

Balance of Payments (BoP)

The Balance of Payments (BoP) is a record of all financial transactions between a country and the rest of the world over a period of time, usually one year.

Credits (+) are money flowing into the country. Debits (−) are money flowing out of the country.

The 3 accounts

The Current Account

The current account records day-to-day international transactions, including trade, income, and transfers. It is often used to judge short-run trade performance and competitiveness.

It has four components:

- Trade in goods (visible): exports and imports of physical goods
- Trade in services (invisible): exports and imports of services (e.g. tourism, finance)
- Primary income: wages, interest, profits, dividends from factor ownership across borders
- Secondary income (current transfers): one-way transfers with no quid pro quo (e.g. foreign aid, contributions to international bodies, remittances)

The Financial Account

The financial account records investment flows, meaning buying and selling assets rather than trade in goods and services.

It includes:

- FDI: long-term investment with influence (e.g. building a factory)
- Portfolio investment: buying shares or bonds without control (often more volatile)
- Reserve assets: central bank holdings of foreign currency or gold (and changes in these)

The Capital Account

The capital account is usually small. It includes capital transfers (e.g. debt forgiveness, migrants' transfers) and trade in non-produced, non-financial assets (e.g. patents and copyrights).

Why the BoP “balances”

The BoP is designed to sum to zero. This means a current account deficit is matched by a surplus in the financial and capital accounts.

Current account deficit vs surplus

Current account deficit

A deficit happens when outflows are greater than inflows, usually because imports are greater than exports overall.

Current account surplus

A surplus happens when inflows are greater than outflows, usually because exports are greater than imports overall.

Causes of a current account deficit

Loss of competitiveness

If domestic prices rise faster than competitors, or quality and productivity are weaker, exports tend to fall and imports rise.

Strong domestic growth

When national income rises, consumers buy more, including imported goods and services. This is more likely when the marginal propensity to import is high.

Exchange rate appreciation

An appreciation makes exports more expensive and imports cheaper. This can worsen net exports ($X-M$).

Structural dependence on imports

Long-term reliance on imported raw materials, energy, or manufactured goods can keep the trade in goods balance negative.

Financing a deficit

A current account deficit must be funded by a financial account surplus. This means net capital inflows into the country.

Common ways it is financed include:

- Borrowing (e.g. foreign investors buying government bonds)
- Asset sales (foreign ownership of domestic firms, land, or shares increases)

Links to macroeconomic objectives

Growth

A current account deficit means net exports ($X-M$) are negative. This reduces aggregate demand and can lower economic growth.

Inflation

Policies to reduce a deficit, such as tariffs, may reduce imports. However, they can also raise costs for firms if they rely on imported inputs, which can add to inflationary pressure.

Unemployment

If net exports fall, output may fall in export industries and import-competing industries. This can increase cyclical unemployment.

Living standards

Imports can increase choice and reduce prices in the short run. However, persistent deficits funded by borrowing or selling assets can reduce future national income through higher outflows of interest and profits, worsening the primary income balance.

Interdependence

Economies are linked through trade and financial connections, so shocks can spread between countries.

Economies are connected through:

- Trade flows: one country's imports are another's exports, so recessions in trading partners reduce export demand
- Supply chains: production relies on imported components, so disruption can affect output and prices

- Financial flows: deficits are often funded by foreign capital, linking countries via debt and asset holdings
- Protectionism: tariffs can trigger retaliation and reduce global efficiency

Fact file: UK current account deficit

Key stats

- Current account : -2.2% of GDP in 2024
- Trade split (2024): goods deficit £206bn partly offset by a services surplus £184bn, leaving an overall trade deficit of £22bn.
- Productivity (G7): in 2023, the UK ranked 4th out of the G7 for GDP per hour worked and was around 20% below the US (and below Germany and France).

Why the UK tends to run a deficit

The UK has a structural deficit in trade in goods, meaning it imports more physical goods than it exports. The UK also runs a strong services surplus, but this is often **not** large enough to cancel out the goods deficit.

Competitiveness issues can make the deficit more persistent. Since the financial crisis period, **weak productivity growth** has limited both cost competitiveness and non-price competitiveness, such as quality, innovation, and efficiency.

How the deficit is funded

A current account deficit must be matched by net financial inflows. In practice, this means the UK funds the gap through overseas investors buying UK assets, such as shares, bonds, and businesses.

Contrasting Fact file: Germany current account surplus

Key stats

- Current account surplus: +5.9% of its GDP
- Trade backdrop: Germany's trade surplus was about €241bn in 2024, showing how export strength supports external surpluses.

Why Germany tends to run a surplus

Written by [udoecon.com](https://www.udoecon.com)

Germany is structurally export-led and specialises in high-value manufactured goods such as machinery, vehicles, and chemicals. This tends to keep exports higher than imports and supports a large current account surplus.

Germany's competitiveness is also supported by strong industrial capability and investment. This helps maintain productivity and non-price competitiveness in global markets.

What a surplus implies

A current account surplus means Germany earns more from the rest of the world through trade and income than it spends abroad. This is typically matched by net outflows in the financial account, as German firms and investors buy foreign assets.