Research Department
Federal Reserve
Bank of
San Francisco

April 20, 1984

FRBSF Weekly Letter

Which Trade Balance?

Humpty Dumpty: "When I use a word, it means just what I choose it to mean, neither more nor less." (Lewis Carroll, Through the Looking Glass.)

In February, newspapers across the nation reported that the U.S. "trade" deficit for 1983 was $60.6 billion. A month later they reported a 1983 "trade" deficit of $40.8 billion. But the national income account data given in the recent *Survey of Current Business* lists still another version of the "trade" deficit—$7.1 billion. Will the real trade deficit please stand up?

Neither media inaccuracy nor government revisions can be blamed for these discrepancies. Rather, what is commonly referred to as "the trade balance" is actually measured and reported in several different ways. Anyone wanting to know this balance has the following choices: the merchandise trade balance, itself measured in several ways; "GNP net exports", which gives the balance of trade in merchandise *and* services; or the current account balance. While these balances generally move closely together over time, their levels are typically very different. For example, it was the merchandise balance that was $60.6 billion in deficit last year, while the current account and GNP net export deficits were $40.8 and $7.1 billion, respectively. For those who still want to know what the deficit really was, this *Letter* provides a short "guide to the perplexed", explaining the various balances, their relation to one another, and their economic significance.

Current account

The most comprehensive summary of U.S. trade with the rest of the world is given by the current account balance. Indeed, the current account contains the other balances mentioned above and all the transactions in them.

The current account includes all transactions that are "current" in an accounting sense, that is, all payments and receipts for goods and services exchanged with foreigners, as well as transfers. Excluded from the current account are U.S. purchases from or sales to foreigners of financial or real assets. These items, which represent U.S. entities' lending to or borrowing from foreigners, comprise the capital account of the U.S. balance of payments.

If, in any year, total U.S. payments to foreigners on a current basis exceed our receipts from them (that is, we run a current account deficit), our country must borrow from abroad to make up the difference. Conversely, we must lend to foreigners any difference between our sales to them on a current basis and our payments. The current account surplus or deficit therefore also measures the *net* amount the U.S. as a whole is lending to or borrowing from abroad during a given year. Last year, we ran a current account deficit of $40.8 billion; this means that we borrowed a net amount of $40.8 billion from abroad.

The current account itself, though, contains three distinct types of transactions: *merchandise trade*, *productive services* provided by land, labor, and capital; and *transfers*, which include foreign aid and private remittances as well as payments to foreigners of interest on their holdings of U.S. government debt. These, in turn, are "arranged" into the three basic balances—merchandise trade, GNP net exports of goods and services, and, finally, the current account balance itself.

Merchandise trade balance

The merchandise trade account contains all exports and imports of *tangible commodities*, e.g., agricultural products, industrial materials such as steel, consumer manufactures, and capital goods. Actual merchan-

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dise trade figures are reported several different ways depending on the extent to which various services involved in transporting them are included.

Imports and exports on a "free-along-side" (f.a.s.) basis are valued as delivered to their point of embarkation for or departure from the U.S. The f.a.s. figures are thus the purest measures of the values of the commodities themselves. Other export/import figures refer to their value "free-on-board" (f.o.b.), that is, inclusive of loading and related costs. Still other figures include the "cost of insurance and freight" (c.i.f.) in addition to the loading costs and the actual (f.a.s.) commodity value.

The first merchandise trade balance figures reported each month by the Commerce Department, and the ones most frequently quoted in the media, are the "census" figures based on the export and import invoices recorded at various U.S. customs stations. These figures value imports at their *point of entry* into the U.S., that is, on a c.i.f. basis, while they value exports on an f.a.s. basis. (Commerce reports the balance on an f.a.s. basis for both exports and imports several days following the release of the census data.) The census balance thus includes the transport and other service costs of bringing imports to the U.S. but excludes the service costs involved in getting our exports abroad. Not surprisingly then, last year's census-based deficit of $69 billion was substantially larger than the f.a.s. merchandise deficit of $60.6 billion.

Services

Services provided by factors of production—land, labor and capital—are the second major category of transactions in the current account. Included in such "factor" services are personal travel and tourism, royalties and other fees from professional services, as well as all services associated with transporting and insuring U.S. merchandise trade.

However, the largest and most rapidly growing component of factor services represents payments for services provided by physical capital. These include recorded earnings from U.S. investments abroad as well as payments to foreigners on their investments in the U.S., *except* for the interest they earn on their holdings of U.S. government (federal, state and local) debt. Interest payments to foreigners on government debt are not included in these services (although they are included in the current account) because, according to U.S. national income accounting conventions, they represent a transfer rather than a payment for a current factor service.

Overall, the service balance typically records a large surplus, nearly $54 billion in 1983. This mainly reflects the fact that the U.S. earns considerably more on its investments abroad than it pays to foreigners on their investments here. Indeed, our reported investment receipts totaled $85 billion last year (nearly two-thirds of all service exports), exceeding payments to foreigners on their investments in the U.S. by nearly $47 billion.

The sum of the (f.a.s.) merchandise trade and service balances yields what is known as "GNP net exports." This is the net export figure given in the U.S. national income statistics and it is one of the four major components of U.S. GNP.

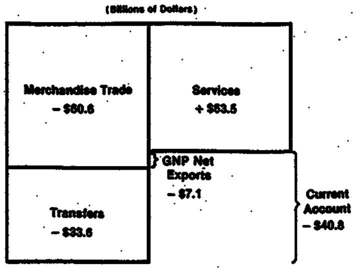
Transfers and the remainder

The remainder of the current account consists of unilateral transfers such as private contributions, pension payments, official foreign aid, as well as interest payments to foreigners on their holdings of U.S. government debt. The U.S. always runs a large deficit overall in these items, amounting to nearly $33 billion in 1983, $18 billion of which represented U.S. government interest paid to foreigners.

Meaning

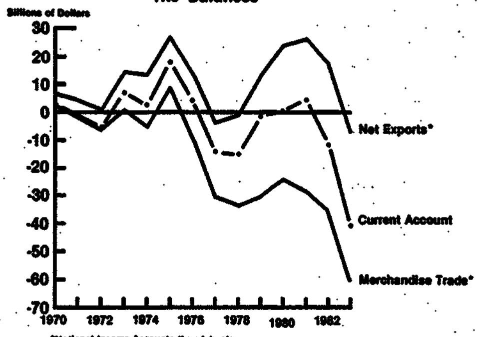
On this basis, last year's $41 billion current account deficit was the sum of our $61

Chart 1
Components of the Current Account: 1983
(Billions of Dollars)



Minus sign means deficit

Chart 2
The Balances



billion merchandise trade *deficit*, the $54 billion *surplus* on factor services (together making up the $7 billion deficit on GNP net exports), and our $33 billion *deficit* in transfers and U.S. government interest payments to foreigners (Chart 1).

Our merchandise trade balance has been in deficit in all but two of the last fourteen years, while the current account and GNP net exports have more often been in surplus (Chart 2). This pattern is due to the large U.S. surplus in factor services—a surplus that has grown very quickly in recent years mainly because of the rapid increase in receipts from our investments abroad. The services surplus means that the U.S. can have a substantial trade deficit even in years when our total current international payments and receipts (the current account) are in balance. Interestingly, the situation is the opposite for several of our trading partners. Japan, for example, typically runs a substantial deficit in services. Its merchandise trade therefore may be in surplus, as is usually the case, even when its current account is in deficit.

Although the merchandise trade balance gets the most media attention, the GNP net export and current account balances are more economically significant. In particular, GNP net exports provide the best summary measure of the foreign sector's impact on U.S. output and employment, while the current account balance measures the impact of the foreign sector on U.S. financial markets, including the value of the dollar on the foreign exchange markets.

GNP net exports comprise one of the four major components of U.S. GNP (along with private consumption and investment, and government expenditures), measuring the difference between foreign purchases of U.S. goods and services and U.S. purchases of foreign goods and services. As such, variations in GNP net exports have a direct and potentially substantial impact on the growth of our national output. As the foreign sector has grown in importance to the U.S. economy over the last decade, forecasts of U.S. growth have become increasingly sensitive to assessments of GNP net exports.

Finally, the current account's significance lies mainly in the fact that it measures the net flow of U.S. lending to or borrowing from abroad, and hence, the change over time in net U.S. indebtedness to foreigners. (The U.S. is still a net claimant on abroad, but this could change if our present deficits persist.) This flow, in turn, has potentially very important implications for financial conditions in the U.S. and for the value of the dollar on the foreign exchanges. In particular, the nearly $41 billion in funds the U.S. "imported" from abroad last year helped to meet the credit needs of our private sector and the growing demand for credit by the federal government. Upward pressures on U.S. interest rates would probably have been greater had these foreign funds not been available.

Likewise, concern is growing that the U.S. is borrowing from abroad at an unsustainably high rate through the current account. This has led several observers to predict a sharp decline in the dollar on the foreign exchanges in 1984 (to bring the current account to a more sustainable level). Thus, for financial markets these days, the "trade" balance to watch is mainly our current account.

Charles Pigott

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 4/04/84	Change from 3/28/84	Change from 12/28/83 Dollar	Percent Annualized
Loans, Leases and Investments[1,2]	177,973	1,323	1,948	4.1
Loans and Leases[1,6]	157,976	1,309	2,621	6.2
Commercial and Industrial	47,111	150	1,148	9.2
Real estate	59,510	91	611	3.8
Loans to Individuals	27,557	121	906	12.6
Leases	5,011	12	– 52	– 3.8
U.S. Treasury and Agency Securities[2]	12,241	42	– 266	– 7.8
Other Securities[2]	7,757	– 27	– 406	– 18.4
Total Deposits	189,072	3,955	– 1,925	– 3.7
Demand Deposits	45,744	2,838	– 3,493	– 26.3
Demand Deposits Adjusted[3]	29,888	1,102	– 1,443	– 17.1
Other Transaction Balances[4]	13,033	976	258	7.5
Total Non-Transaction Balances[6]	130,295	140	1,310	3.7
Money Market Deposit Accounts—Total	40,287	– 272	690	6.4
Time Deposits in Amounts of $100,000 or more	37,913	– 120	– 252	– 2.4
Other Liabilities for Borrowed Money[5]	17,114	–1,521	– 5,893	– 95.1

Two Week Averages of Daily Figures	Period ended 3/26/84	Period ended 3/12/84
Reserve Position, All Reporting Banks		
Excess Reserves (+)/Deficiency (–)	188	189
Borrowings	44	49
Net free reserves (+)/Net borrowed(–)	144	139

1 Includes loss reserves, unearned income, excludes interbank loans
2 Excludes trading account securities
3 Excludes U.S. government and depository institution deposits and cash items
4 ATS, NOW, Super NOW and savings accounts with telephone transfers
5 Includes borrowing via FRB, TT&L notes, Fed Funds, RPs and other sources
6 Includes items not shown separately

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