

Imbalance of Payments

The place is New York City. The store is McDonald's. A visitor from Japan tries to buy a Big Mac with several yen. The store refuses. McDonald's wants dollars. Somewhere, somehow, this tourist needs to exchange yen for dollars to buy lunch.

The tourist's plight is no different from the situation Boeing faces when it sells airplanes to France. Indeed, whether the product is one Big Mac or 20 airplanes, when people from different nations exchange goods, they also have to exchange currencies. And whether the goods are Big Macs or airplanes, nations like to keep track of currency transactions with other nations. They record purchases of imports, sales of exports, investments in other nations and foreign investment in the domestic country. A record of foreign transactions, called the *balance of payments*, is essential for making sense of a nation's position in the global economy.

There are three accounts within the balance of payments: *current*, *capital* and *official transactions* (or *reserve*) *accounts*. Market transactions determine the first two; the third is an offsetting account the government controls.

The current account records a nation's exports and imports of goods, services (such as travel to other countries, shipping and insurance), net investment income (U.S. earnings on investment abroad *minus* foreign earnings from capital invested in the U.S.) and net transfers (foreign aid, pensions paid to U.S. citizens living abroad and funds immigrants send to family abroad).

The capital account records the flows of money from the purchase and sale of real and financial assets domestically and abroad. A real asset might be a hotel building in Tokyo, while a financial asset might be shares of stock in a Swedish company. Foreign investors may buy similar assets in the U.S. When these real and financial assets are bought and sold, nations use or earn foreign exchange.

When classifying a transaction, consider whether a country uses (loses) or earns (gains) foreign currency. For the current and capital accounts, if the international transaction *uses* foreign currency to complete the transaction, it is a *debit* (*negative*). If it *earns* foreign currency, it is a *credit* (*positive*).

The official transactions account is a counterbalancing account: A country uses foreign assets or currency to offset a balance of payments deficit, and this is recorded as a credit (positive). Similarly, when there is a balance of payments surplus, the earned foreign currency is recorded as a debit (negative).

Part A

To make sure you understand the components of the current account, the capital account and the difference between a credit (transaction that earns foreign exchange) and a debit (transaction that uses foreign currency), identify each of the following transactions on the U.S. balance of payments. Complete Figure 52.1 by putting check marks in the appropriate boxes for credit or debit and for capital or current account. The first one has been done for you.



Figure 52.1
Transactions on the U.S. Balance of Payments

	Credit +	Debit -	Current Account	Capital Account
1. Harley Davidson USA purchases \$25 million in production machinery from a Japanese company.		✓		✓
2. André Prenoor, U.S. entrepreneur, invests \$50 million to develop a theme park in Malaysia.				
3. A Chinese company sells \$1 million worth of berets to the U.S. Army.				
4. BMW pays \$1 million to a U.S. shipper for transporting cars from Germany to the United States.				
5. Each month, Ima Grent, who recently arrived in the United States, sends half her paycheck to her sister in Poland.				
6. Bank of America pays \$5 million in interest to French depositors.				
7. Senor Ramos from Spain buys a shopping center in Florida.				
8. A Brazilian investor buys five \$10,000 U.S. Treasury bonds.				
9. German tourists spend \$3 million in the United States; U.S. tourists spend \$5 million in Germany.				
10. Brit-Disz, a London record store, spends \$10,000 on CDs by the Generic Gurls, a U.S. kiddy-pop group.				
11. Sam Boney, U.S. ice-rink magnate, buys stock in a Chilean ice-rink chain.				

Part B

We can investigate an important balance of payments identity. In the absence of any governmental or central bank intervention, *the current account balance and the capital account balance must sum to zero*. If a nation imports more than it exports (current account deficit), a surplus in the capital account must necessarily offset the deficit because, by definition, goods must either be paid for or the payment is owed. The foreign currency used to buy imports had to come from somewhere (in addition to currency earned from exports); and in this simplified situation, only a capital account surplus could supply the needed foreign currency. In other words, *the excess spending on imports must have found its way back into the United States in the form of foreign investment, a capital account credit*.

12. Analyze the data in Figure 52.2. Compute the missing figures, and answer the questions that follow.



Figure 52.2

2002 Balance of Payments, Z-Land

Current Account

Z-Land exports of goods	\$ +300	
Z-Land imports of goods	-400	
Z-Land exports of services	+150	
Z-Land imports of services	-120	
Balance of trade		_____
Net investment income	+10	
Net transfers	-14	
Balance on current account		_____

Capital Account

Z-Land capital going abroad	-110	
Foreign capital coming into Z-Land	+160	
Balance on capital account		_____

Balance on Current Account

Plus Balance on Capital Account _____

Official Reserves Account

Official reserves transactions balance _____

Total \$ 0

13. Does Z-Land have a current account deficit or surplus? How do you know?

14. Without central bank intervention, does Z-Land carry a balance of payments surplus or deficit? How do you know?

15. If Z-Land runs a balance of payments deficit, how can this difference be made up? If it carries a balance of payment surplus, what will happen?