Chap. 5 Balance of Payments and International Linkages

- **Balance of Payments Concepts**
- **The International Flow of Goods, Services and Capital**
- **The U.S. Trade Deficit**
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Balance of Payment Concepts

- The ***Balance of Payments (BOP) measures all international economic*** and ***financial transactions*** over a specified period of time
- Usually over a calendar year.
- In theory, BOP uses ***double-entry bookkeeping***
- With double-entry bookkeeping, each ***activity*** that results in a currency inflow (called ***Credits***) is matched with an equal dollar amount of an ***activity*** that results in a dollar outflow (***Debits***)

Balance of Payment Concepts

- ***Examples of credits***
- **In a firm**: firm sells goods or services, ***firm borrows money from a bank*** or issues bonds.
- ***In a household:*** you do a week's work, you sell some old furniture in a yard sale, you take out an auto loan or new mortgage. You get check from Grandma for your Birthday.
- ***In a nation:*** The U.S. exports wheat, a U.S. insurance company sells protection to a French company. Japanese buy U.S. Treasury bonds.

Balance of Payment Concepts

- ***Examples of debits***
- ***In a firm:*** firm buys new office equipment, has workers work, ***firm pays interest or principal on a loan. A business donates to a local charity.***
- ***In a household:*** you buy groceries, invest in a savings bond. You make payments on your credit card.
- ***In a nation:*** A U.S. company imports laptops from Taiwan, The government pays its membership assessment to the U.N., American citizens invest in a foreign stock market. Some of us go to Europe. We use Air France.

Balance of Payment Concepts

- ***Debits and credits should match up.***
- ***In a firm:*** firm ***buys*** new office equipment (debit), ***pays*** with a bank check (credit).
- ***In a household***: you ***work*** (credit), your employer ***direct-deposits your pay*** into your bank (debit)
- ***In the U.S.:*** A U.S. company ***imports*** laptops from Taiwan, (debit) Taiwan company ***is paid*** from the U.S. company's account in Taiwan (credit).
- ***In the U.S.*** A European ***travels to Disney world*** (credit), ***paying with Amex Travelers-checks*** (debit).

Balance of Payment Concepts

For a Nation, there are three Major Accounts:

1. ***Current Account:*** records net flow of goods, services, ***interest payments***, and unilateral transfers. Essentially measures ***economic activity***
2. ***Capital Account:*** records public and private investment and lending. Investment Activity
3. ***Official Reserves Account:*** records ***changes in foreign reserves owned by the central bank***.

   "Should" reflect any ***intervention*** activities.

Balance of Payment Concepts

Official Reserves include

(1) **Foreign currency** in the form of securities (usually in a ***foreign Government's T-bills***)

(2) to a ***much*** lessor extent, ***gold***. This gold is often stored in Fort Knox, at the NYC Federal Reserve Bank Branch, or at the ***Bank for International Settlements*** in Basle, Switzerland.

If the Fed intervenes to support the USD, it sells reserves, and buys back dollars. This results in a credit to the BOP. (think of it as ***exporting gold)***

Balance of Payment Concepts

Sum of all transactions, under double-entry, should add up to zero:

BOP = current account + capital account + official reserves = zero.

However, given the amount of bad data, smuggling, etc., it usually doesn't sum to zero.

We add in a ***Statistical Discrepancy***

This "fudge factor" is added to the the three BOP items to get a zero sum.

Balance of Payment Concepts

- ***Current Account:*** U.S. a ***Deficit*** since the late 1980s.
- 1) ***Merchandise (trade balance):*** goods - must be transported. $452.4 Billion deficit in 2000.
- We imported more than we exported: a new record
- 2) ***Services (invisibles)****:* Investment ***income*** (***dividends and interest***), travel and tourism, fees for financial services, insurance premiums, etc.
- Our net investment income went negative in 1998.
- The U.S. still has a surplus in invisibles (in surplus since 1946.)

Balance of Payment Concepts

- 3) ***Unilateral Transfers:*** pensions, gifts, foreign aid, (free and paid for) military aid.
- In deficit, except in 1991. ***(Gulf War 'gift': $40 B)***
- ***Capital Account:*** We have had a ***surplus*** in recent years. This surplus means that foreigners have been investing more in the U.S. than Americans have been investing overseas.
- The BOJ buys our T-Bills when it intervenes to hold down the value of the Yen.
- Thus the U.S., as a nation, has been increasing it's net liabilities as the ***world's biggest debtor***.

Balance of Payment Concepts

- ***Capital Account****:****Two Types of Classifications****:*
- 1) ***Short-term Debt:*** Potentially the "hot money", influenced by s.t. rates. Ex., trade credit, Certificates of Deposit of one year or less.
- 2) ***Portfolio Investments****:* Stocks and Long-term Debt. Affected by the country's economy, inflation outlook, political climate.
- 3) ***Direct Investment:*** Owner has control of asset. Ex: Honda's U.S. auto factories, Pebble Beach. Or 50+% control of a company's stock.
- See totals on graph (page 180).

Balance of Payment Concepts

- 1) ***U.S. Investment overseas*****:** If American dollars are going overseas to purchase ***foreign investments***, it is a ***debit***, if dollars are returning from an earlier investment ***(disinvestment)*** it is a ***credit***.
- Our invest overseas seems to always exceeds our disinvestment so the ***net investment is a debit***.
- 2) ***Foreign Investment in the U.S.****:* If dollars are coming in from overseas to purchase American investments, it is a credit. Dollars leaving the States ***(disinvestment by foreigners)*** is a ***debit***.

Balance of Payment Concepts

Statistical Discrepancy

An example (1997)

U.S Current Acct. -$139.8 Billion

U.S. Capital Acct. (including official reserves, etc.)

-$487.3 B + $759.3 B = $262.0 B (inflow)

thus ***Statistical Discrepancy*** = - $132.2 B.

Curr. Acct + Cap. Acct (etc.) + SD = Zero

-$139.8 B + $ 262 B -$132.2B = Zero

I view the ***Statistical Discrepancy*** as the result of adding ***fairly accurate*** current acct. numbers to ***inaccurate*** capital acct. numbers.

Balance of Payment Concepts

- In the past there was a ***tendency*** for this "Fudge Factor" to be ***routinely positive***. (During the late 1970 and through the 1980s). Reversed in 1991-2, 1997
- A positive sign could mean that a current acct. deficit is not fully offset by a capital acct. surplus. Possibly because…
- 1) ***Dollars are leaving*** the U.S. and ***not returning***. Perhaps the currency is being held as store of value by foreigners or as a medium of exchange. The U.S. "collects" seigniorage.
- 2) **Capital** Account ***inflows may be understated***. "Flight Capital", or funds coming into the U.S. from an unstable region, are often undeclared.

International Flow of Goods, Capital

- ***The "Twin Deficit": The Federal deficit rose sharply after 1981*** (see handout from the Economic Report of the President).
- At about the same time the ***merchandise trade account went into a large deficit.***
- ***What was the connection between the two deficits?*** Simply put: the ***government cut taxes but did not cut spending***: Government began to live well beyond its means.
- Households received a tax cut which was ***the equivalent of a pay raise.***

International Flow of Goods, Capital

- Consumers ***saved some of the "raise"*** but logically increased overall spending on goods and services.
- ***Thus, the government spent the same, household spent more: so, the nation as a whole increased spending***.
- Some of this new demand was met with ***increased domestic output,*** but the rest was met with ***increased imports.***
- ***Thus we ran a large trade deficit.***
- The trade deficit only began to shrink when economies overseas began to recover and we could start exporting to them. Also we went to into recession in 1991 – and curtailed our household spending.

International Flow of Goods, Capital

- ***In the mid 1990s the Federal government started to run a substantial surplus yet we still had a large trade deficit***. Note: Surplus was largely due to higher tax collections (SS tax went up and govt collected taxes on large stock market gains)
- Americans are now often referred to as the as the "consumer of the last resort".
- ***The private sector is not saving (relative to income from wages, interest and dividends).***
- ***Possible demographic reason: Younger Baby Boomers are still accumulating goods like larger houses, etc. Older boomers are putting kids through college.***

International Flow of Goods, Capital

- Thus this very large group is a ***net spender***. Eventually kids will be through college, big houses will be traded down for condo's.
- When this happens, the boomer cohort will start thinking about retirement and become ***major savers***. (like those folks in Europe and Japan).
- Note, in both cases, the ***only way the deficits could be financed*** without "crowding out" private borrowing ***is to borrow abroad*** (resulting in ***capital inflows*** or ***"a capital account surplus***).
- Thus BOP = Zero!

International Flow of Goods, Capital

- ***Japan*** is almost ***our mirror image***: (America in reverse)
- Largest International creditor – the Bank of Japan has about $0.5 trillion in foreign reserves (mostly USDs).
- Huge level of ***private saving.*** Possible reasons***: age profile***: saving for retirement.
- ***Government is in deficit however***! (Trying to stimulate economy, also tax revenues are low with the weak economy)
- ***Japanese save so much*** that they ***can cover private investment needs, and the Federal deficit, and still have plenty left over***. So they need to move some savings overseas (to the U.S. mostly).
- ***Thus Japan has a capital account deficit,***

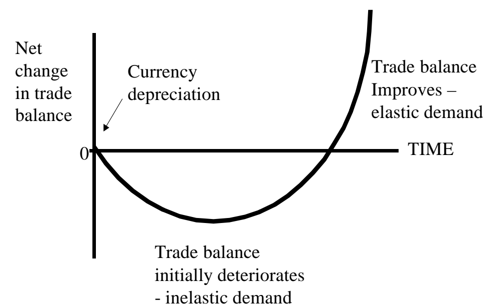
Coping with Trade Deficits

- ***A current account deficit is often considered a sign of poor economic health***. Brazil had a deficit before its devaluation in 1999. So did Mexico in 1995. Thailand in 1997. Etc. …
- ***However,*** Japan has a surplus and has been in recession for a decade. The U.S. has a deficit yet has had strong growth.
- Ignoring the contradictions above, ***assume we wish to "cure" a current account or trade deficit***:
- Brazil, Mexico, and Thailand ***devalued their currencies and eventually ran trade surpluses.***

Coping with Trade Deficits

- A ***falling currency should reduce a trade deficit*** but this policy can ***backfire in the short-term***.
- Idea of a lower USD is to get U.S. consumers to substitute U.S. goods for now higher-priced Japanese goods.
- ***If U.S. demand*** for the product is ***inelastic,*** total spending on Japanese exports may actually rise. This rise is what often happens in the short-term.
- ***In the long-term,*** however, ***demand becomes more elastic*** and spending is more likely to drop.
- ***This pattern is said to form a J-shaped curve***.

THE J - CURVE



Coping with Trade Deficits

- A falling dollar would raise inflation, may cause financial panic. Falling dollar in 1985-87 culminated in the stock market crash of Oct.1987.
- ***Some potential governmental policy solutions***
- ***1) Protectionism:***
- ***Tariffs:*** unit or value-based (ad valorem) tax
- ***Quotas:*** limits number of imported units
- Protectionist policies typically causes domestic inflation through lack of competition.
- Also, if it is more expensive to ***import investment goods*** (machine tools, parts), protectionist policies may ***make whole economy less competitive.***

Coping with Trade Deficits

- ***2) Boosting the savings rates (Austerity).***
- Savings can be boosted with a tight monetary or fiscal policy. The underlying theory is that a ***trade deficit is caused by a country living beyond its means.***
- However, ***demographics can play a large role***.
- National differences: Social Security ***may*** reduce the ***perceived*** need to save for retirement. (??)
- ***Easy to borrow in U.S.***. Low down payments on houses, automobiles, appliances.
- ***Difficult to borrow in Japan.*** Cash for cars. 50 percent down on houses. Lenders are mostly ***loan sharks***