Date: 03.04.02

The Balance of Trade and International Transactions

I. What is the Balance of Trade?

Balance of trade= Exports – Imports

Defined for: Merchandise, merchandise and services, income on factors, including capital (income from financial investments: interest and dividends) and labor (wages earned in another country).

Not in Balance of Trade: transfers, which are gifts of money (or goods) given to people in other countries. This is not trade because one gets nothing in return.

The sum of the Balance of Trade, income on factors, and transfers is the Current Account Balance.

II. What Does the Balance of Trade NOT Mean?

A. A trade deficit/surplus is often spoken of in "bad/good" terms, but it shouldn't be spoken of in this way. Neither a surplus nor a deficit is necessarily good or bad; it all depends on the situation.

B. Deficits mean losing money. Not true in most countries today. However, with pegged exchange rates, deficits do have the connotation of losing international reserves, as we will study later.

C. Deficits means "losing jobs." Importing does not mean you are not buying a good at home. For example, in the 1990s, the United States had huge trade deficits but had historically very low unemployment. In fact, in the US historically, as trade deficits have increased, unemployment as decreased.

III. International Transactions

2 largest categories: trade and financial flows (formerly called capital flows).

Minor category: transfer payments

A. Current Account (CA): includes Trade, incomes from investment and labor, and transfers. Examine the flow of money (or direction of payment) to understand with which sign (positive or negative) a transaction should be entered into the current account. For example, Exports (+), Imports (–).

B. Financial Account (FA): change in US assets abroad (–) and change in foreign assets in the US (+).

See Table 9.3 in Gerber text and subsequent tables as well.

IV. What Does the Balance of Trade Really Mean?

A. From Balance of Payments (BOP) accounting:

CA balance + FA balance = 0.

This is an accounting identity; these two things have to add up to zero! It must be true (if they are measured correctly). Any deviation from a sum of zero is due to errors, omissions and statistical discrepancies in the data collection process.

Why is this true? Every transaction has two parts (positive and negative parts). There are always two parties to a transaction. Example: buy a book from a French Bookseller. This is an import and is a negative entry in the current account. If you pay by writing them a check, then until they cash it, this is also a positive entry in the financial account, since they have

added to their holdings assets (your check) in the United States. If they deposit it in a dollar-denominated bank account, then it is their holds of dollar deposits that rises, and so forth. If they exchange the dollar for francs, then whoever buys the dollar will be holding them (adding to their dollar assets), or when they spend the dollars on U.S. exports or financial assets, the positive item will show up there.
Again, CA balance = – FA balance.
Trade Deficit = Financial Account surplus.
If financial transactions included only borrowing and lending, then we would have:

Trade surplus implies net lending by a nation
Trade deficit implies net borrowing by a nation

In fact the financial transactions also includes purchase and sale of assets, so it is a bit more complicated than this, but these statements still capture the sense of how the current account and the financial account are related.

B. From National Income Accounting

$$Y = C + I + G + (X - M) \quad \text{(income)}$$
$$S = Y - C - G \quad \text{(savings)}$$
$$Y - C - G = I + (X - M)$$
$$S = I + (X - M)$$
$$X - M = S - I$$

From this we can see that a trade deficit ($M>X$) implies $I > S$.
Also, if we examine expenditure vs. income:

$$(X - M) = Y - C - I - G$$

If $X \neq M$, a nation is spending more or less than its income. Nations can do this by borrowing and lending from abroad (or by selling or buying assets).

Again, is a trade surplus good? Is a trade deficit bad?
A deficit implies we are adding to what we owe more than we are adding to what we own. This may be bad for the United States, as the US has been in a trade deficit for years and going further and further into debt to the rest of the world. If the rest of the world suddenly became uncomfortable with holding US assets, there could be trouble.
So debt can be a problem. But it can also make sense. It all depends on the situations. If one is going into debt to invest in their future it could be exactly the right thing to do.