Econ 340
Lecture 12
The Balance of Trade and International Transactions
News: Oct 14-27

- South Korea Agrees to drop developing country status in WTO -- FT: 10/25 | Canvas
  - The WTO gives special privileges to "developing countries," but lets countries self-identify as that. President Trump has complained about that, arguing that many such countries are now high-income.
  - South Korea, such a relatively high-income country, this week responded to the Trump Administration's pressure and agreed to drop that designation.
  - The action is expected to put pressure on other countries also to give up developing-country status. Countries that Trump had identified in July as having "unsupportable" developing country designations include China, as well as South Korea, Hong Kong (not a country), Singapore, Qatar and the United Arab Emirates.

- The US will stop preferential treatment for exports from Thailand -- FT: 10/26 | Canvas
  - The US, like other developed countries, applies the Generalized System of Preferences to most developing countries. This means applying tariffs on many of their exports (though not all) that are lower than the MFN tariffs they applies to richer countries.
  - The Trump administration has announced that it will suspend that preferential treatment for $1.3 billion of exports from Thailand, including all seafood products.
  - The reason given for this the failure of Thailand to enforce worker rights.
  - "The country has faced criticism from the US and EU for its tolerance of human trafficking, forced labour, and modern-day slavery, notably in the seafood and fishing industries — practices Thai authorities and companies have since taken steps to combat."

  - The World Bank published an annual ranking of countries by the ease of "Doing Business" in them. This year's ranking just came out.
  - Some notable features of the latest ranking: China moved from 78th to 31st in the last three years, now topping France. India has risen steadily and now tops Luxembourg. New Zealand continues to top the rankings, and Somalia is at the bottom.
  - The ranking has become in indicator that many leaders and countries, especially in the developing world, strive to work their way up in. As a result, it is argued to be less useful than when it originated, as countries are able to game the system once they know the criteria.

- British Prime Minister seeks Brexit extension -- NYT: 10/19 | Canvas | FT: 10/20 | Canvas
  - Earlier in the week, Boris Johnson reached agreement with the EU on Brexit. The agreement would avoid the hard border in Ireland/Northern Ireland but require a maritime border between Northern Ireland and the rest of the UK.
  - He took the deal to the British House of Commons, having them meet on a Saturday for the first time in over 30 years. He failed to get approval, leaving the status of the deal in the UK unclear as the October 31 deadline for exit approaches.
  - Late on Saturday, as required by earlier legislation, he sent an unsigned letter to the EU requesting an extension. But he also sent a letter saying that a further extension would be damaging. And it appears that he still hopes to get the deal approved by Parliament.

- G20 Finance Ministers seeking to revise international tax for the digital age -- WSJ: 10/18 | Canvas | FT: 10/18 | Canvas
  - Countries are debating "new global rules to coordinate corporate taxes." For almost a century, the practice has been to tax corporate profits based on the physical presence of a company in a jurisdiction. This is understood to be inadequate for the modern world in which digital companies earn profits in countries without a physical presence. Those governments are unable, therefore, to tax those profits.
  - In response to the failure to find a coordinated approach several countries have unilaterally levied taxes on such companies, most of which are based in the United States. France led the way with a 3% tax earlier this year, informally called the "web tax," and several other countries have announced similar plans. The United States has threatened retaliation against the French tax.
  - The United States is, however, participating in the discussions overseen by the OECD and led by Japan, to find new practices of corporate taxation that all can agree on. The discussions are taking place in Washington, DC.
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- World Bank issues its latest country ranking of Doing Business
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Outline: The Balance of Trade and International Transactions

• What Is the Balance of Trade?
• What the Balance of Trade Does Not Mean
• International Transactions
  – Current Account
  – Financial Account
• What the Balance of Trade Does Mean
  – From Balance of Payments Accounting
  – From National Income Accounting
What Is It?

• Definition: Balance of Trade
  = Exports minus Imports
  – Defined for
    • Merchandise (i.e., goods)
      = “Balance on Merchandise Trade”
    • Merchandise plus services
      = “Balance on Goods and Services”
  – “Trade Surplus” = Bal of Trade > 0
  – “Trade Deficit” = Bal of Trade < 0
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What It Does Not Mean

- **Common Misinterpretations**
  - That a deficit means we are “losing money”
  - This was sort of true when
    - All money was gold (the Gold Standard), and
    - There were no international capital flows
  - Then imports > exports meant you were spending more gold than you were earning; gold was flowing out
  - Today there are capital flows
    - A country with imports > exports can
      - Borrow
      - Sell assets to foreigners
What It Does **Not** Mean

- **Common Misinterpretations**
  - That a deficit means we are “losing jobs”
    - It is true that
      - Imports are goods we *don’t* produce, and
      - Exports are goods we *do* produce
    - But whether an increase in imports means a loss of jobs depends on *why* imports went up
      - Often it is because more people are working, earning income, and buying more from abroad
What It Does Not Mean

• Common Misinterpretations
  – That a deficit means we are “losing jobs”
    • Scott draws a direct connection from exports to jobs gained and from imports to jobs lost
      – He assumes that imports somehow replace domestic production.
      – That is sometimes true, but mostly it is not
    • Griswold points out that the US economy has done _best_ when the trade deficit was growing!
      – True, but that doesn’t mean that the trade deficit _caused_ us to do well
      – Instead, high incomes led to higher imports
What It Does Not Mean

• Common Misinterpretations
  – That a deficit means other countries are misbehaving
    • Not at all, as we’ll see.
Outline: The Balance of Trade and International Transactions

• What Is the Balance of Trade?
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• International Transactions
  – Current Account
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• What the Balance of Trade Does Mean
  – From Balance of Payments Accounting
  – From National Income Accounting
International Transactions

• To understand the trade balance, it is necessary to consider all international transactions
  – Trade
  – Financial flows
  also
  – Transfer payments, i.e. gifts
    (this is small for U.S. but large for some developing countries: e.g., foreign aid and remittances)
International Transactions

- Transactions are divided into two* parts, called
  - Current Account
  - Financial Account

*There are also two other small items, not part of these two accounts, called
  - Capital Account
  - Statistical Discrepancy

We’ll mostly ignore these in this course
International Transactions

– Current Account
  • Trade in goods
  • Trade in services
  • Investment income
  • Unilateral transfers (i.e, gifts, foreign aid)

– Financial Account
  – Includes only changes in asset holdings
    (Let $\Delta$ mean “change in”)
    • $\Delta$ US ownership of assets abroad
    • $\Delta$ foreign ownership of assets in US
International Transactions

• All transactions are recorded as either
  – Credits (+)
    • If they correspond to payment into the country
      – E.g., exports, capital inflows
  or
  – Debits (−)
    • If they correspond to payment out of the country
      – E.g., imports, capital outflows
Clicker Question

Which of the following transactions would appear as a debit in the US balance of payments?

- a) A German imports a Ford from the US
- b) An American takes out a loan from a Canadian bank
- c) An American philanthropist gives money to refugees in Greece
- d) A British corporation pays dividends to a US shareholder
- e) A Japanese business person buys stock in GM
Which of the following transactions would appear as a **debit** in the **financial** account of the US balance of payments?

- **a)** A German imports a Ford from the US
  - Current; credit
- **b)** An American takes out a loan from a Canadian bank
  - Financial; credit
- **c)** An American philanthropist gives money to refugees in Greece
  - Current; debit
- **d)** A US corporation pays dividends to a British shareholder
  - Current; debit
- **e)** An American buys stock in the Japanese company, Toyota
  - Financial; debit
International Transactions

• Balances
  – Balance of Trade
    = credits minus debits on trade transactions
      (merchandise only, or goods and services)
  – Balance on Current Account
    = credits minus debits on trade, investment income, and transfers
  – Balance on Financial Account
    = Also called net “capital inflows”
TABLE 9.3  The U.S. Balance of Payments, 2011  
(Gerber 6th ed.)

- Balance of payments = current account + capital account + financial account

<table>
<thead>
<tr>
<th>Current Account</th>
<th>Billions of Dollars</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Goods and services</td>
<td></td>
</tr>
<tr>
<td>Exports</td>
<td>2,105</td>
</tr>
<tr>
<td>Imports</td>
<td>-2,665</td>
</tr>
<tr>
<td>2. Investment income</td>
<td></td>
</tr>
<tr>
<td>Investment income received</td>
<td>739</td>
</tr>
<tr>
<td>Investment income paid</td>
<td>-518</td>
</tr>
<tr>
<td>3. Net unilateral transfers</td>
<td>-135</td>
</tr>
<tr>
<td>Capital Account</td>
<td></td>
</tr>
<tr>
<td>4. Capital account transactions, net</td>
<td>-2</td>
</tr>
<tr>
<td>Financial Account</td>
<td></td>
</tr>
<tr>
<td>5. Net change in U.S. assets abroad (increase/outflow (-))</td>
<td>-396</td>
</tr>
<tr>
<td>6. Net change in foreign assets in the United States (increase/inflow (+))</td>
<td>784</td>
</tr>
<tr>
<td>7. Net change in financial derivatives</td>
<td>7</td>
</tr>
<tr>
<td>Statistical Discrepancy</td>
<td>80</td>
</tr>
<tr>
<td>Memoranda</td>
<td></td>
</tr>
<tr>
<td>Balance on current account (1 + 2 + 3)</td>
<td>-473</td>
</tr>
<tr>
<td>Balance on capital and financial accounts (4 + 5 + 6 + 7)</td>
<td>393</td>
</tr>
</tbody>
</table>

The financial and capital accounts measure capital inflows and outflows and are equal to the current account, with the signs reversed. The statistical discrepancy measures the amount by which our measurements are off and is calculated as the sum of the three accounts, with the sign reversed.

TABLE 9.2 The U.S. Current Account Balance, 2011

<table>
<thead>
<tr>
<th>1. Goods and services</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Exports of goods</td>
<td>1,497</td>
</tr>
<tr>
<td>Exports of services</td>
<td>608</td>
</tr>
<tr>
<td>Imports of goods</td>
<td>−2,236</td>
</tr>
<tr>
<td>Imports of services</td>
<td>−429</td>
</tr>
<tr>
<td>2. Investment income</td>
<td></td>
</tr>
<tr>
<td>Investment income received</td>
<td>739</td>
</tr>
<tr>
<td>Investment income paid</td>
<td>−517</td>
</tr>
<tr>
<td>3. Net unilateral transfers</td>
<td></td>
</tr>
<tr>
<td></td>
<td>−135</td>
</tr>
<tr>
<td>Memoranda</td>
<td></td>
</tr>
<tr>
<td>Goods and services balance</td>
<td>−560</td>
</tr>
<tr>
<td>Current Account Balance</td>
<td>−473</td>
</tr>
</tbody>
</table>

The U.S. current account deficit in 2011 was $473 billion. The deficit is largely the result of merchandise goods imports exceeding exports. The United States has surpluses in services and investment income.

(Textbook Data)

• The slides above, with data from 2011, are from Gerber 6\textsuperscript{th} edition
• I also have Gerber’s 7\textsuperscript{th} edition, with data from 2014 – the next 2 slides
• But they are reported differently and much harder to understand (in my opinion)
• So I will go back to the 2011 data after the next two slides
**TABLE 9.3 The U.S. Balance of Payments, 2014**

<table>
<thead>
<tr>
<th>U.S. Balance of Payments, 2014</th>
<th>Billions of dollars</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Current account balance</td>
<td>-390</td>
</tr>
<tr>
<td>2. Capital account balance</td>
<td>0</td>
</tr>
<tr>
<td>3. Financial account</td>
<td></td>
</tr>
<tr>
<td>3a. Net acquisition of financial assets</td>
<td>792</td>
</tr>
<tr>
<td>3b. Net incurrence of financial assets</td>
<td>977</td>
</tr>
<tr>
<td>3c. Net change in financial derivatives</td>
<td>-54</td>
</tr>
<tr>
<td>4. Statistical discrepancy</td>
<td>151</td>
</tr>
<tr>
<td>5. Memoranda</td>
<td></td>
</tr>
<tr>
<td>5a. Balance on current and capital accounts (1+2)</td>
<td>-390</td>
</tr>
<tr>
<td>5b. Balance on financial account (3a-3b+3c)</td>
<td>-239</td>
</tr>
</tbody>
</table>

- **Balance of payments =** current account + capital account + financial account
## The Current Account (5 of 6)

<table>
<thead>
<tr>
<th>United States Current Account, 2014</th>
<th>Billions of dollars, 2014</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Goods and services exports (credit) (1a + 1b)</td>
<td>2,343</td>
</tr>
<tr>
<td>1a. Goods exports</td>
<td>1,633</td>
</tr>
<tr>
<td>1b. Services exports</td>
<td>711</td>
</tr>
<tr>
<td>2. Primary income receipts (credit) (2a + 2b)</td>
<td>823</td>
</tr>
<tr>
<td>2a. Investment income received</td>
<td>816</td>
</tr>
<tr>
<td>2b. Compensation of employees received</td>
<td>7</td>
</tr>
<tr>
<td>3. Secondary income receipts (credit)</td>
<td>140</td>
</tr>
<tr>
<td>4. Goods and services imports (debit) (4a + 4b)</td>
<td>2,852</td>
</tr>
<tr>
<td>4a. Goods imports</td>
<td>2,374</td>
</tr>
<tr>
<td>4b. Services imports</td>
<td>477</td>
</tr>
<tr>
<td>5. Primary income paid (debit) (5a + 5b)</td>
<td>585</td>
</tr>
<tr>
<td>5a. Investment income paid</td>
<td>569</td>
</tr>
<tr>
<td>5b. Compensation of employees paid</td>
<td>16</td>
</tr>
<tr>
<td>6. Secondary income payments (debit)</td>
<td>259</td>
</tr>
<tr>
<td>7. Current account balance (1+2+3-4-5-6)</td>
<td>-390</td>
</tr>
</tbody>
</table>
TABLE 9.4 Components of the U.S. Financial Account, 2011

<table>
<thead>
<tr>
<th><strong>1. Net change in U.S. assets abroad (increase/outflow (−))</strong></th>
<th><strong>Billions of Dollars</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>A. U.S. official reserve assets</td>
<td>−16</td>
</tr>
<tr>
<td>B. U.S. government assets, other than official reserve assets</td>
<td>−102</td>
</tr>
<tr>
<td>C. U.S. private assets</td>
<td>−278</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th><strong>2. Net change in foreign assets in the United States</strong> (increase/inflow (+))</th>
<th><strong>Billions of Dollars</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>A. Foreign official assets in the United States</td>
<td>165</td>
</tr>
<tr>
<td>B. Other foreign assets in the United States</td>
<td>619</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th><strong>3. Net change in financial derivatives</strong></th>
<th><strong>Billions of Dollars</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>7</td>
</tr>
</tbody>
</table>

There are six main categories of financial flows. Each of these categories can be further subdivided.

### TABLE 9.5 Private Flows in the U.S. Financial Account, 2011

<table>
<thead>
<tr>
<th>Subcomponents</th>
<th>Billions of Dollars</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>1. U.S. private assets abroad, net (increase/outflow (−))</strong></td>
<td>−278</td>
</tr>
<tr>
<td>A. Direct investment</td>
<td>−406</td>
</tr>
<tr>
<td>B. Foreign securities</td>
<td>−93</td>
</tr>
<tr>
<td>C. Loans to foreign firms, including banks</td>
<td>221</td>
</tr>
<tr>
<td><strong>2. Foreign-owned assets in the United States, other than official assets, net (increase/inflow (+))</strong></td>
<td>619</td>
</tr>
<tr>
<td>A. Direct investment</td>
<td>228</td>
</tr>
<tr>
<td>B. U.S. securities and currency</td>
<td>120</td>
</tr>
<tr>
<td>C. Loans to U.S. firms, including banks</td>
<td>271</td>
</tr>
<tr>
<td><strong>3. Net change in financial derivatives</strong></td>
<td>7</td>
</tr>
</tbody>
</table>

Private assets flows are the largest part of the financial account. Both private outflows and inflows are usefully divided into three symmetrical subcomponents. The net change in the value of financial derivatives comprises the other major category of private flows.

Current Account is mostly the Trade Balance, which deteriorated greatly from 1990 until 2005.
The Current Account (6 of 6)
International Transactions: Data

From OECD via FRED

Grey shaded strips are recessions. Note that deficits tend to:
• Rise in **booms**
• Fall in **recessions**
More recently, from Survey of Current Business, with details.
International Transactions: Data

US Export and Import Shares Since 1962
(Shaded strips are recessions)

Source: Survey of Current Business February 2013
More recently, from Survey of Current Business, with details
Clicker Question

Which of the following tends to fall in a recession?

a) Exports  
b) Imports  
c) The trade deficit  
✓ d) All of the above  
e) None of the above
### U.S. International Transactions

#### Current Account

<table>
<thead>
<tr>
<th>Line</th>
<th>Current account</th>
<th>2017</th>
<th>2018</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Exports of goods and services and income receipts (credits)</td>
<td>3,433,239</td>
<td>3,701,694</td>
</tr>
<tr>
<td>2</td>
<td>Exports of goods and services</td>
<td>2,351,072</td>
<td>2,500,756</td>
</tr>
<tr>
<td>3</td>
<td>Goods</td>
<td>1,553,383</td>
<td>1,672,331</td>
</tr>
<tr>
<td>4</td>
<td>Services</td>
<td>797,690</td>
<td>828,425</td>
</tr>
<tr>
<td>5</td>
<td>Primary income receipts</td>
<td>928,118</td>
<td>1,060,362</td>
</tr>
<tr>
<td>6</td>
<td>Investment income</td>
<td>921,816</td>
<td>1,053,931</td>
</tr>
<tr>
<td>7</td>
<td>Compensation of employees</td>
<td>6,302</td>
<td>6,431</td>
</tr>
<tr>
<td>8</td>
<td>Secondary income (current transfer) receipts /1/</td>
<td>154,049</td>
<td>140,576</td>
</tr>
<tr>
<td>9</td>
<td>Imports of goods and services and income payments (debts)</td>
<td>3,882,380</td>
<td>4,190,166</td>
</tr>
<tr>
<td>10</td>
<td></td>
<td>2,903,349</td>
<td>3,122,862</td>
</tr>
<tr>
<td>11</td>
<td>Goods</td>
<td>2,360,878</td>
<td>2,563,651</td>
</tr>
<tr>
<td>12</td>
<td>Services</td>
<td>542,471</td>
<td>559,211</td>
</tr>
<tr>
<td>13</td>
<td>Primary income payments</td>
<td>706,386</td>
<td>816,066</td>
</tr>
<tr>
<td>14</td>
<td>Investment income</td>
<td>686,699</td>
<td>795,820</td>
</tr>
<tr>
<td>15</td>
<td>Compensation of employees</td>
<td>19,687</td>
<td>20,246</td>
</tr>
<tr>
<td>16</td>
<td>Secondary income (current transfer) payments /1/</td>
<td>272,645</td>
<td>251,237</td>
</tr>
</tbody>
</table>
# U.S. International Transactions

## Financial Account

<table>
<thead>
<tr>
<th>Line</th>
<th>Description</th>
<th>2017</th>
<th>2018</th>
</tr>
</thead>
<tbody>
<tr>
<td>19</td>
<td>Net U.S. acquisition of financial assets excluding financial derivatives (net increase in assets / financial outflow (+))</td>
<td>1,182,749</td>
<td>301,618</td>
</tr>
<tr>
<td>20</td>
<td>Direct investment assets</td>
<td>379,222</td>
<td>-50,633</td>
</tr>
<tr>
<td>21</td>
<td>Portfolio investment assets</td>
<td>586,695</td>
<td>210,330</td>
</tr>
<tr>
<td>22</td>
<td>Other investment assets</td>
<td>218,522</td>
<td>136,932</td>
</tr>
<tr>
<td>23</td>
<td>Reserve assets</td>
<td>-1,690</td>
<td>4,989</td>
</tr>
<tr>
<td>24</td>
<td>Net U.S. incurrence of liabilities excluding financial derivatives (net increase in liabilities / financial inflow (+))</td>
<td>1,537,683</td>
<td>800,913</td>
</tr>
<tr>
<td>25</td>
<td>Direct investment liabilities</td>
<td>354,829</td>
<td>267,081</td>
</tr>
<tr>
<td>26</td>
<td>Portfolio investment liabilities</td>
<td>799,182</td>
<td>320,006</td>
</tr>
<tr>
<td>27</td>
<td>Other investment liabilities</td>
<td>383,671</td>
<td>213,826</td>
</tr>
<tr>
<td>28</td>
<td>Financial derivatives other than reserves, net transactions / 2/</td>
<td>23,074</td>
<td>-20,261</td>
</tr>
</tbody>
</table>
### U.S. International Transactions Balances

<table>
<thead>
<tr>
<th>Line</th>
<th>Description</th>
<th>2017</th>
<th>2018</th>
</tr>
</thead>
<tbody>
<tr>
<td>30</td>
<td>Balance on current account (line 1 less line 9) / 4/</td>
<td>-449,142</td>
<td>-488,472</td>
</tr>
<tr>
<td>31</td>
<td>Balance on goods and services (line 2 less line 10)</td>
<td>-552,277</td>
<td>-622,106</td>
</tr>
<tr>
<td>32</td>
<td>Balance on goods (line 3 less line 11)</td>
<td>-807,495</td>
<td>-891,320</td>
</tr>
<tr>
<td>33</td>
<td>Balance on services (line 4 less line 12)</td>
<td>255,219</td>
<td>269,214</td>
</tr>
<tr>
<td>34</td>
<td>Balance on primary income (line 5 less line 13)</td>
<td>221,731</td>
<td>244,295</td>
</tr>
<tr>
<td>35</td>
<td>Balance on secondary income (line 8 less line 16)</td>
<td>-118,597</td>
<td>-110,661</td>
</tr>
</tbody>
</table>

Survey of Current Business

April 2019

$m.$
Outline: The Balance of Trade and International Transactions

• What Is the Balance of Trade?
• What the Balance of Trade Does Not Mean
• International Transactions
  – Current Account
  – Financial Account

• What the Balance of Trade \textbf{Does} Mean
  – From Balance of Payments Accounting
  – From National Income Accounting
What the Trade Balance Does Mean

• From Balance of Payments Accounting
  – It must be true that credits and debits (if they were known) would add up to zero
  • Reason: Every transaction, if known completely, involves two offsetting entries
    – Example 1: I import a book (US debit) from a London bookstore which deposits my payment into its NY bank account (US credit)
    – Example 2: Donald Trump (an American) borrows euros from a German (US credit) and exchanges them for dollars with an Italian who has sold stock in a US corporation (US debit)

These are only samples; infinitely many other possibilities exist, but each must add to zero
What Does the Trade Balance Really Mean?

• From Balance of Payments Accounting
  – It must be true that credits and debits add up to zero
  – Therefore (ignoring the small “capital account” and "Statistical Discrepancy"),

\[
\text{Current Account Surplus} + \text{Financial Account Surplus} = 0
\]
What Does the Trade Balance Really Mean?

• From Balance of Payments Accounting
  – It follows that
    A current account deficit
    Implies ↓
    A financial account surplus

(and vice versa)
What Does the Trade Balance Really Mean?

• From Balance of Payments Accounting
  – Thus, a Trade Deficit

  (if it is not financed by investment income and transfers, which are also parts of the current account)

implies that we are either

• Borrowing from foreigners, or
• Selling assets to foreigners

Financial Account Surplus
What Does the Trade Balance Really Mean?

• Thus the large (and usually growing) current account deficit of the US, which we saw earlier, means that the US is selling off its assets and/or borrowing from foreigners

• Sure enough, look at the data…
US Balance on Current Account
(Millions of dollars)
International Transactions: Data

From Survey of Current Business

Became negative about 1986

US Investment Position
Billions of dollars


-20,000 -10,000 0 10,000 20,000 30,000 40,000

- Net International Investment Position
  - U.S.-owned assets abroad
  - Foreign-owned assets in U.S.
What Does the Trade Balance Really Mean?

- Put this in perspective
  - US current account deficit reached about $700 b. per year. US population is about 300 m. So US was selling assets and/or borrowing about $2,300 per year per person. (Less now.)
  - US net investment position is over $9 trillion. So our net debt to foreigners is over $30,000 per person.
  - $9 trillion is about 45% of US GDP; so on average each of us owes over 5 months income to foreigners.
    - And it’s growing.
  - (A student points out, correctly, that much of this debt is private, and therefore is not the responsibility of most of the population. Only the portion that is government debt deserves to be spoken of as I do in this slide.)
Clicker Question

If our Financial Account is in surplus, that means that

a) The trade balance is positive
b) We are lending more than we are borrowing
c) The US is adding to its holding of assets abroad
d) The rest of the world is giving us money

✓ e) Our net debt to the world is rising
Outline: The Balance of Trade and International Transactions

• What Is the Balance of Trade?
• What the Balance of Trade Does Not Mean
• International Transactions
  – Current Account
  – Financial Account
• What the Balance of Trade Does Mean
  – From Balance of Payments Accounting
  – From National Income Accounting
What Does the Trade Balance Really Mean?

• From National Income Accounting
  (I’ll do this first without government)
  – Recall from Econ 102
    GDP = Output = Income = Y
  – Output:
    \[ Y = C + I + (X - M) \]
  – Income:
    \[ Y = C + S \]
  – Therefore
    \[ X - M = S - I \]

• Where
  – C = Consumption
  – I = Investment
  – X = Exports
  – M = Imports
  – S = Savings
What Does the Trade Balance Really Mean?

• From National Income Accounting
  – Thus, since $X - M = S - I$
    • Trade surplus $\Rightarrow$ savings $>$ investment
    • Trade deficit $\Rightarrow$ savings $<$ investment
  – If we are not saving enough to finance investment, how do we pay for it?
    • By borrowing from abroad, or
    • By selling assets

Both positive in Financial Account
What Does the Trade Balance Really Mean?

• From National Income Accounting
  (This time with government)
  – Even more simply
    \[ Y = C + I + G + (X - M) \]
  – implies
    \[ X - M = Y - (C + I + G) \]
What Does the Trade Balance Really Mean?

- From National Income Accounting

\[(X - M) = Y - (C + I + G)\]

- So a trade deficit

\[(X - M) < 0\]

means that we are spending

\[(C + I + G)\]

more than our income \(Y\)
What Does the Trade Balance Really Mean?

• Therefore, in spite of its name, and it’s definition, the trade balance
  – Is not really about trade, which is just the symptom
  – It is about whether we are living within our means
  – As Porter explains, a trade deficit means that we are consuming and investing more than we earn

• When is a trade deficit good?
  – When the country (like a young person) is investing for the future (like a successfully developing country)
  – Not when it is going into debt just to finance current consumption (like the US)
## Sample Trade Surpluses & Deficits

<table>
<thead>
<tr>
<th>Country</th>
<th>(Exports − Imports) / GDP</th>
<th>2007</th>
<th>2015</th>
</tr>
</thead>
<tbody>
<tr>
<td>Brazil</td>
<td></td>
<td>+1.5%</td>
<td>+0.8%</td>
</tr>
<tr>
<td>Canada</td>
<td></td>
<td></td>
<td>−0.8%</td>
</tr>
<tr>
<td>China</td>
<td></td>
<td>+8.8%</td>
<td>+6.1%</td>
</tr>
<tr>
<td>Costa Rica</td>
<td></td>
<td>−4.8%</td>
<td>−10.7%</td>
</tr>
<tr>
<td>Germany</td>
<td></td>
<td>+7.1%</td>
<td>+9.2%</td>
</tr>
<tr>
<td>Greece</td>
<td></td>
<td>−12.0%</td>
<td>−11.2%</td>
</tr>
<tr>
<td>India</td>
<td></td>
<td>−4.1%</td>
<td>−6.9%</td>
</tr>
<tr>
<td>Japan</td>
<td></td>
<td>+1.7%</td>
<td>−0.03%</td>
</tr>
<tr>
<td>Saudi Arabia</td>
<td></td>
<td>+27.0%</td>
<td>+10.4%</td>
</tr>
<tr>
<td>United States</td>
<td></td>
<td>−5.1%</td>
<td>−4.2%</td>
</tr>
</tbody>
</table>

Source: 2007, IMF; 2015, CIA World Fact Book (est)
Implications of the US Trade Deficit

• Who, in the US, is doing this?
  – Partly it has been the US government, running a deficit due to
    • Tax cuts
    • War
    • Stimulus
  – But it is also due to falling private saving
Implications of the US Trade Deficit

• Who, abroad, is (or was) financing this?  
  – Mostly foreign governments & central banks
Implications of the US Trade Deficit

• Who, abroad, has been financing this?

Figure 5. Foreign Official and Private Investment Positions in the United States, 1994-2015

Source: Department of Commerce.
Implications of the US Trade Deficit

• Is the U.S. Deficit Sustainable?
  – Buffett (in 2003) says NO, as others will cease to be willing to lend to us
  – Some say this is sustainable:
    • This is a “balance” between US dis-saving and rest of world saving
    • US has comparative advantage in "providing wealth storage facilities"
Implications of the US Trade Deficit

• Is the U.S. deficit a problem?
  – Mankiw says no.
    • It’s a reflection of
      – The attractiveness of the US as a destination for investment
      – Strength of the US economy
    • Trump’s policies of deregulation, tax cuts, and spending will increase it (and that’s OK, he says)
    • An increase in import tariffs would just cause
      – The US dollar to appreciate, and
      – Exports to fall
Implications of the US Trade Deficit

• Can trade policy reduce the trade deficit?
  – Obstfeld (was Director of IMF Research) says no
    • Attempts to reduce it are like a game of “whack-a-mole”
      – If we reduce imports of one thing or from one place, imports of or from another will rise, and/or exports will fall
      – Example: Tariff to reduce imports of aluminum will reduce our exports of aircraft
    • Since US is at full employment, even if we hire more labor in one sector, we’ll have to employ less in another
Global Imbalances

• This refers to
  – Large current account deficits by US and others
  together with
  – Large current account surpluses by China and others
Global Imbalances

• What can be done to change these imbalances?
    • These won’t change spending
    • See Mankiw
  – What’s needed is for both
    • US to spend less, and
    • China to spend more
  – Porter argues for an international agreement to reduce the value of the US dollar
    • This was done in the “Plaza Accord” of 1985, and it worked
    • It’s not clear that it would work today
The United States in both 2011 and 2014 had a surplus in its

a) Balance on merchandise trade
b) Balance on goods and services
c) Balance on current account

✓ d) Balance on financial account
e) None of the above
Next Lecture

• Exchange Rates
  – What they are
  – What determines them
  – Simple theories of exchange rates