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WHEN IS THE BALANCE OF PAYMENTS A PROBLEM?
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Q: When is the balance of payments a problem?
A: I think you should first ask me 'What is the balance of payments?

Q: I know what it is.
A: Then tell me.

Q: It's the difference between exports and imports.
A: No. That's the balance of trade.

Q: Then it's that, plus invisible earnings.
A: No. That's the balance on current account.

Q: OK, then maybe you should you tell me.
A: The balance of payments is the balance of *international* payments ...

Q: ... which can show either a surplus or a deficit.
A: No! It can only show that payments balance; in other words, all the positive entries in the accounts are off-set by all the negative entries.

Q: I thought this was going to be simple.
A: It might be *simpler,* if you would stop trying to anticipate me.

Q: Sorry.
A: Suppose that you kept a balance of payments account which recorded the details of your personal transactions.

Q: OK
A: If you buy a loaf for £1-20, you gain a loaf valued at £1-20 and you part with £1-20 in coins.

Q: Obviously.
A: Your accounts show £1-20 of imports (current account deficit) and a £1-20 reduction in your holdings of currency (capital account surplus)...

Q: ... which cancel out.

A: And the baker’s accounts would show £1-20 of exports (current account surplus) and a £1-20 increase in holdings of currency (capital account deficit). The exact opposite.

Q: I understand my bread import at £1-20, but how is my £1-20 payment a surplus?
A: Because the £1-20 is exported to the shop.

Q: Most odd.
A: Not at all. It follows from ‘double-entry’ accountancy conventions.

Q: I am still puzzled.
A: Let’s take it step-by-step. For a simple trading economy, an excess of imports over exports (trade deficit) is financed by payments of gold (or foreign currency reserves) taken from the nation’s treasury.

Q: A nation with a trade deficit loses gold from its treasury?
A: That’s right; and gold is exported (capital account surplus).

Q: What happens when the gold runs out?
A: Trade ceases. Unless a nation exports something, it has no means - other than its accumulated reserves (gold) - to buy imports.

Q: The trade deficit plus the gold out-flow is zero; a trade surplus plus the gold in-flow is zero?
A: Yes. The current account plus the capital account always sum to zero

Q: Where are ‘invisible’ earnings featured, and what precisely are they?
A: Invisible earnings are recorded on current account. They accrue from sales of services of all kinds: tourism, banking, insurance, shipping and so on.

Q: The ‘current account’ can be in surplus or in deficit?
A: Yes, a current account deficit measures the value of goods and services purchased from abroad but not paid for out of current income from goods and services sold to foreigners. This deficit is financed from the capital account.

Q: So a current account deficit indicates that the nation is living beyond its means.
A: Yes, but this is not necessarily bad; nor is a current account surplus necessarily good.

Q: What, then, is the basis for that kind of judgement? When is the balance of payments a problem?
A: Everything turns on the interpretation given. Different interpretations may be made of the changes on capital account, by which a current account deficit is financed.

Q: I’m confused.
A: Although the eighteenth century mercantilists abhorred current account deficits (because of the loss of gold reserves), a modern view is that net *long-term* capital exports cause no concern.

Q: Why?
A: Say, for example, that efficient work practices attract foreign investment in domestic industry. Would you regard this as a bad sign?

Q: Of course not, but we wouldn't be losing gold would we?
A: No. That net inflow of foreign investment would obviate any loss of reserves incurred as a result of a current account deficit. In other words, a current account deficit *could* be funded by a net surplus on the long-term capital account.

Q: So?
A: So, by this interpretation, so long as the current account plus net long-term capital movements is not in deficit, there is no basis for concern. This is called the 'basic balance'.

Q: By '*net* long-term capital movements' you mean the two way flow of foreign investments into our country, and our investments overseas.
A: Precisely**.**

Q: So, it is desirable for foreigners to invest with us and undesirable for use to invest abroad?
A: Not necessarily.

Q: Why does it have to be so complicated?
A: These accounts are nothing more than a record of transactions which bring mutual benefits to international traders in goods, services and capital. No record can 'speak for itself'. Interpretations are always necessary and these may be contentious. If you are not up to this, just say so.

Q: Keep your temper. I thought you were saying that, if the basic balance is zero, there is no balance of payments problem?
A: That is one interpretation; but there are others.

Q: I should have guessed.
A: Another view is that the distinction between short-term and long-term capital movements is arbitrary. If so, this makes the definition of the basic balance arbitrary.

Q: What exactly is the distinction between long-term and short-term capital movements?
A: The distinction turns on the speed with which an investment decision can be reversed.

Q: Go on.
A: Many financial investments (bonds, shares, *etc.*) can be bought and sold minute by minute. Other investments (say, in a new car plant) take much longer to negotiate.

Q: So where is the difficulty?
A: The examples I gave were from the extremes. The middle grey area raises definitional problems. If it takes an hour, a day, a week, or a month, to negotiate a

deal, in which category should that capital account transaction be placed? In practice, many decisions were arbitrary.

Q: I see the difficulty. Given this practical difficulty, what should be done?
A: Well, some would focus attention upon the nation's gold and foreign exchange reserves.

Q: Like the mercantilists.
A: Yes; but more recent interest has been with the net change in the official gold and foreign exchange reserves.

Q: Assets owned by the state?
A: That's right. Changes in official gold and foreign exchange reserves, together with net foreign currency borrowing by the government, comprise the 'balance for official financing'.

Q: This is the focus for balance of payments problems?
A: It has attracted great interest where the national currency has no fixed international value.

Q: A flexible exchange rate regime?
A: Yes. When the exchange rate is flexible, the balance for official financing is the amount which must be met from (or absorbed by) the official gold and foreign exchange reserves, if the currency exchange rate is to remain unchanged.

Q: So, what happens if the 'balance for official financing' is in deficit and the authorities refuse to release funds from the official reserves?
A: If the authorities refuse to draw upon foreign exchange reserves to purchase the excess supply of sterling on foreign exchange markets, then the international value of sterling must fall.

Q: Sterling depreciates, until the demand and supply of sterling are in equilibrium?
A: Yes.

Q: How does this affect the balance of payments accounts?
A: The valuations (in sterling) of all foreign currency earnings across the full range of international transactions are raised. By these readjustments, the overall balance of payments will *necessarily* be zero.

Q: Can we stop there?
A: Perhaps we should.