International Trade

by Sophia Tutorial

WHAT'S COVERED

This tutorial will cover the topic of international trade, discussing the balance of payments, as well as trade surpluses and deficits, and their impact on the balance of payments.

Our discussion breaks down as follows:

1. Balance of Payments
2. Current Account
3. Trade Surplus/Deficit
4. Capital Account

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1. Balance of Payments

When we are discussing international trade, we are focusing on the flow of goods and services, as well as capital, among countries.

Now, this is not a new occurrence; it has been taking place throughout history, though its importance increases more and more every decade, with certain impacts:

- Political effects
- Social effects
- Economic effects

So, how do we measure the economic impact of international trade on a nation? Well, one way is to measure the **balance of payments**. This involves comparing our demand and supply of foreign exchange or foreign currency.

The balance of payments is a record of all monetary transactions that flow across a country's border. The two major components are the current account and the capital account.

Let's briefly review this idea of foreign exchange.

Our demand for foreign exchange increases when we want to buy things in other currencies.

EXAMPLE For example, when Americans vacation in Mexico, or buy a German car, or invest in stock issued by a Japanese company, in all of these situations, they would need to purchase the foreign currency. This is because they need to supply their U.S. dollars in order to purchase these items in those currencies, whether it is in the yen, the euro, or the peso.

Our supply of foreign exchange increases when we sell our stuff to foreigners.

EXAMPLE Consider these examples:

- European tourists vacation in the United States
- A Japanese businessman flies on a U.S. airline
- Canadians invest in General Motors stock

In all of these situations, they would need to purchase U.S. currency with theirs, increasing our supply of foreign exchange.

TERM TO KNOW

Balance of Payments
A record of all monetary transactions that flow across a country's border; two major components are the current account and the capital account

2. Current Account

As mentioned, the balance of payments is composed of the current account and the capital account. Let's begin by discussing the **current account**, which represents the sum of all recorded transactions, including traded goods and services, income, and net transfer payments.

The current account is essentially the sum of our balance of trade. It shows how much a nation has spent on foreign goods, services, income, and transfer payments compared to how much it has earned in those things.

HINT

It is important to note that exports, with the goods and services, will credit this account and lead to a surplus in the current account, whereas imports will debit this account, creating a deficit in the current account.

EXAMPLE Here are some examples of the current account activities:

- Americans sell and purchase, otherwise known as import and export, foreign goods and services.
- Americans earn investment income by investing in foreign nations' stocks, bonds, etc.; any income earned off of those investments would be in the current account.
- Americans donate money to charity in other nations, such as a relief effort after a natural disaster, which is known as transfer payments.

TERM TO KNOW

Current Account
Represents the sum of all recorded transactions including traded goods, services, income, and net transfer payments

3. Trade Surplus/Deficit

Now, this is the point where **trade surplus and deficit** come into play.

A trade surplus occurs when our exports exceed our imports, meaning our net exports is positive.

$X - M > 0$

A trade deficit occurs when our imports are greater than our exports, meaning the net exports is negative.

$X - M < 0$

Now, exports are going to credit the current account and create a surplus. This will cause a nation's currency to appreciate over time because, in this situation, that nation's currency is being demanded in order to purchase these things measured in the current account.

> EXAMPLE When Europeans vacation here, they are demanding U.S. dollars and supplying their euros. Therefore, our nation's currency, the U.S. dollar, would be appreciating over time.

On the other hand, when we import things, this creates a deficit in the current account, which will cause a nation's currency to depreciate over time. When we are supplying a lot of our U.S. dollars in order to get other nation's currencies, then ours will lose value or depreciate against the other currencies.

TERM TO KNOW

Trade Surplus/Deficit
Trade surplus occurs when exports exceed imports ($X – M > 0$) and a trade deficit occurs when imports exceed exports ($X – M < 0$)

4. Capital Account

Every transaction that is occurring in the current account is offset by an equal and opposite activity in the **capital account**, which captures investment and financing flows.

Whereas exports in the current account have an appreciating impact on a currency, now it is inflows in the capital account that will have an appreciating impact on a currency. Outflows have an opposite effect, or depreciating impact.

The capital account involves comparing a nation's ownership of foreign assets with foreign ownership of that nation's assets.

> EXAMPLE Examples would include the purchase or construction of machinery, buildings, or plants in other nations, or the investment in a foreign nation's shares and bonds.

Now, when foreigners are investing in those kinds of things in our country, that represents an inflow into the capital account, which creates a surplus.

Conversely, if our citizens are investing in those things in foreign nations, this is an outflow which creates a deficit in the capital account.

HINT

Remember, these activities are opposite to what is going on in the current account. Because these two things are offsetting each other, these two accounts would sum to zero.

IN CONTEXT

Let's explore a real-world example of how the current account and capital account work together.

Suppose you decide to buy a German car. What kind of impact does that have?

Well, first of all, if you buy a German car, that means that U.S. imports are increased by that car, which represents the impact in the current account.

On the other hand, foreign assets in the United States are also increased, which occurs in the capital account. You had to supply your dollars in order to purchase the car in euros. You are demanding euros, and therefore, foreign ownership in the U.S. is increased.

The net result is that the net wealth position of the U.S. compared to the rest of the world has decreased by the price of the car.

Clearly, one person's purchase of a car is not going to have a dramatic impact, but you can see that over time, being a net-exporting or net-importing nation can have a significant impact on a nation's currency and the current and capital accounts.

TERM TO KNOW

Capital Account
Captures investment and financing flows; inflows have an appreciating impact on a given currency; outflows have the opposite, or depreciating, impact.

SUMMARY

Today we learned about the **balance of payments** and how it is composed of the **current account** and the **capital account**. We learned that the current and capital accounts contain equal and opposite transactions, so they sum to zero. We also learned about **trade surpluses and deficits** and the impact that they have on the balance of payments.

Source: Adapted from Sophia instructor Kate Eskra.

TERMS TO KNOW

Balance of Payments
A record of all monetary transactions that flow across a country's border; two major components are the current account and the capital account.

Capital Account
Captures investment and financing flows; inflows have an appreciating impact on a given currency; outflows have the opposite, or depreciating, impact.

Current Account
Represents the sum of all recorded transactions including traded goods, services, income, and net transfer payments.

Trade Surplus/Deficit
Trade surplus occurs when exports exceed imports ($X - M > 0$) and a trade deficit occurs when imports exceed exports ($X - M < 0$).