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AP Macroeconomics

The Balance of Payments

Balance of Payments

- **Measure of money inflows and outflows between the United States and the Rest of the World (ROW)**
 - Inflows are referred to as CREDITS
 - Outflows are referred to as DEBITS
- **The Balance of Payments is divided into 3 accounts**
 - Current Account
 - Capital/Financial Account
 - Official Reserves Account

Double Entry Bookkeeping

- Every transaction in the balance of payments is recorded twice in accordance with standard accounting practice.
 - Ex. U.S. manufacturer, John Deere, exports \$50 million worth of farm equipment to Ireland.
 - A credit of \$50 million to the current account
(- \$50 million worth of farm equipment or physical assets)
 - A debit of \$50 million to the capital/financial account
(+ \$50 million worth of Euros or financial assets)
 - Notice that the two transactions offset each other. Theoretically, the balance payments should always equal zero...Theoretically

Double Entry Bookkeeping

- Lucky for you, in AP Macroeconomics we only worry about the 1st half of the transaction. We simplify and see the export of farm equipment as a credit (inflow of \$) to the current account.
- Why then, did I mention double entry bookkeeping?
 - To illustrate my innate intelligence?
 - No
 - To help you understand that the current account and capital/financial account are intrinsically linked together and help balance each other?
 - Yes, that's it!

Current Account

- **Balance of Trade or Net Exports**
 - Exports of Goods/Services – Import of Goods/Services
 - Exports create a credit to the balance of payments
 - Imports create a debit to the balance of payments
- **Net Foreign Income**
 - Income earned by U.S. owned foreign assets – Income paid to foreign held U.S. assets
 - Ex. Interest payments on U.S. owned Brazilian bonds – Interest payments on German owned U.S. Treasury bonds
- **Net Transfers (tend to be unilateral)**
 - Foreign Aid → a debit to the current account
 - Ex. Mexican migrant workers send money to family in Mexico

Capital/Financial Account

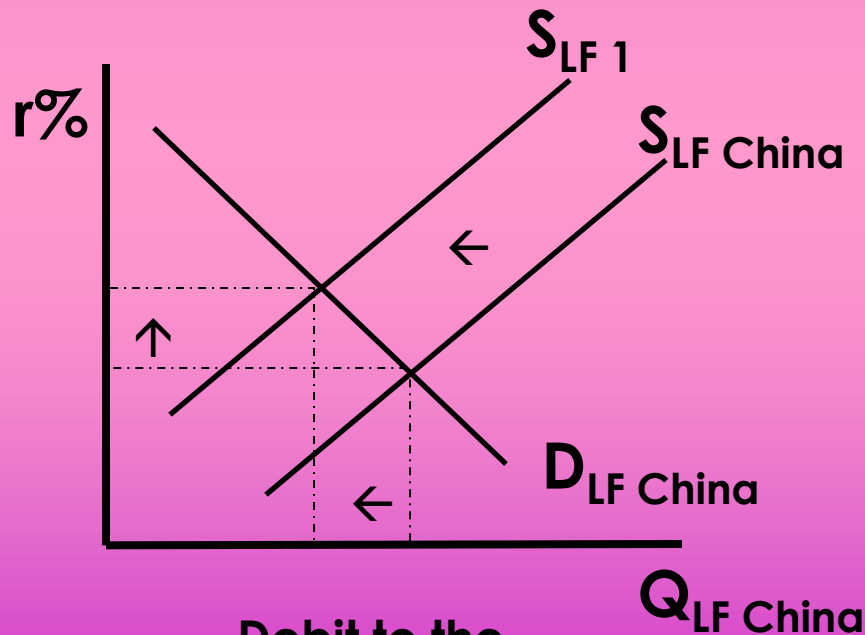
- The balance of capital ownership
- Includes the purchase of both real and financial assets
- Direct investment in the United States is a credit to the capital account
 - Ex. The Toyota Factory in San Antonio
- Direct investment by U.S. firms/individuals in a foreign country are debits to the capital account
 - Ex. The Intel Factory in San Jose, Costa Rica

Capital/Financial Account

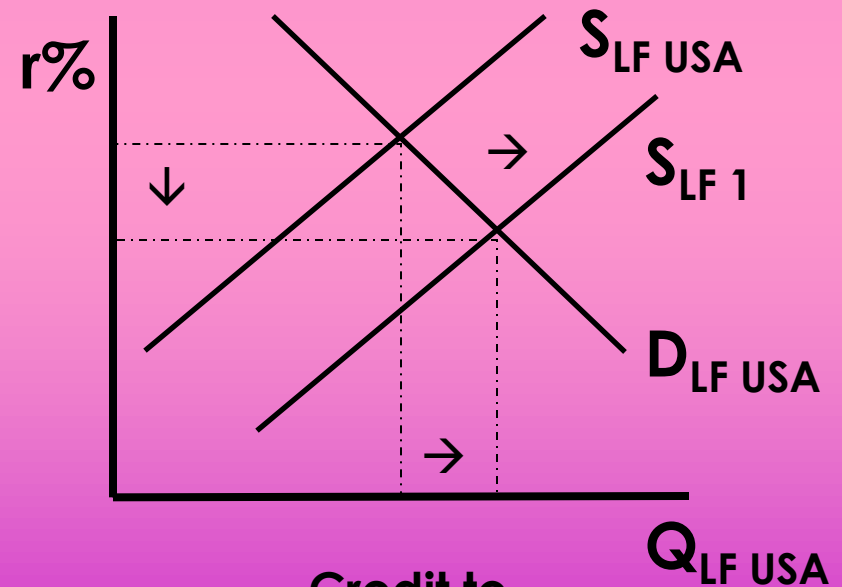
- **Purchase of foreign financial assets represents a debit to the capital account.**
 - **Ex. Warren Buffet buys stock in Petrochina.**
- **Purchase of domestic financial assets by foreigners represents a credit to the capital account.**
 - **The United Arab Emirates sovereign wealth fund purchases a large stake in the NASDAQ.**

What causes Capital/Financial Flows?

- Differences in rates of return on investment
- Ceteris Paribus, savings will flow toward higher returns



Debit to the
Chinese
Capital
Account



Credit to
the U.S.
Capital
Account

Relationship between Current and Capital Account

- Remember double entry bookkeeping?
- The Current Account and the Capital Account should zero each other out.
- That is... If the Current Account has a negative balance (deficit), then the Capital Account should then have a positive balance (surplus).
- Ex. The constant net inflow of foreign financial capital to the United States (capital account surplus) is what enables us to import more than we export (current account deficit)

Official Reserves

- The foreign currency holdings of the United States Federal Reserve System
- When there is a balance of payments surplus the Fed accumulates foreign currency and debits the balance of payments.
- When there is a balance of payments deficit the Fed depletes its reserves of foreign currency and credits the balance of payments
- The Official Reserves zero out the balance of payments

Active v. Passive Official Reserves

- The United States is passive in its use of official reserves. It does not seek to manipulate the dollar exchange rate.
- The People's Republic of China is active in its use of official reserves. It actively buys and sells dollars in order to maintain a steady exchange rate with the United States.

Let's have fun with the Balance of Payments!

- **Classify each as either a credit or a debit to the U.S. Balance of Payments**
 - Paris Hilton buys a majority share in Korean electronics manufacturer Samsung.
 - Queen Elizabeth II imports a Dodge Viper to the U.K.
 - Bank of America purchases \$200 million worth of Euros.
 - Homer Simpson buys a new Ferrari, the Enzo.
 - Malaysian government purchases a new Boeing 787.
 - The United States Federal Reserve System sells \$4 billion worth of U.S. currency in the foreign exchange market.

More fun with the Balance of Payments!

- **Classify each as either a Current Account, Capital/Financial Account or Official Reserves Transaction**
 - Paris Hilton buys a majority share in Korean electronics manufacturer Samsung.
 - Queen Elizabeth II imports a Dodge Viper to the U.K.
 - Bank of America purchases \$200 million worth of Euros
 - Homer Simpson buys a new Ferrari, the Enzo.
 - Malaysian government purchases a new Boeing 787.
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