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Balance of Payments

by Herbert Stein

About the Author

Search the CEE
Browse the CEE
by title
by author
by category
Biographies
Appendix
Index
1st Edition
About the CEE
Frequently Asked Questions
FAQs about Searching CEE

Econlib Resources
About Econlib
Contact Econlib
Quote of the Day
Birthdays & Commemorations
Frequently Asked Questions
Get Econlib Newsletter

Few subjects in economics have caused so much confusion—and so much groundless fear—in the past four hundred years as the thought that a country might have a deficit in its balance of payments. This fear is groundless for two reasons: (1) there never is a deficit, and (2) it would not necessarily hurt anything if there was one.

The balance-of-payments accounts of a country record the payments and receipts of the residents of the country in their transactions with residents of other countries. If all transactions are included, the payments and receipts of each country are, and must be, equal. Any apparent inequality simply leaves one country acquiring assets in the others. For example, if Americans buy automobiles from JAPAN, and have no other transactions with Japan, the Japanese must end up holding dollars, which they may hold in the form of bank deposits in the United States or in some other U.S. INVESTMENT. The payments Americans make to Japan for automobiles are balanced by the payments Japanese make to U.S. individuals and institutions, including banks, for the acquisition of dollar assets. Put another way, Japan sold the United States automobiles, and the United States sold Japan dollars or dollar-denominated assets such as treasury bills and New York office buildings.

Although the totals of payments and receipts are necessarily equal, there will be inequalities—excesses of payments or receipts, called deficits or surpluses—in particular kinds of transactions. Thus, there can be a deficit or surplus in any of the following: merchandise trade (goods), services trade, foreign investment income, unilateral transfers (FOREIGN AID), private investment, the flow of gold and money between central banks and treasuries, or any combination of these or other international transactions. The statement that a country has a deficit or surplus in its "balance of payments" must refer to some particular class of transactions. As **Table 1** shows, in 2004 the United States had a deficit in goods of $665.4 billion but a surplus in services of $48.8 billion.

Many different definitions of the balance-of-payments deficit or surplus have been used in the past. Each definition has different implications and purposes. Until about 1973 attention was focused on a definition of the balance of payments intended to measure a country's ability to meet its

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obligation to exchange its currency for other currencies or for gold at fixed exchange rates. To meet this obligation, countries maintained a stock of official reserves, in the form of gold or foreign currencies, that they could use to support their own currencies. A decline in this stock was considered an important balance-of-payments deficit because it threatened the ability of the country to meet its obligations. But that particular kind of deficit, by itself, was never a good indicator of the country's financial position. The reason is that it ignored the likelihood that the country would be called on to meet its obligation and the willingness of foreign or international monetary institutions to provide support.

After 1973, interest in official reserve positions as a measure of balance of payments greatly diminished as the major countries gave up their commitment to convert their currencies at fixed exchange rates. This reduced the need for reserves and lessened concern about changes in the size of reserves. Since 1973, discussions of "the" balance-of-payments deficit or surplus usually refer to what is called the current account. This account contains trade in goods and services, investment income earned abroad, and unilateral transfers. It excludes the capital account, which includes the acquisition or sale of securities or other property.

Because the current account and the capital account add up to the total account, which is necessarily balanced, a deficit in the current account is always accompanied by an equal surplus in the capital account, and vice versa. A deficit or surplus in the current account cannot be explained or evaluated without simultaneous explanation and evaluation of an equal surplus or deficit in the capital account.

A country is more likely to have a deficit in its current account the higher its price level, the higher its gross national product, the higher its INTEREST RATES, the lower its barriers to imports, and the more attractive its investment opportunities—all compared with conditions in other countries—and the higher its exchange rate. The effects of a change in one of these factors on the current account balance cannot be predicted without considering the effect on the other causal factors. For example, if the U.S. government increases tariffs, Americans will buy fewer imports, thus reducing the current account deficit. But this reduction will occur only if one of the other factors changes to bring about a decrease in the capital account surplus. If none of these other factors changes, the reduced imports from the tariff increase will cause a decline in the DEMAND for foreign currency (yen, deutsche marks, etc.), which in turn will raise the value of the U.S. dollar (see FOREIGN EXCHANGE). The increase in the value of the dollar will make U.S. exports more expensive and imports cheaper, offsetting the effect of the tariff increase. The net result is that the tariff increase brings no change in the current account balance.

Table 1 The U.S. Balance of Payments, 2004

Goods	−665.4
Services	+48.8
Investment income	+30.4
Balance on goods, services, and income	−587.2
Unilateral transfers	−80.9
Balance on current account	−668.1
Nonofficial capital*	+270.6
Official reserve assets	+397.5
Balance on capital account	+668.1
Total balance	0

Source: U.S. Department of Commerce, *Survey of Current Business*.

Notes: Dollar amounts are in billions; += surplus; − = deficit.

*. Includes statistical discrepancy.

Contrary to the general perception, the existence of a current account deficit is not in itself a sign of bad economic policy or bad economic conditions. If the United States has a current account deficit, all this means is that the United States is importing capital. And importing capital is no more unnatural or dangerous than importing coffee. The deficit is a response to conditions in the country. It may be a response to excessive INFLATION, to low PRODUCTIVITY, or to inadequate SAVING. It may just as easily occur because investments in the United States are secure and profitable. Furthermore, the conditions to which the deficit responds may be good or bad and may be the results of good or bad policy; but if there is a problem, it is in the underlying conditions and not in the deficit per se.

During the 1980s there was a great deal of concern about the shift of the U.S. current account balance from a surplus of $5 billion in 1981 to a deficit of $161 billion in 1987. This shift was accompanied by an increase of about the same amount in the U.S. deficit in goods. Claims that this shift in the international position was causing a loss of employment in the United States were common, but that was not true. In fact, between 1981 and 1987, the number of people employed rose by more than twelve million, and employment as a percentage of POPULATION rose from 60 percent to 62.5 percent.

Many people were also anxious about the other side of the accounts—the inflow of foreign capital that accompanied the current account deficit—fearing that the United States was becoming owned by foreigners. The inflow of foreign capital did not, however, reduce the assets owned by Americans. Instead, it added to the capital within the country. In any event, the amount was small relative to the U.S. capital stock. Measurement of the net amount of foreign-owned assets in the United States (the excess of foreign assets in the United States over U.S. assets abroad) is very uncertain.

At the end of 1988, however, it was surely much less than 4 percent of the U.S. capital stock and possibly even zero. Later, there was fear of what would happen when the capital inflow slowed down or stopped. But after 1987 it did slow down and the economy adjusted, just as it had adjusted to the big capital inflow earlier, by a decline in the current account and trade deficits.

These same concerns surfaced again in the late 1990s and early 2000s as the current account went from a surplus of $4 billion in 1991 to a deficit of $666 billion in 2004. The increase in the current account deficit account, just as in the 1980s, was accompanied by an almost equal increase in the deficit in goods. Interestingly, the current account surpluses of 1981 and 1991 both occurred in the midst of a U.S. recession, and the large deficits occurred during U.S. economic expansions. This makes sense because U.S. imports are highly sensitive to U.S. economic conditions, falling more than proportionally when U.S. GDP falls and rising more than proportionally when U.S. GDP rises. Just as in the 1980s, U.S. employment expanded, with the U.S. economy adding more than twenty-one million jobs between 1991 and 2004. Also, employment as a percentage of population rose from 61.7 percent in 1991 to 64.4 percent in 2000 and, although it fell to 62.3 percent in 2004, was still modestly above its 1991 level.

How about the issue of foreign ownership? By the end of 2003, Americans owned assets abroad valued at market prices of $7.86 trillion, while foreigners owned U.S. assets valued at market prices of $10.52 trillion. The net international investment position of the United States, therefore, was $2.66 trillion. This was only 8.5 percent of the U.S. capital stock.[1]

About the Author

Herbert Stein, who died in 1999, was a senior fellow at the American Enterprise Institute in Washington, D.C., and was on the board of contributors of the *Wall Street Journal.* He was chairman of the Council of Economic Advisers under Presidents Richard Nixon and Gerald Ford. The editor, David R. Henderson, with the help of Kevin Hoover and Mack Ott, updated the data and added the last two paragraphs.

Further Reading

Dornbusch, Rudiger, Stanley Fischer, and Richard Startz. *Macroeconomics.* 9th ed. New York: McGraw-Hill Irwin, 2003. For general concepts and theory, see pp. 298–332.

Economic Report of the President. 2004. For good, clear reasoning about balance of payments, see pp. 239–264.

Survey of Current Business. Online at: **http://www.bea.gov/bea/pubs.htm** (for current data).

Footnotes

1. If by capital stock we mean the net value of U.S. fixed reproducible assets, which was $31.4 trillion in 2003. See *Survey of Current Business,* September 2004, online at: **http://www.bea.gov/bea/ARTICLES/2004/09September/Fixed_A**

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