Measuring Trade Across Borders

A Conversation About Trade Reports

Imagine that you are eating lunch at a posh Washington, D.C., restaurant. Seated at the next table are Ms. Deficit, a US trade negotiator, and her German counterpart, Herr Plus. Let's listen in on their conversation as they discuss the trade problems of their respective countries.

Ms. Deficit: This imbalance in our trade cannot continue. If you look in the balance of payments account, it is obvious that we have a deficit in the current account. This balance of trade deficit in the current account has put many of our exporting companies out of business and is pushing the United States into a recession.

Herr Plus: My country agrees that the situation cannot continue. The surplus in Germany's balance of trade is raising the price of our imported goods, and we are exporting so many goods that the German people are left with fewer products at home.

Ms. Deficit: So we agree something needs to be done. But what? Some of our businesses are calling for higher tariffs, and others want us to drop the value of the dollar, but neither of those actions is an acceptable alternative to the President.

Herr Plus: We also could raise the value of our currency or further stimulate our economy, but either of those actions would surely cost the Chancellor his job.

Fortunately, the waiter arrives to take our order, sparing us the rest of their conversation. While our order is being prepared, let's investigate some of the ideas the two diplomats are discussing.

What are the balance of payments accounts? They are an accounting report of all the payment flows leaving and entering a country, whether from individuals, businesses, or governments. The US Department of Commerce records all US international transactions to help government officials as well as interested private citizens and businesses make informed decisions concerning world trade and finance.

These transactions are divided into two categories: those which give rise to an inflow of payments between residents of one country and the rest of the world (called credits), and those which give rise to an outflow of payments (called debits). Consider the export of an automobile from the United States to Germany. The German buyer will supply the exchange market with euros in order to acquire the United States dollars needed to pay the US supplier. Likewise, a German tourist in the United States will supply euros to the currency market in order to buy dollars to pay bills in the United States. Both transactions are recorded as credits to the US balance of payments because they lead to an inflow of payments to the United States.

If US tourists plan to visit Germany, they must supply US dollars to the currency market to acquire euros. A US film buyer who wishes to acquire film rights to a German movie must supply US dollars to the currency market to acquire euros. Both transactions are recorded as debit items in the US balance of payments because they lead to an outflow of payments from the United States.

1. Do you understand what a credit is? Which way does the payment of money flow?

   ____

   ____

MEASURING TRADE ACROSS BORDERS

2. Do you understand what a debit is? Which way does the payment of money flow?

____

____

3. All trades must involve payment of money. What is not counted in these reports?

____

____

4. How would these reports change if the flow of money from illegal drug sales were reported?

____

____

THE CONVERSATION ABOUT TRADE REPORTS CONTINUES

Your food has arrived and your interest in the nearby conversation at the nearby table has returned. Is the current account deficit a bad thing for the United States? Or is Germany's surplus a bad thing for Germany? Here we must investigate a bit further. Ah, Ms. Money has arrived to join the trade negotiators at the table next to us. Ms. Money is an international banker. Let's eavesdrop again and hear what she has to say.

Ms. Money: You two are missing half the story! If the United States is importing more than it is exporting, how can it pay for the imports? By definition, what is acquired in imports must be either paid for or owed. What you have been ignoring is the flow of monetary capital: the so-called "capital/financial accounts."

Ms. Deficit: What has that got to do with this terrible deficit in the current account?

Herr Plus: Or our current account surplus?

Ms. Money: Let's consider your country's situation, Herr Plus. Your country is earning far more US dollars on its exports than it is using for its imports. What is happening to all those funds? Or your country, Ms. Deficit? How is the United States paying for that excess of imports over exports?

Herr Plus: I see what you mean. Many of our banks have invested those dollars back in the US banks and are earning interest on them. Other German companies are investing in buildings and other projects in the United States as well.

Ms. Deficit: And I believe we are also obtaining funds from your citizens who are buying US. Government bonds. This action helps to finance our government's budget deficit and helps keep our taxes down.

Ms. Money: Correct. So now you understand that a current account deficit or surplus is, simply, a measure of the balance between the goods and services being exchanged; it does not tell us much about the total amount of currency changing hands. You both were talking about an “imbalance” of trade as if your exchanges were like a teeter-totter with a football player on one end and a ballerina on the other.

I think now you understand that every exchange is beneficial to both sides and that the perceived imbalance in trade is really balanced by other, perhaps less visible activities. If trade truly were imbalanced, like the teeter-totter, it would stop very quickly.

Thank goodness that misunderstanding is cleared up! Let’s look more closely at the capital/financial account.

Suppose the US businesses borrow funds from Germany to finance imports which exceed exports of goods and services. Are the borrowed funds recorded as a credit or a debit item? To answer this question, it is easiest to think of the United States as an exporter of an IOU; and, like other exports, IOUs would be recorded as credits in the capital account. As before, this borrowing of funds would give rise to an inflow of payments to the United States, which was our definition of a credit. Likewise, if a US bank lends money to a German investor to construct a new building, this action would lead to a debit in the capital account of the US balance of payments because it give rise to an outflow of payments to Germany.

These two accounts, the current account and the capital/financial account, almost completely record the flow of currency into and out of the United States. But, like any measure, they are not completely accurate. The accounts include a place for “net errors and omissions” to measure unrecorded transactions and other imperfections in the data, and another account, the “reserves and related items account,” to measure movements of official intergovernmental settlements that do any “balancing” necessary during a given time.

1. What does the current account measure?

   ____

   ____

2. What does the capital/financial account measure?

   ____

   ____

3. Is borrowing entered as a debit or a credit? In which account?

   ____

   ____

4. Why do you think that the current account and capital/financial account don’t always balance exactly? Why is there a need for a net errors and omissions account?

   ____

   ____

MEASURING TRADE ACROSS BORDERS

HOW TO CALCULATE THE CURRENT ACCOUNT

Now it is your turn to record some international transactions. Record each of the transactions below in the respective balance of payments accounts of the United States and Germany. The first transaction has been done for you.

Remember to think about which way the cash goes and whether that is like revenues (fees earned) or expenses. Revenues, when money comes into a country, are counted as credits. Expenses, when money goes out of the country, are debits.

	United States		Germany	
	Debit	Credit	Debit	Credit
A US company sells $1 million of steel to a German builder		$1m	$1m	
Bank of America pays $5 million in interest to German depositors				
US citizens spend $3 million on Mercedes automobiles				
A US firm receives a $2 million dividend on its German investments				
German tourists spend $3 million in the United States, while American tourists spend $5 million in Germany				
A German firm pays $1 million to a US shipping line to transport load of cars				
US exchange students spend $8 million for tuition at a German university				
The German government buys a $10 million missile for the US Army to improve German defenses				
Total				

The transactions in the examples above are all recorded in the current account of the balance of payments, and are what most of us think of as exports and imports of goods and services. Notice that the United States has exported less than it has imported and is left with a deficit in its current account (debits exceed credits in respect to Germany). Germany is in exactly the opposite situation; it has a surplus in its current account in respect to the United States.