Re: Balance of payments

Source: http://sci.tech−archive.net/Archive/sci.econ/2005−04/msg00165.html

- *From*: William F Hummel <wfhummel@xxxxxxxxxxx>
- *Date*: Sat, 09 Apr 2005 10:57:40 −0700

On Sat, 09 Apr 2005 07:55:30 GMT, "Curt" <curt2@xxxxxxxxxxxx> wrote:

>To be completely honest I'm actually a little confused; what exactly is
>meant by financing the deficit? why is this necessary? (Id imagine that
>sounds very stupid, but I need to check I know what's going on)

Financing means borrowing to pay. If you already had the funds
required to cover the purchase you wouldn't need to finance it.
>
>Could you give me an example? Say I go out and buy a Mercedes, which has
>been imported from Germany. The money I pay must go back to Germany. Exactly
>where in the loop does money show up in the loop? Does it have something to
>do with the fact that the Germans will sell the pounds I've given them?
>Could you clarify this?
>
>Sorry, I know I'm sounding really dumb now, but seeing as I have relative
>anonymity here, I don't terribly mind ;−).
>
>Thanks again,
>
>Curt
>
The balance of payments record is an accounting of receipts and
payments between one country and all other countries. From the U.S.
perspective, a receipt represents any dollars flowing into the country
or any transaction that require the exchange of foreign currency into
dollars. A payment represents dollars flowing out of the country or
any transaction that requires the conversion of dollars into some
other currency.

A country runs a current account deficit when its payments exceed its
receipts for goods and services or investment income. A country runs
a capital account surplus when its receipts exceed its payments for
the purchase of bonds, equities, and direct investments.

One nation invests in another by selling more goods and services to it
more than it buys. For example, when an American buys a Japanese−made
auto and pays in dollars, the Japanese auto company acquires a dollar
balance in a U.S. bank. In so doing, the Japanese company has

invested in the U.S. If the auto were invoiced in yen, the buyer would have to exchange dollars for yen in order to pay for it. That means the seller of yen rather than the Japanese auto company has invested in the U.S. Ultimately that is another Japanese.

Foreign investment in the U.S. equals the deficit in its so−called current account. The major item in the current account is the trade in goods and services. Each year the U.S. has a deficit in its current account, the net claims of foreigners on its residents increases.

Foreigners can use their dollar holdings in at least four different ways:

(1) They can invest them in dollar−denominated assets including new enterprise, which will help support U.S. economic growth.

(2) They can buy U.S. goods and ship them home for their own use or resale, which will reduce the trade deficit and help support U.S. employment.

(3) They can trade them for their own or another currency in the forex market, in which case the dollars will simply change hands without affecting net investment in the U.S.

(4) They can sell the dollars to their central banks, which will invest them in U.S. Treasury securities, thereby helping to hold down long term interest rates.

As long as foreigners run a net current account surplus with the U.S., their dollar−denominated assets will necessarily increase. They can repatriate their dollar holdings individually, but not collectively.
A wave of selling dollars would leave the same quantity of dollars in foreign hands, but at a lower value in terms of the foreign currencies. That means the current account deficit is largely self−correcting if foreigners collectively try to repatriate their dollars.
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