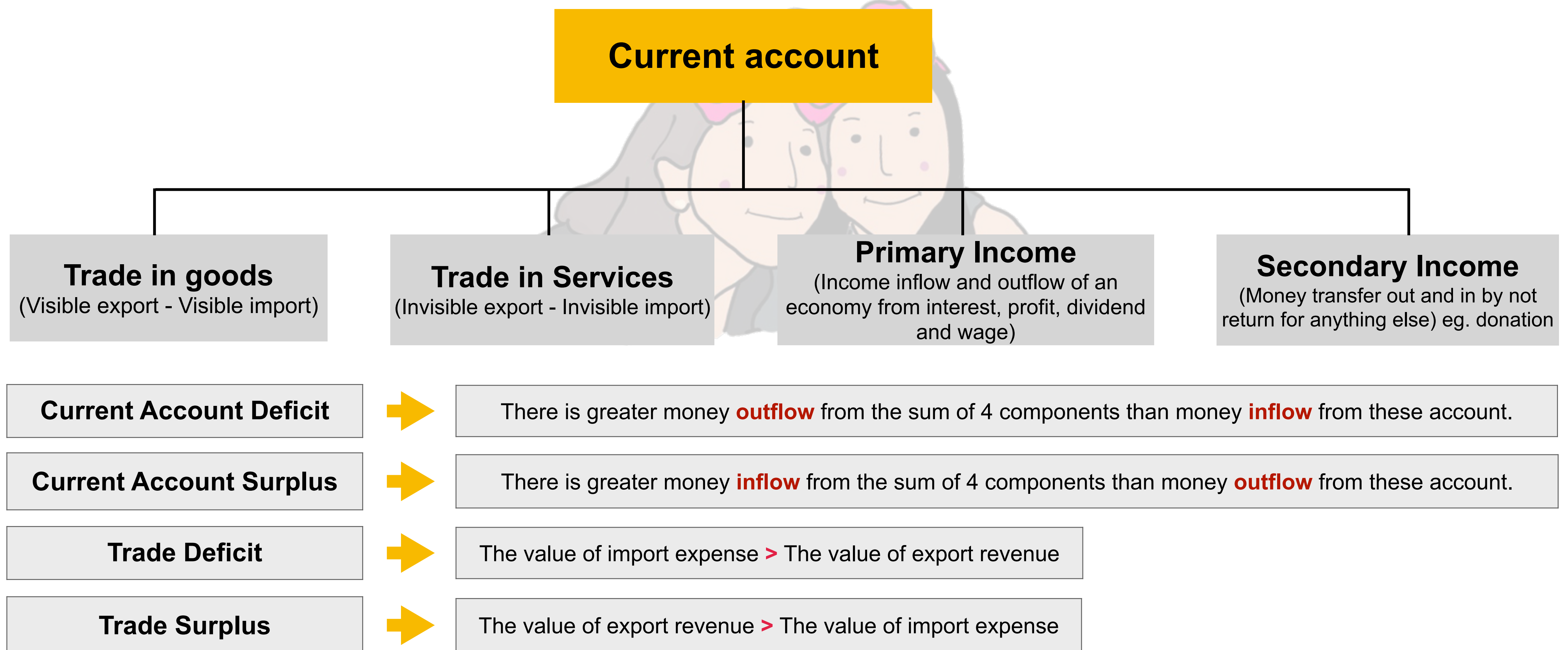
Overviews

1. Structure of the current account
2. Factors influencing exports and imports
3. The causes of current account deficit
4. The consequences of current account deficit
5. The causes of current account surplus
6. The consequences of current account surplus
7. Policies to achieve balance of payment stability



1. Structure of the current account

Current account : shows income received by the country and the expenditure made by it in its dealing with other countries.



2. Factors influencing exports and imports

1. Country's inflation	Higher inflation => Exports become more expensive => <i>Exports</i> ↓ => Imports become cheaper than domestic goods => <i>Imports</i> ↑
2. Country's exchange rate	Currency depreciation => Exports become cheaper in foreigners' views => <i>Exports</i> ↑ => Imports become more expensive than domestic goods => <i>Imports</i> ↓
3. Productivity	Higher productivity => Cost and price of exports falls => <i>Demand for exports</i> ↑
4. Quality	Higher quality of export => <i>Demand for exports</i> ↑ => <i>Export revenue</i> ↑
5. Foreign GDP	Foreigners' income increases => <i>Demand for exports</i> ↑ => <i>Export revenue</i> ↑
6. Domestic GDP	An increase in domestic income => <i>Demand for imports</i> ↑ => <i>Import expense</i> ↑
7. Trade restriction	An increase tariff => <i>Price of imports</i> ↑ => <i>Demand for imports</i> ↓ => <i>Imports</i> ↓

3. The causes of current account deficit

Current account deficit : There is greater money **outflow** from the sum of the 4 components than money **inflow** from these accounts. Current account combines **trade in goods and services, primary income and secondary income account**.

Causes of current account deficit

1. Appreciated currency	<ul style="list-style-type: none"> ➔ Imports become cheaper in domestic's view => Demand for imports ↑ ➔ Exports become more expensive in foreigners' view => Demand for exports ↓ ➔ <i>Import expense</i> ↑ , <i>Export revenue</i> ↓ => <i>Trade balance deficit</i>
2. Low quality of domestic product	<ul style="list-style-type: none"> ➔ People want to buy imported products ➔ Demand for imports ↑ ➔ <i>Trade balance deficit</i>
3. Low income abroad	<ul style="list-style-type: none"> ➔ Foreigners have low ability to spend on imports ➔ Country's export revenue ↓ ➔ <i>Trade balance deficit</i>
4. High cost of production	<ul style="list-style-type: none"> ➔ Exports become less price competitive ➔ Demand for exports ↓ ➔ <i>Trade balance deficit</i>
5. Low investment income earned abroad	<ul style="list-style-type: none"> ➔ Money inflow into a country in primary income account ↓ ➔ <i>Primary income account worsen</i>
6. Money transfer out of a country from workers' remittances	<ul style="list-style-type: none"> ➔ Money outflow from a country in secondary income account ➔ <i>Secondary income account worsen</i>

4. The consequences of current account deficit

- KNOCKOUT 1**
1. Economic growth
 2. Low unemployment
 3. Price stability
 4. Balance of payment stability
 5. Redistribution of income
 6. Reducing pollution & resource waste

Advantages of current account deficit

1. It reduces inflation and price level.

=> Lower net export => AD ↓ => Demand-pull inflation ↓
=> Lower price level => Standard of living improved

2. It reduces pollution.

=> Lower net export => Lower domestic production for exports => Lower pollution created

3. Trade deficit can be balanced for the country with floating exchange rate.

Trade deficit: Imports > Exports
Exports decrease => Demand for currency ↓
Imports increase => Supply of the currency ↑

Currency depreciation

↓
Trade Balance

Disadvantages of current account deficit

1. It can slow down economic growth.

=> Export revenue ↓ => National income and output ↓

2. Current account deficit might cause balance of payment deficit

=> Money outflow from a country
=> National reserve ↓, higher national debt

3. It can increase unemployment.

=> Export revenue ↓ => Domestic production ↓
=> Employment ↓

4. Government gains lower tax revenue and has high expenditure on unemployed benefit.

=> It reduces opportunity to develop country.

5. The causes of current account surplus

Current account surplus : There is greater money **inflow** from the sum of the 4 components than money **outflow** from these accounts. Current account combines **trade in goods and services, primary income and secondary income account**.

Causes of current account surplus

1. Depreciated currency	<ul style="list-style-type: none"> ➔ Imports become more expensive in domestic's view => Demand for imports ↓ ➔ Exports become cheaper in foreigners' view => Demand for exports ↑ ➔ <i>Import expense ↓, Export revenue ↑ => Trade balance surplus</i>
2. High quality of domestic product	<ul style="list-style-type: none"> ➔ People do not want to buy imported products => Demand for imports ↓ ➔ Demand for exports ↑ due to high quality of exports ➔ <i>Trade balance surplus</i>
3. High income abroad	<ul style="list-style-type: none"> ➔ Foreigners have high ability to spend on imports ➔ Country's export revenue ↑ ➔ <i>Trade balance surplus</i>
4. Low cost of production	<ul style="list-style-type: none"> ➔ Exports become more price competitive ➔ Demand for exports ↑ ➔ <i>Trade balance surplus</i>
5. High investment income earned from abroad	<ul style="list-style-type: none"> ➔ Money inflow into a country in primary income account ↑ ➔ <i>Primary income account improved</i>
6. Money transfer into a country from workers' remittances	<ul style="list-style-type: none"> ➔ Money inflow from a country in secondary income account ➔ <i>Secondary income account improved</i>

6. The consequences of current account surplus

- KNOCKOUT 1**
1. Economic growth
 2. Low unemployment
 3. Price stability
 4. Balance of payment stability
 5. Redistribution of income
 6. Reducing pollution & resource waste

Advantages of current account surplus

1. It can increase economic growth.

=> Export revenue \uparrow => National income and output \uparrow

2. Current account surplus might cause balance of payment surplus.

=> Money inflow into a country

=> National reserve \uparrow , National debt falls

3. It can increase employment.

=> Domestic production \uparrow due to higher exports

=> Employment \uparrow

4. Government gains high tax revenue and has low expenditure on unemployed benefit.

=> It increases opportunity to develop country.

Disadvantages of current account surplus

1. It increases inflation and price level.

=> Higher net export => AD \uparrow => Demand-pull inflation \uparrow

=> Higher price level => Standard of living worsen

2. It increases pollution.

=> Higher net export => Higher domestic production for exports => Higher pollution created

3. Trade surplus can be balanced for the country with floating exchange rate.

Trade surplus : Exports > Imports
Exports increase => Demand for currency \uparrow
Imports decrease => Supply of the currency \downarrow

Currency appreciation

\downarrow
Trade Balance

7. Policies to achieve balance of payment stability

To reduce current account deficit

1. Tariff

: Tax on imports => Price on import \uparrow => Demand for import \downarrow
=> Import expense \downarrow => Trade balance & current account improved

2. Quota

: limit amount of imports => import expense \downarrow
=> Trade balance & current account improved

3. Subsidy

: Subsidy on domestic producers => lower price of domestic products => Demand for import \downarrow

4. Currency devaluation

Price of export \downarrow => Demand for export \uparrow => Export revenue \uparrow

Price of import \uparrow => Demand for import \downarrow => Import expense \downarrow

Net export and current account improved

5. Increasing income tax + Increasing interest Rate

=> High income tax decreases disposable income => Imports \downarrow
=> High interest rate encourages saving => Spending on imports \downarrow

6. Supply-side policy

=> Education and training => Improving skills and productivity
=> Export revenue \uparrow from better quality and lower price of exports

To reduce current account surplus

1. Currency revaluation

Price of export \uparrow => Demand for export \downarrow => Export revenue \downarrow

Price of import \downarrow => Demand for import \uparrow => Import expense \uparrow

Net export worsen, Decreasing current account surplus

2. Expansionary Fiscal and monetary policy

Reducing income tax:

=> It increases disposable income and spending

=> Imports expense \uparrow

=> Current account surplus \downarrow

Decreasing interest rate:

=> People want to spend rather than save.

=> Spending on imports \uparrow

=> Current account surplus \downarrow

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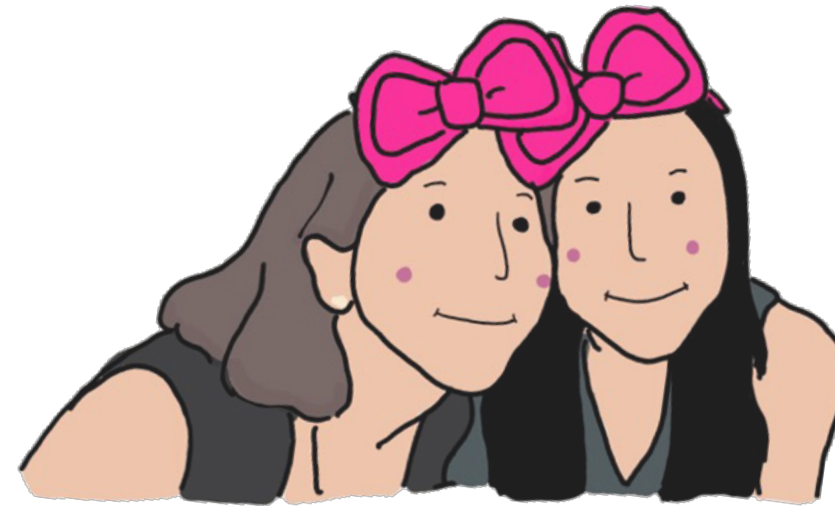
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MACROECONOMICS -

Exercise : Current account of balance of payments

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Exercise: MCQ

1.) A government decided to give \$10 million to a developing country to help supply medicine aid. In which part of the current account of the balance of payment was this payment recorded?

- A. Trade in goods
- B. Trade in services
- C. Income flows or primary income account
- D. Current transfer flows or secondary income account*



Exercise: MCQ

2.) Which policy would a government take to reduce current account deficit ?

A. Increase value added tax

B. Increase quota

C. Increase income tax*

D. Reduce tariff



Exercise: MCQ

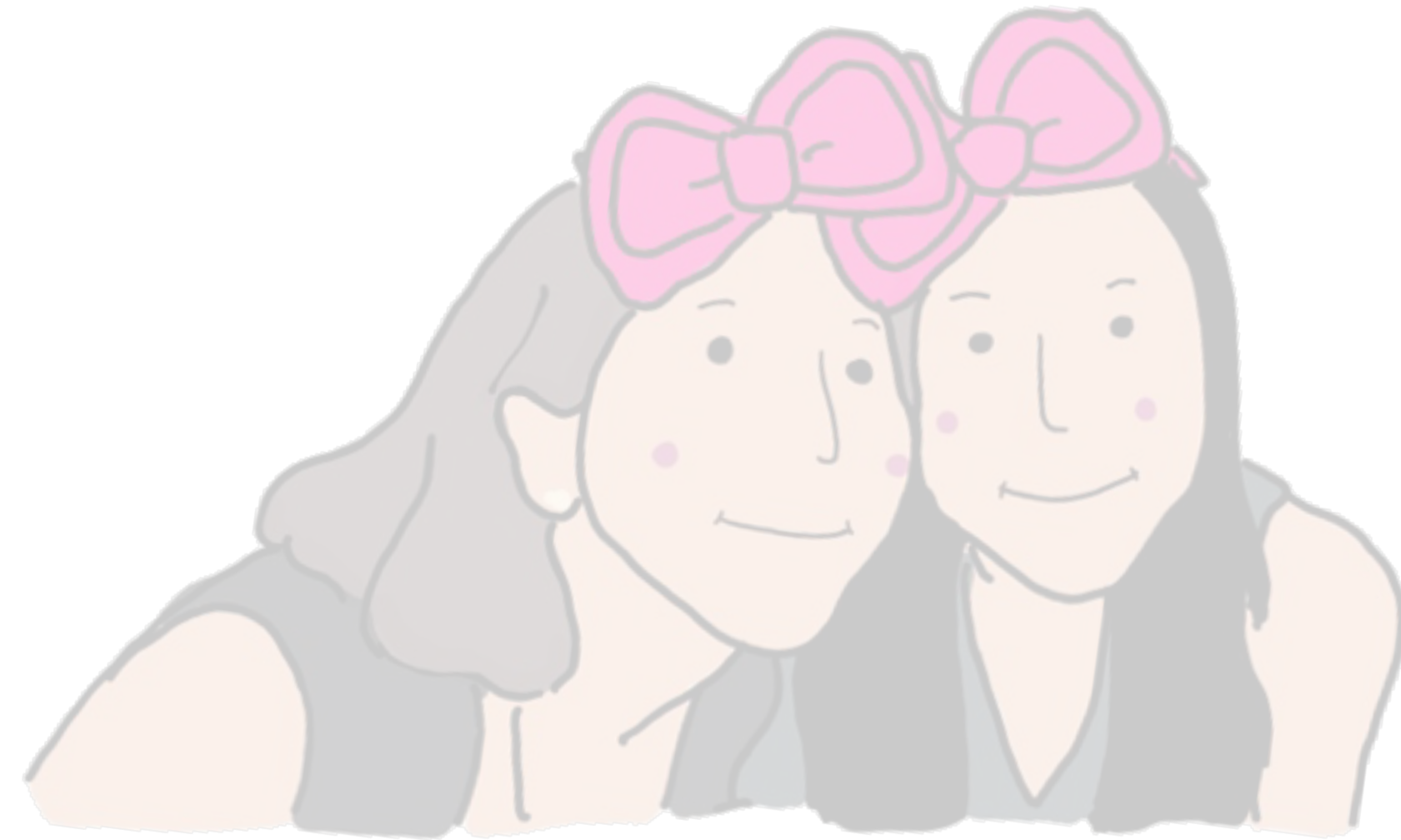
3.) What might cause the current account of Thailand to improve ?

- A. An increase in purchase of imported banana from Vietnam
- B. An increase in spending by Thai tourists on holidays in the UK
- C. A decrease in demand for Thailand exported rice
- D. An increase in spending by tourists in hotels in Thailand*



Exercise: Essay

1. Explain why a large current account deficit on the balance of payments is regarded as a serious problem. [4]



Exercise: Essay

1. Explain why a large current account deficit on the balance of payments is regarded as a serious problem. [4]

- **It can slow down economic growth.**

- => Export revenue ↓

- => National income and output ↓

- **Current account deficit might cause balance of payment deficit**

- **It can increase unemployment.**

- => Export revenue ↓

- => Domestic production ↓

- => Employment ↓

- **Government gains lower tax revenue and has high expenditure on unemployed benefit.**

- => It reduces opportunity to develop country

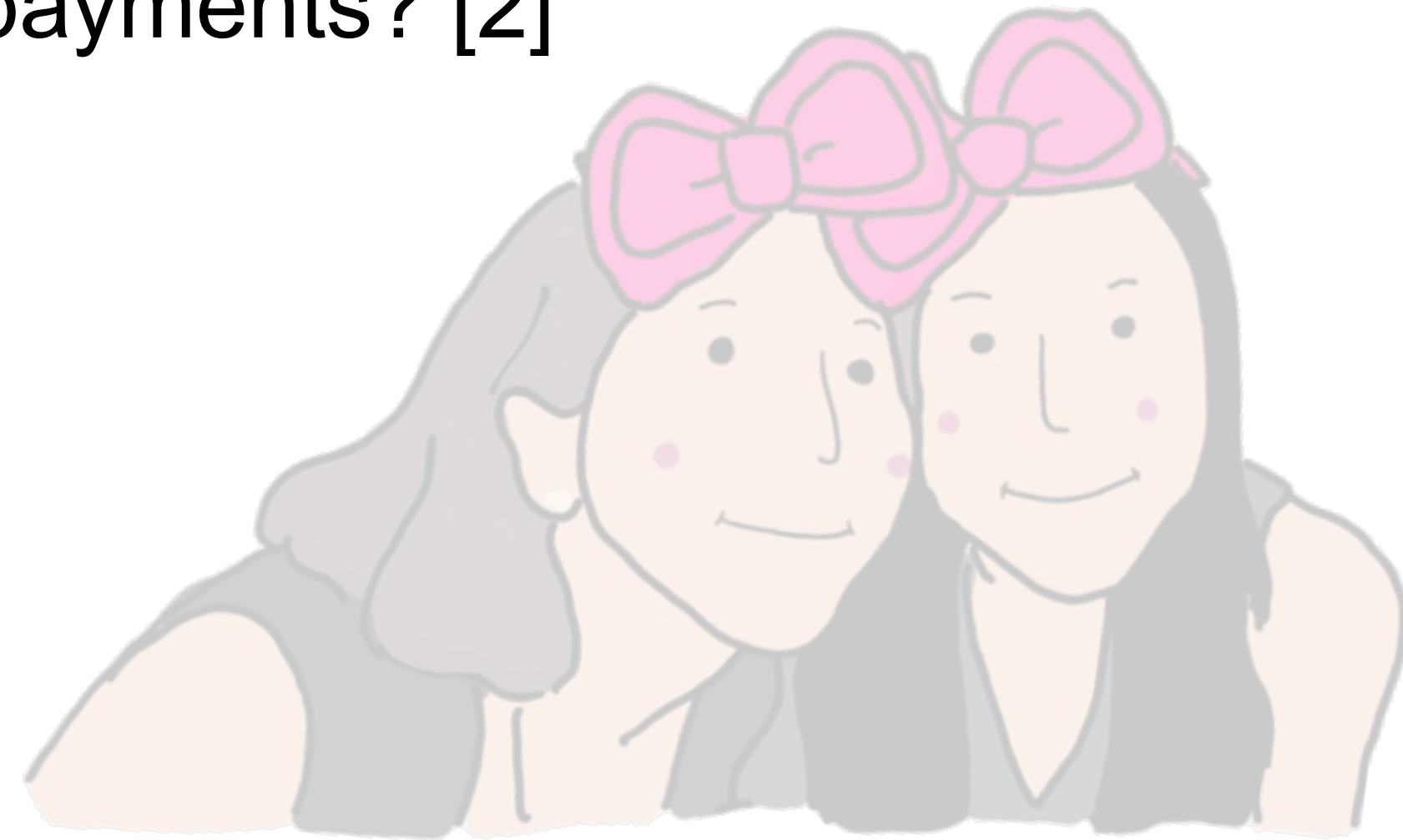
- **Poverty may increase**

- => Poor people working in export sector might loss job and income



Exercise: Essay

2. How are incomes received by a country from foreign tourism recorded in the current account of its balance of payments? [2]



Exercise: Essay

2. How are incomes received by a country from foreign tourism recorded in the current account of its balance of payments? [2]

➔ Money inflow in trade in service



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