

13.5: Balance of Payments Deficits and Surpluses

Learning Objective

1. Learn the definitions and usage of balance of payments deficits and surpluses in a fixed exchange rate system.

To maintain a fixed exchange rate, the central bank will need to automatically intervene in the private foreign exchange (Forex) by buying or selling domestic currency in exchange for the foreign reserve currency. Clearly, in order for these transactions to be possible, a country's central bank will need a stock of the foreign reserve currency at the time the fixed exchange rate system begins. Subsequently, if excess demand for foreign currency in some periods is balanced with excess supply in other periods, then falling reserves in some periods (when dollars are bought on the Forex) will be offset with rising reserves in other periods (when dollars are sold in the Forex) and a central bank will be able to maintain the fixed exchange rate. Problems arise, though, if a country begins to run out of foreign reserves. But before discussing that situation, we need to explain some terminology.

When the central bank buys domestic currency and sells the foreign reserve currency in the private Forex, the transaction indicates a balance of payments deficit. Alternatively, when the central bank sells domestic currency and buys foreign currency in the Forex, the transaction indicates a balance of payments surplus.

Central bank transactions are recorded in an account titled **official reserve transactions**. It is found in the financial account of the balance of payments. If this account indicates an addition to official reserves over some period, then the country is running a balance of payments surplus. If over some period the official reserve balance is falling, then the country is running a balance of payments deficit. The deficit or surplus terminology arises from the following circumstances.

Suppose a country runs a trade deficit in a fixed exchange rate system. A trade deficit means that demand for imports exceeds foreign demand for our exports. This implies that domestic demand for foreign currency (to buy imports) exceeds foreign demand for domestic currency (to buy our exports). Assuming no additional foreign demands for domestic currency on the financial account (to keep the exchange rate fixed), the central bank would need to intervene by selling foreign currency in exchange for domestic currency. This would lead to a reduction of foreign reserves and hence a balance of payments deficit. In the absence of transactions on the financial account, to have a trade deficit and a fixed exchange rate implies a balance of payments deficit as well.

More generally, a balance of payments deficit (surplus) arises whenever there is excess demand for (supply of) foreign currency on the private Forex at the official fixed exchange rate. To satisfy the excess demand (excess supply), the central bank will automatically intervene on the Forex and sell (buy) foreign reserves. Thus by tracking sales or purchases of foreign reserves in the official reserve account, we can determine if the country has a balance of payments deficit or surplus.

Note that in a floating exchange rate system, a central bank can intervene in the private Forex to push the exchange rate up or down. Thus official reserve transactions can show rising or falling foreign reserves and hence suggest a balance of payments deficit or surplus in a floating exchange system. However, it is not strictly proper to describe a country with floating exchange rates as having a balance of payment deficit or surplus. The reason is that interventions are not *necessary* in a floating exchange rate. In a floating system, an imbalance between supply and demand in the private Forex is relieved by a change in the exchange rate. Thus there need never be an imbalance in the balance of payments in a floating system.

Key Takeaways

- When the central bank buys domestic currency and sells the foreign reserve currency in the private Forex, the transaction indicates a balance of payments deficit.
- When the central bank sells domestic currency and buys foreign currency in the Forex, the transaction indicates a balance of payments surplus.
- A balance of payments deficit (surplus) arises whenever there is excess demand for (supply of) foreign currency on the private Forex at the official fixed exchange rate.

exercises

1. **Jeopardy Questions.** As in the popular television game show, you are given an answer to a question and you must respond with the question. For example, if the answer is “a tax on imports,” then the correct question is “What is a tariff?”
 - The account on the balance of payments (BoP) used to record all central bank transactions.

- The balance on the BoP when the central bank sells foreign reserves.
- Of *BoP deficit*, *BoP surplus*, or *BoP balance*, this is what a central bank will run if there is excess demand for its own currency in the private Forex market while maintaining a fixed exchange rate.
- Of *BoP deficit*, *BoP surplus*, or *BoP balance*, this is what a central bank will run if there is excess demand for the reserve currency in the private Forex market while maintaining a fixed exchange rate.
- Of *BoP deficit*, *BoP surplus*, or *BoP balance*, this is what China's central bank will run if there is excess demand for Chinese yuan in the private Forex market if China fixes its currency to the U.S. dollar.
- Of *BoP deficit*, *BoP surplus*, or *BoP balance*, this is what China's central bank will run if there is excess demand for U.S. dollars in the private Forex market if China fixes its currency to the U.S. dollar.

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