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

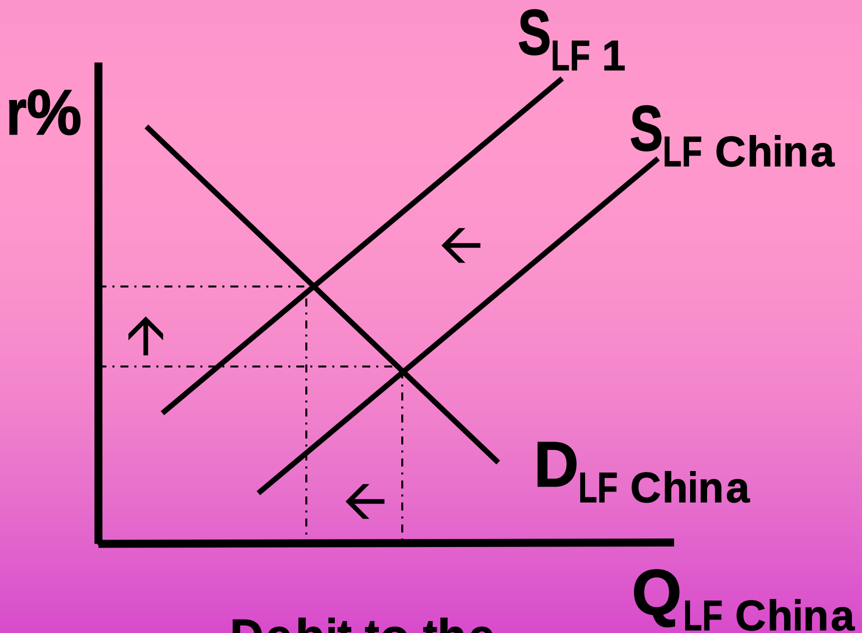
Capital/Financial Account

- **Purchase of foreign financial assets represents a debit to the capital account.**
  - **Ex. Warren Buffet buys stock in Petrochina.**

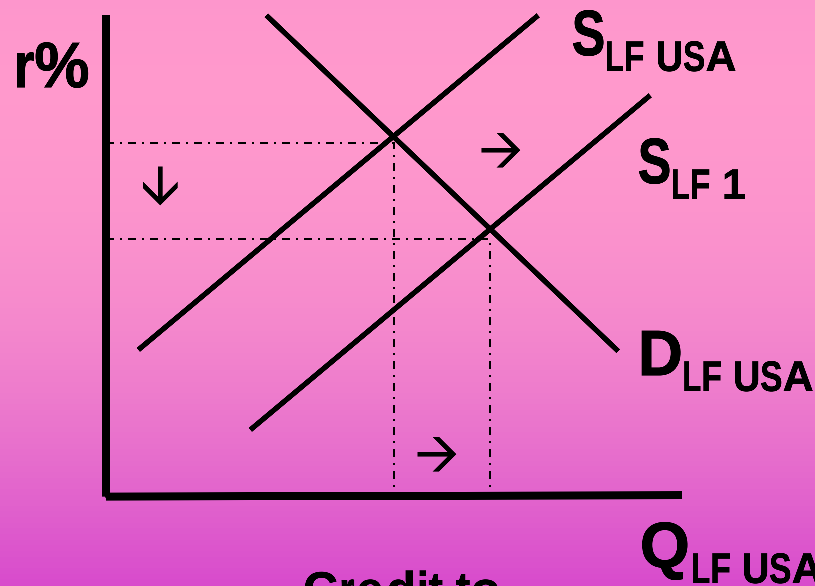
- **Purchase of domestic financial assets by foreigners represents a credit to the capital account.**
  - **The United Arab Emirates sovereign wealth fund purchases a large stake in the NASDAQ.**

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.
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