

The Balance of Payments

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AP Macroeconomics

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The 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.

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Double Entry Bookkeeping

- Every transaction in the balance of payments is recorded twice in accordance with standard accounting practice.
 - Ex. U.S. manufacturer, Ford Motor Co, exports \$100 million worth of vehicles to Great Britain.
 - A credit of \$100 million to the current account.
(- \$100 million worth of vehicles or physical assets)
 - A debit of \$100 million to the capital/financial account.
(+ \$100 million worth of British Pounds or financial assets)
 - Notice that the two transactions offset each other. Theoretically, the balance payments should always equal zero...Theoretically. Remember, ceteris paribus!

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AP Tips & Tricks

- When thinking debits and credits, don't think about credit cards and debit cards. In accounting this simply is referring to inflows and outflows of money.
- Lucky for you, in AP Macroeconomics we only worry about the 1st half of the transaction. We simplify and see the export of motor vehicles as a credit. (inflow of \$) to the current account.
- Why then, did I mention double entry bookkeeping?
 - To help you understand that the current account and capital/financial account are intrinsically linked together and help balance each other

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Current Accounts

- *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

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Capital/Financial Accounts

- *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. Sterling Heights Fiat in Michigan.
- *Direct investment by U.S. firms/individuals in a foreign country are debits to the capital account.*
 - Ex. Ford Li Ho Assembly in Taiwan.

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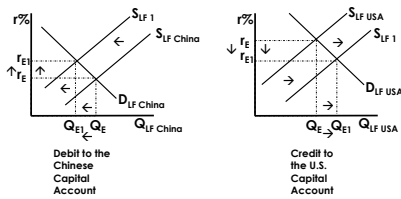
Capital/Financial Accounts

- *Purchase of foreign financial assets represents a debit to the capital account.*
 - Ex. Warren Buffet buys stock in Sony Corporation.
- *Purchase of domestic financial assets by foreigners represents a credit to the capital account.*
 - The Saudi Arabian royal family purchases a large stake of shares in the NASDAQ.

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Why are there Capital & Financial flows of Money?

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



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The Relationship between Current and Capital Accounts

- Remember double entry bookkeeping?
- The Current Account and the Capital Account should zero each other out.
- i.e. : 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)

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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

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The Differences between Active & 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.

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Balance of Payments Practice

- Classify each as either a credit or a debit to the U.S. Balance of Payments:
 - A Japanese company purchases U.S. Treasury Bonds.
 - A U.S. citizen consumes a meal at a restaurant in Paris.
 - A Korean immigrant living in Dallas sends a check drawn from his Wells Fargo bank account as a gift to his parents living in Seoul, South Korea.
 - U.S. computer programmer hired by a British company for consulting.

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Balance of Payments Practice

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- CREDIT
- A U.S. citizen consumes a meal at a restaurant in Paris.
- DEBIT

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Balance of Payments Practice

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- A Korean immigrant living in Dallas sends a check drawn from his Wells Fargo bank account as a gift to his parents living in Seoul, South Korea.
- DEBIT
- U.S. computer programmer hired by a British company for consulting.
- CREDIT

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Summary

- Inflows of money are referred to as CREDITS
- Outflows of money are referred to as DEBITS
- The AP Macroeconomics test will only worry about the first half of the transaction when dealing with B.O.P. questions.

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Summary

- The Balance of Payments is divided into 3 accounts
 - Current Account.
 - Capital/Financial Account.
 - Official Reserves Account.
- You will commonly see free response questions pertaining to this in conjunction with the Loanable Funds graph.

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