

# Module 4I

## 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 1<sup>st</sup> 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

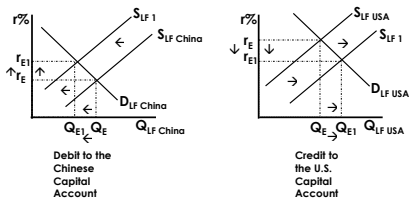
- *Purchase of foreign financial assets represents a debit to the capital account.*
  - Ex. Warren Buffet buys stock in Sony Corporation.
- *Purchase of domestic financial assets by foreigners represents a credit to the capital account.*
  - The Saudi Arabian royal family purchases a large stake of shares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

- Classify each as either a credit or a debit to the U.S. Balance of Payments:

– A Japanese company purchases U.S. Treasury Bonds.

– CREDIT

– A U.S. citizen consumes a meal at a restaurant in Paris.

– DEBIT

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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 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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