CHAPTER 14

The Link Between Trade and Capital Flows

Movements of goods and services across borders are often thought of as distinct from international capital flows. For example, an individual who allocates part of his or her retirement savings to a mutual fund that invests in an international portfolio might not think that this cross-border transaction has an impact on the price of imports, such as foreign cars or food at the supermarket. Yet, for important but subtle reasons, trade flows and capital flows are closely intertwined—indeed, they are two sides of the same coin.

This chapter explores the linkages between trade and capital flows. The key points in this chapter are:

- Changes in a country's net international trade in goods and services, captured by the current account, must be reflected in equal and opposite changes in its net capital flows with the rest of the world.
- The United States has experienced a large net inflow of foreign capital in recent years. Any such inflow must be accompanied by an equally large current account deficit.
- The size and movement of current and capital accounts reflect fundamental economic forces, including saving and investment rates, and relative rates of growth across countries.

The Basic Accounting Identity

The *balance of payments* is the accounting system by which countries report data on their international borrowing and lending, as well as on the flow of goods and services in and out of the country. The balance of payments includes a number of different accounts (Box 14-1). The central relationship of the balance of payments is that the *net* flow of capital into a country, as measured by the financial and capital accounts, must balance the *net* flow of goods, services, transfer payments, and income receipts out of the country, as measured by the current account.

When the current account balance is negative, this means that purchases of foreign goods and services (and other outflows) exceed sales of goods and services to foreigners (and other inflows). This situation is referred to as a *current account deficit*. The *trade balance* is generally the largest component of the current account and captures the net inflows of goods and services. A positive net flow of capital into the United States means that foreigners are purchasing more U.S. assets than U.S. citizens are purchasing foreign assets. According to the balance of payments, a positive net flow of capital into the United States must be balanced by a current account deficit.

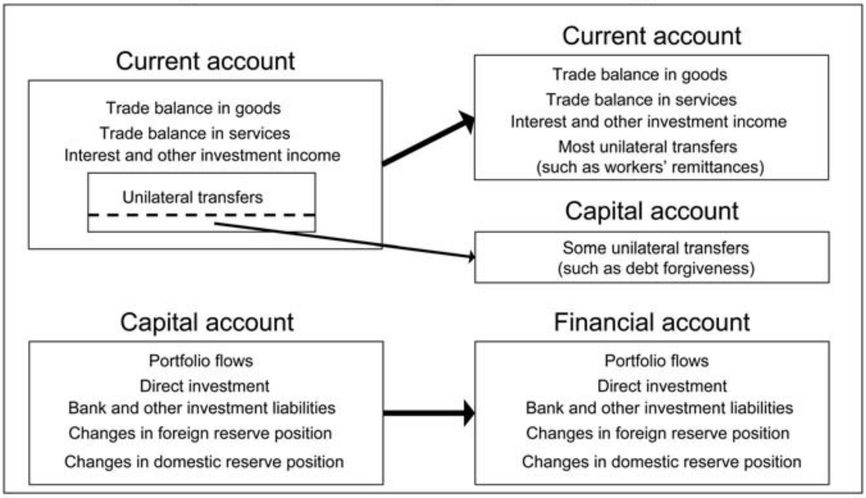
Box 14-1: A New Look for the Balance of Payments

Just as a country's national accounts keep track of macroeconomic variables such as GDP, saving, and investment, a country's balance of payments accounts serve as the bookkeeping for its international transactions, such as exports, imports, and international investment flows. In 1999, the Bureau of Economic Analysis announced that it would adopt new terminology to be consistent with international best practices for balance of payments accounting, as outlined by the International Monetary Fund.

The *old* balance of payments system used two accounts: the *capital account* and the *current account*. The *new* system uses three accounts (Chart 14-1). The new current account includes the trade balance in goods and services, net income receipts, and the balance of most unilateral transfers (one-way transfers of assets, such as pension payments to foreign residents). Some unilateral transfers, including debt forgiveness and the transfer of bank accounts by foreign citizens when immigrating to the United States, have been removed from the *old* current account and are now in a separate account, the *new* capital account. The new capital account represents a very small portion of overall capital flows. Private capital flows and changes in foreign and domestic reserves (formerly in the old capital account) are now in the *financial account*. This new treatment preserves the balance of payments identity that the sum of all the accounts is zero.

To simplify terminology, this *Economic Report of the President* refers to the new capital and financial accounts as *net capital flows*—that is, inflows of capital from foreign countries minus outflows from the United States. Positive net capital flows indicate that more capital is flowing into the United States than out.

Chart 14-1 **Changes to the Balance of Payments Terminology in 1999**



To understand how the balance of payments works in practice, consider a consumer in the United States who purchases a scarf from a foreign seller for one dollar. This transaction is recorded as an import and reduces the U.S. current account balance by one dollar. The foreign seller could spend the dollar on U.S. goods or on U.S assets, such as stocks or bonds. If the foreigner purchases U.S. goods, this would be recorded in the balance of payments as a U.S. export in the current account. The U.S. purchase of the foreign scarf and the foreign purchase of U.S. goods would cancel each other out, so there would be no change in the current account and no change in net capital flows. Alternatively, if the foreigner decided to purchase U.S. assets, this would be recorded as a capital inflow into the United States. The increase in net capital flows would balance the decrease in the U.S. current account. In both examples, the resulting change in the current account, if any, exactly balances any change in net capital flows.

Trade in goods can lead to changes in financial balances (such as with the payment for the scarf in the example above), or financial transactions can lead to changes in trade balances. The latter case would occur if a foreigner purchased a U.S. asset, such as a bond, and the American seller of the bond used the proceeds to purchase foreign goods. In both cases, the balance between the current account and net capital flows still holds.

To understand how financial flows can affect trade balances, suppose that at the prevailing rate of return, investors in the United States seek to undertake $200 billion worth of projects. If U.S. savers were willing to provide only $150 billion in capital through saving, then the other $50 billion could come from the rest of the world as $50 billion in capital inflows. If the U.S. investors choose to spend this capital inflow on foreign goods (perhaps imports of new computers), then net purchases of foreign goods would increase by $50 billion. The resulting $50 billion current account deficit would balance the $50 billion capital inflow. If investors in the United States were not able to obtain the initial $50 billion from abroad, both net capital flows and the current account would equal zero. There would be no current account deficit. Would this be good or bad? One immediate effect would be that the $50 billion gap between desired investment and saving would need to be closed by scaling back investment projects or raising national saving. These changes should be evaluated on their own merits; there is nothing particularly beneficial about having a trade balance or net capital flows exactly equal to zero.

A country's saving and investment decisions are critical to evaluating the implication of any given level of its current account balance. In a world without capital flows, the only funds available for investment come from domestic saving. Capital flows allow a country to finance higher levels of investment by drawing on funds from abroad. This net inflow of funds corresponds to greater net purchases from the world and a decline in the current account balance.

The desirability of positive net capital flows and a current account deficit depend on what the capital inflows are used for. Household borrowing—an excess of household spending or investment over saving—provides a useful analogy. Household debt could reflect borrowing to finance an extravagant vacation, a mortgage to buy a home, or a loan to finance education. Without knowing its purpose, the appropriateness of the borrowing cannot be judged. Similarly for countries, borrowing from abroad can be productive or unproductive. Borrowing from abroad can be justified if it raises the potential output of the economy and this, in turn, generates the resources needed to repay the foreign lenders.

This entire discussion has focused on trade balances and net capital flows with the world as a whole, and not with any individual country. There is no economic basis for concern about trade deficits and the corresponding net capital flows with an individual trading partner when there are many countries in the world (Box 14-2).

Box 14-2: Bilateral Versus Multilateral Balances

A country's aggregate trade deficit matters only to the extent that it reveals information about underlying economic forces, such as relative international growth rates or national saving and investment patterns. In contrast, *bilateral deficits*, such as the U.S. trade deficit with China, reveal *nothing* about underlying economic forces in either country. While trade barriers are a cause for concern, there is no economic sense in which a bilateral deficit is either good or bad. It would be an extraordinary coincidence if all countries had balanced trade with each of their partners. One of the benefits of the international financial system is that it frees countries from these bilateral constraints.

For example, imagine a simplified world that consisted of only the United States, Australia, and China. Suppose the United States ships $100 billion of machine tools to Australia and imports no goods in return. Australia ships $100 billion of wheat to China with no reciprocal goods imports, and China ships $100 billion of toys to the United States. Each country would have $100 billion of exports and $100 billion of imports, so that each would have balanced trade overall. Yet some Americans might complain about their bilateral deficit with China. Some Chinese might complain about their deficit with Australia, and some Australians about their deficit with the United States. All of these complaints would be unfounded; bilateral deficits and surpluses are a natural consequence of a trading world composed of many countries.

Domestic transactions provide a useful analogy. A plumber who spends no more than he earns can still run a bilateral deficit with the local grocer. The plumber can earn money from other sources to pay the grocer and is not constrained to buying only from grocers who have plumbing problems. The bilateral imbalance that exists between the plumber and the grocer is an entirely natural feature of a well-functioning economy with a strong payments system and specialization.