Current and capital account of the balance of payments

This revision note is designed for A2 economists

There are two main parts to the balance of payments accounts

The current account which measures the net balances in

1. Trade in goods
2. Trade in services
3. Investment income from overseas assets
4. Transfers (private and government) between countries

The capital account measures the net flows of different forms of capital between nations

1. Direct capital investment including foreign direct investment
   E.g. Inflows of capital spending by foreign firms
         Takeovers of domestic businesses by foreign-owned businesses / investors

2. Financial investment flows
   E.g. Inflows of money from overseas into government bonds, property

3. Banking flows
   E.g. Inflows of “hot money” into a country’s banking system seeking the highest rate of return

Basic assumption is that – if a country is running a current account deficit, this is “balanced up” or “financed” by seeking to run a capital account deficit

The UK is a good case in point as for some years we have been operating with a large (and rising) current account deficit, largely because of trade deficit in goods and net transfers of money overseas e.g. payments to the EU.

Thus the country needs to attract sufficient capital inflows to balance the books up. This has happened

- Relatively high interest rates and a fairly strong currency – makes the UK an attractive home for hot money
- Strong performance of the UK property market (until recently!)
- Several hi-profile foreign takeovers of UK businesses e.g. Tata Steel buying Corus in 2007 and Tata’s takeover of Land Rover and Jaguar in 2008
- UK continues to be a favoured venue for inward investment

If insufficient capital flows come in to offset a current account deficit, then under IMF rules, a country must make an adjustment to the size of their stock of gold and foreign currencies e.g. a deficit country might reduce their official reserves. For the UK this is not a major problem – but other nations with a lower stock might run into a foreign currency crisis. Typically when this happens, that country’s exchange rate will fall as investors take fright.

The balancing item is there to make sure everything adds up! It is designed to reflect errors and omissions in the balance of payments statistics and can be pretty large!

If a country is running a large current account surplus (e.g. China, or the OPEC oil producers), this gives them the scope to run capital account deficits (i.e. they can use some of their mountain of foreign exchange reserves to invest overseas. The rapid development of sovereign wealth funds is testimony to big global trade imbalances).

Financing the trade / current account deficit is not the same as correcting or reducing it – this requires a combination of expenditure reducing and expenditure-switching policies.