LSE EC1B5 Macroeconomics

Handout 18

Open Economy Macroeconomics (II)

Current Account
And
Financial Account

In 2019, the United States imported $3,105.1 billion in total, with $472.3 billion coming from China.

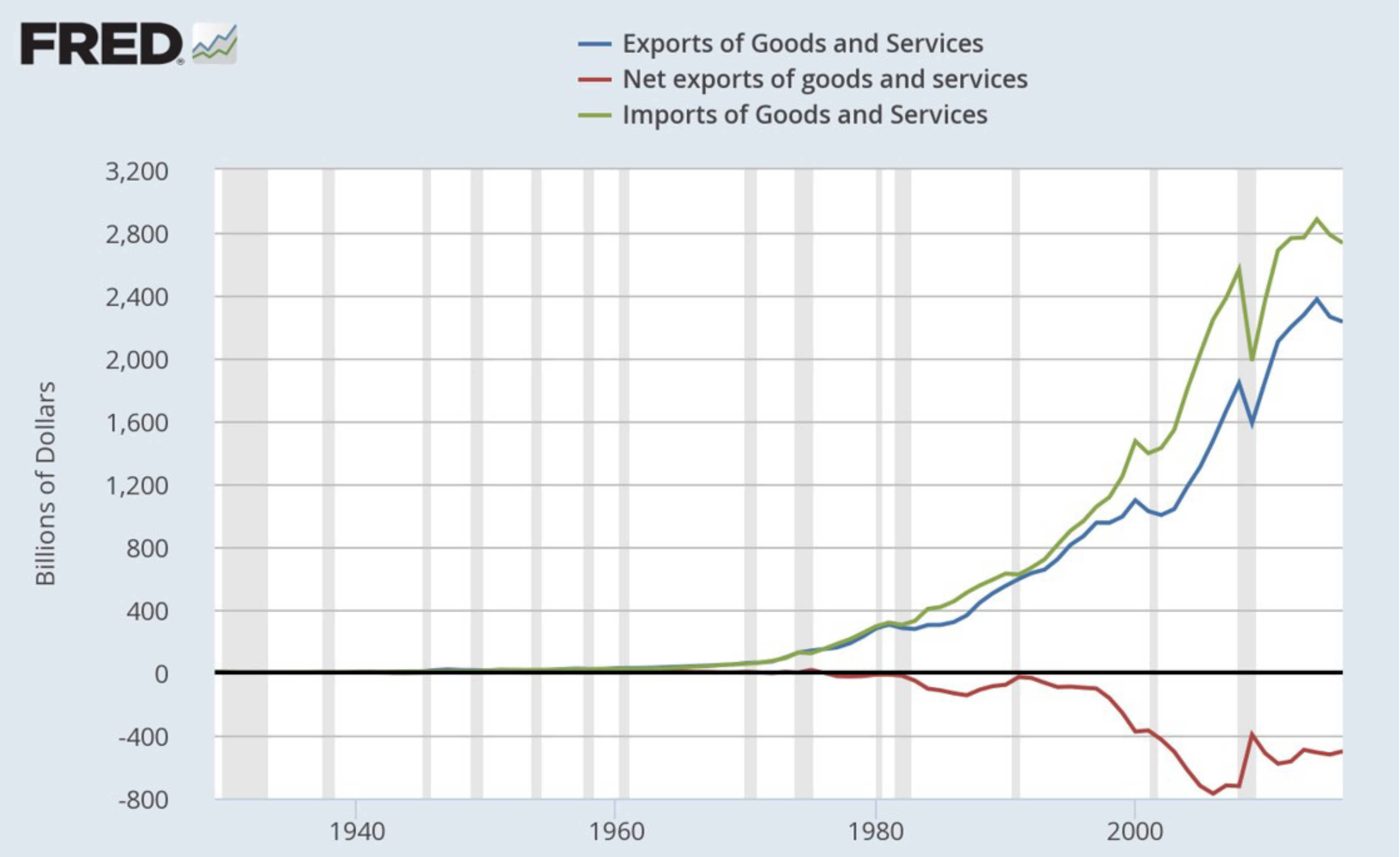
In 2019, the United States exported $2,528.2 billion in total, with only $164.5 billion going to China.

What does this mean? More importantly, should the US be concerned?

Net exports or the **trade balance** is defined as exports minus imports.

When the trade balance is positive, it is called a **trade surplus**.

When the trade balance is negative, it is called a **trade deficit**.



Source: U.S Bureau of Economic Analysis

The international accounting system is built on the concept of residency:

- Income-based payments *from* foreigners

- Income-based payments *to* foreigners

Income-Based Payments *from* Foreigners

1. Receiving payments from the sale of goods and services to foreigners: *exports*
2. Receiving income from assets that the domestic resident owns in foreign countries: *factor payments from foreigners*
3. Receiving transfers from individuals who reside abroad or from foreign governments: *transfers from foreigners*

Income-Based Payments *to* Foreigners

1. Making payments to foreigners in return for their goods and services: *imports*
2. Paying income on assets that foreign residents own in the domestic economy: *factor payments to foreigners*
3. Making transfers to individuals who reside abroad or to foreign governments: *transfers to foreigners*

The Current Account and the Financial Account

For each item, we can sum payments from foreigners (+) and payments to foreigners (–):

Net exports = (Payments from abroad for exports) – (Payments to foreigners for imports)

Net factor payments from abroad = (Factor payments from abroad) – (Factor payments to foreigners)

Net transfers from abroad = (Transfers from abroad) – (Transfers to foreigners)

The Current Account

The **current account** is the net flow of payments made to domestic residents from foreign residents on goods, services, factor payments, and transfers:

Current account = (Net exports) + (Net factor payments from abroad) + (Net transfers from abroad)

The Current Account

- In sum, current account summarizes the flow of all international market transactions in **goods, services, factor services** and nonmarket transfers.
- Example
  - A UK resident imports a Nintendo Wii
  - A German tourist purchases a ticket of a play in London
  - A Pilipino domestic worker in the UK remits her income back to the Philippines

The US Current Account and the Financial Account

The Current Account of the United States in 2019 (Billions of 2019 dollars)

	Payments from Foreigners	Payments to Foreigners	Net Payments
Trade in goods and services	2,514	3,125	-611
Factor payments	1,170	900	+270
Transfer payments	147	309	-162
Current account	3,831	4,334	-503

The Financial Account

- Financial account records international transactions in **assets.**
  - Debt (bonds and loans)
  - Equity
  - Real assets such as land
  - Transfers, gifts
- Example:
  - UK resident purchases an Apple stock
  - Nintendo deposits the check in a Barclays bank

The Current Account and the Financial Account

The **financial account** is the increase in domestic assets held by foreigners minus the increase in foreign assets held domestically.

The **financial account** is defined so that the net flows in the financial account offset the net flows in the current account:

(Current account) + (Financial account) = 0

Question: What are the consequences of running a current account deficit?

Idea: When U.S. residents make $503 billion of net payments to foreigners, the payments are made in U.S. dollars.

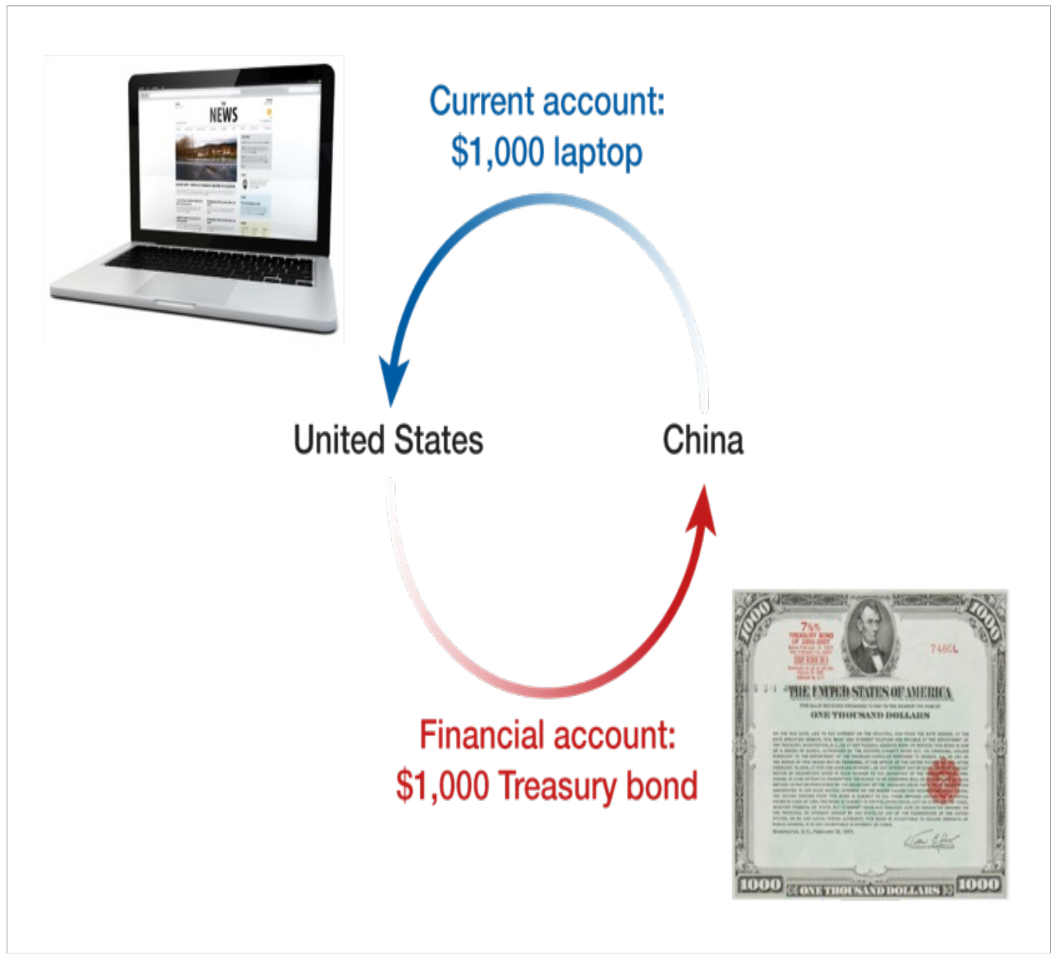
Answer: These dollars enable the foreign residents to buy U.S. assets, which can be exchanged for U.S. goods and services at some point in the future.

Let’s take an example, from the perspective of Hungary…

Transaction	Amount
A Hungarian citizen buys German state bonds	€10,200,500
Dividends received by Hungarian investors from foreign investments	€10,000
The Hungarian government provides tied aid to Sri Lanka	€500,000
Expenditure incurred by Mercedes to expand its capacity to build cars in Hungary	€1,000,000
Payments made by British citizens for medical services availed in Hungary	€20,000
Payment made by a Hungarian to rent a boat in Croatia	€30,000
Entry fees paid by French citizens to the National Museum in Budapest	€500
Receipt of funds from the European Union	€10,000,000
Salary earned by American citizens pursuing a temporary job in Hungary	€300,000

	Payments from Foreigners	Payments to Foreigners	Net Payments
Trade in goods and services	British people go to the dentist in Hungary, and French citizens visit the National Museum in Budapest	A Hungarian citizen rents a boat in Croatia	= 20,000 + 500 – 30,000 = –9,500
Factor payments	Hungarian investors receive dividends from their foreign investment	Americans come to Hungary to consult on a temporary job	= 10,000 –300,000 = –290,000
Net transfer payments	Hungary receives funds from the EU	The Hungarian state provides tied aid to Sri Lanka	= 10,000,000 – 500,000 = 9,500,000
Current account			9,200,500
	Increase in domestic assets held by foreigners	Increase in foreign assets held domestically	
Net sales to foreigners	Mercedes in Hungary is expanding its capacity to build cars	A Hungarian citizen buys German state bonds	= 1,000,000 –10,200,500
Financial account			= –9,200,500

The U.S. International Transaction Accounts



Some Accounting

- $Y = C+I+G$ in a closed economy
- $Y = C+I+G+NX$ in an open economy
  - $NX = S-I$ where $S = Y-C-G$
  - If $S>I$ current account surplus
  - If $S<I$ current account deficit

Net capital outflows are the difference between investment by the home country in foreign countries and foreign investment in the home country.

The national income accounting identities yields:

$$\mathbf{S - \mathit{I} = \mathit{NX} =} \textbf{\textit{Net capital outflows}}$$

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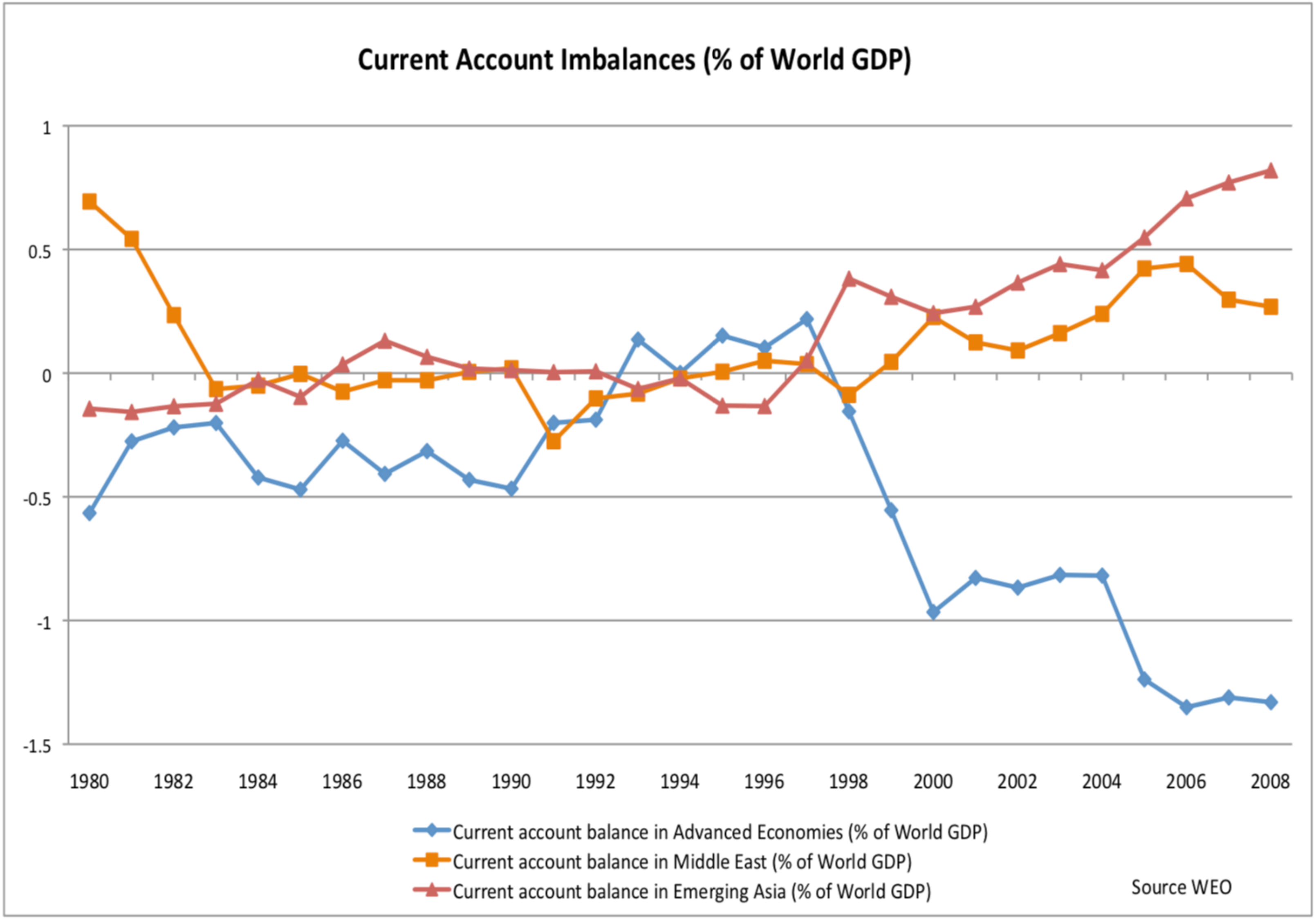


Current Account Imbalances (% of World GDP)
1
0.5
0
-0.5
-1
-1.5
1980
1982
1984
1986
1988
1990
1992
1994
1996
1998
2000
2002
2004
2006
2008
Current account balance in Advanced Economies (% of World GDP)
Current account balance in Middle East (% of World GDP)
Current account balance in Emerging Asia (% of World GDP)
Source WEO

- Can the U.S. borrow forever?
- At some point, it will have to repay by running trade surpluses—sharp depreciation?
- Two views:
  - Benevolent view: US has better financial assets
  - Pessimistic view: US borrowing beyond its means
  - Saving glut from emerging markets

Foreign Direct Investment (FDI)

Foreign direct investment refers to investments by foreign individuals and companies in domestic firms and businesses.

To qualify as foreign *direct* investment, this capital flow must generate a large ownership stake in a local firm for the foreign investors.

Foreign direct investment is a major conduit for technology transfer.

Are companies like Nike harming workers in Vietnam?

Question: Are companies like Nike harming workers in Vietnam?

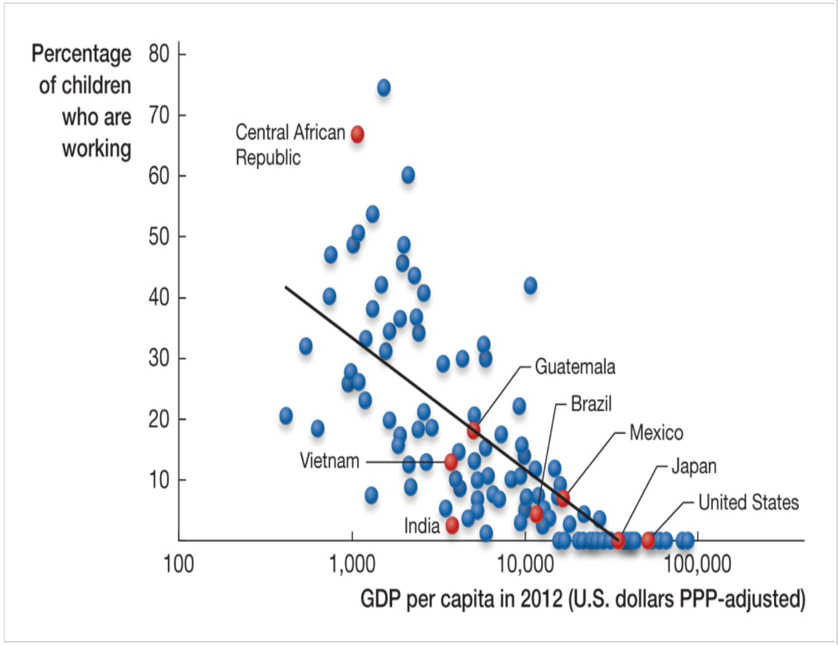
Data: Agricultural and factory wages in Vietnam, as well as data on trade, growth, poverty, and child labor-force participation.

Are companies like Nike harming workers in Vietnam?

Unskilled workers in the factories that manufacture Nike products earn \$4–\$5 per day under poor working conditions.

Unskilled workers on Vietnamese farms earn \$1–\$3 per day in similar conditions. Unskilled workers in the United States earn over \$50 per day.

GDP per capita and child labor (age 7-14)



Are companies like Nike harming workers in Vietnam?

Question: Are companies like Nike harming workers in Vietnam?

Answer: The Vietnamese workers who make Nike's sneakers are paid extremely low wages and work in unsafe conditions. However, the next best alternative—to work in the agricultural sector—appears to be even worse?!