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trade (im)balance

Current account

If typically trade is about the exchange of goods between two or more economies.

Formally this exchange is accounted on the Current Account (CA)

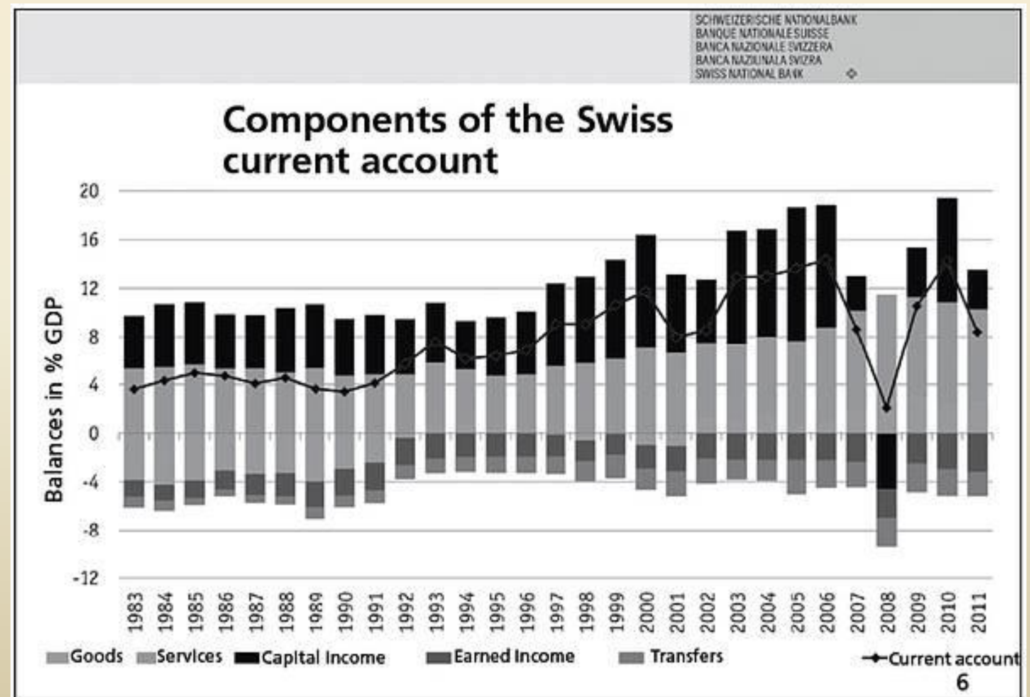
$CA = (E - H) + NY + NCT$

E = exports

H = imports

NY = net income from abroad

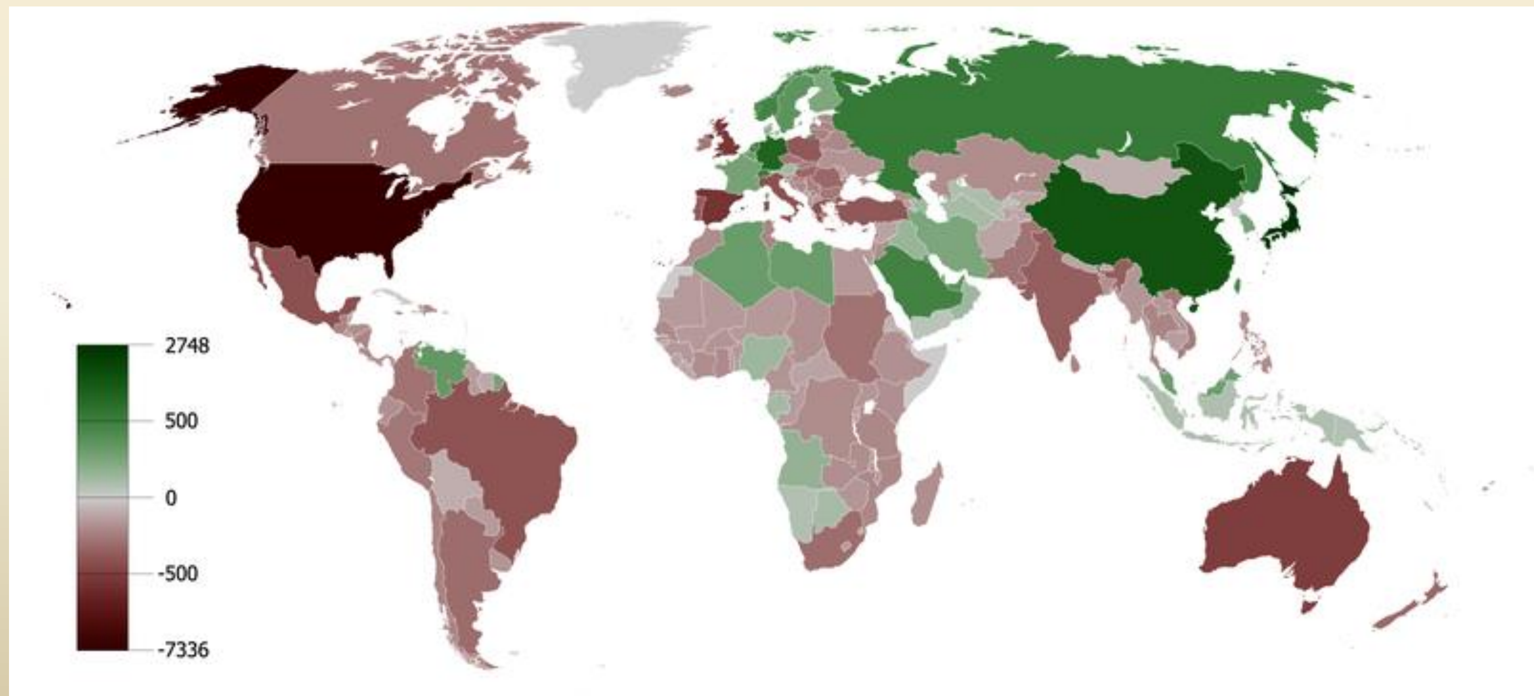
NCT = net current transfers



The following components are accounted:

1. Goods: general merchandise, goods for processing, repairs on goods, goods procured in ports by carriers, trade of non-monetary gold.
2. Services: transportation, insurance, travel, communications, construction, finance, information transactions, royalties and license fees and recreational services.
3. Income: compensation of employees and investment income.
4. Current transfers: state international cooperation, payments of current taxes and benefits

Thus the current account is in balance when the difference between exports E and imports H is nil: CAB = X = E – H = 0. Thus when E > H, there is current account surplus = main exporter (in green) and when E < H there is current account deficit = main importer (in dark purple)



Capital account

But it is not only goods that are traded: capital crosses borders too. Formally such capital constitutes the Capital Account (KA) (financial account)

It includes the following main components:

1. Capital flows: transfers of ownership of fixed assets, migrants' transfers, debt forgiveness, patented entities, leases.
2. Direct investment (transaction between the investor and the firm): equity capital, reinvested earnings and inter-company transactions.

3. Portfolio investment (transactions in equity securities and debt securities): bonds, notes, derivatives.
4. Credits: loans, deposits, trade credits.
5. Reserve assets (transactions that are used to meet the balance of payments): monetary gold, foreign exchange assets.

But the capital account must also be in balance:

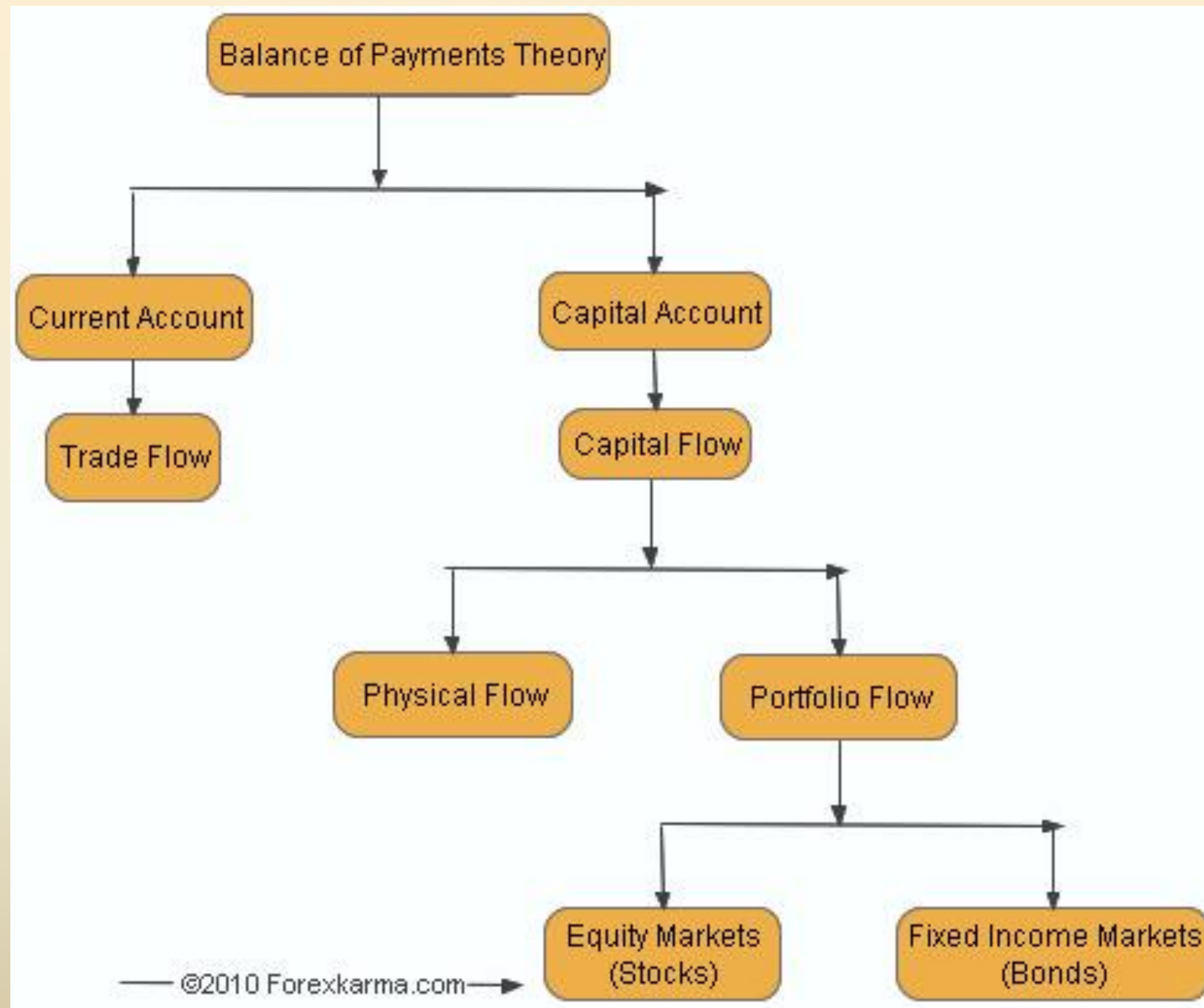
capital inflows and outflows must be equal

BoP

The Balance of Payments (BOP) refers to the equilibrium between the goods traded, the Current Account (CA), and capital flows, the Capital Account (KA).

Otherwise put, the sum of all international transactions, current CAB and capital KAB, is in principle equal to zero (balance of payments identity):

CAB + KAB = 0.


Balance of Payments Theory
Current Account
Capital Account
Trade Flow
Capital Flow
Physical Flow
Portfolio Flow
Equity Markets (Stocks)
Fixed Income Markets (Bonds)
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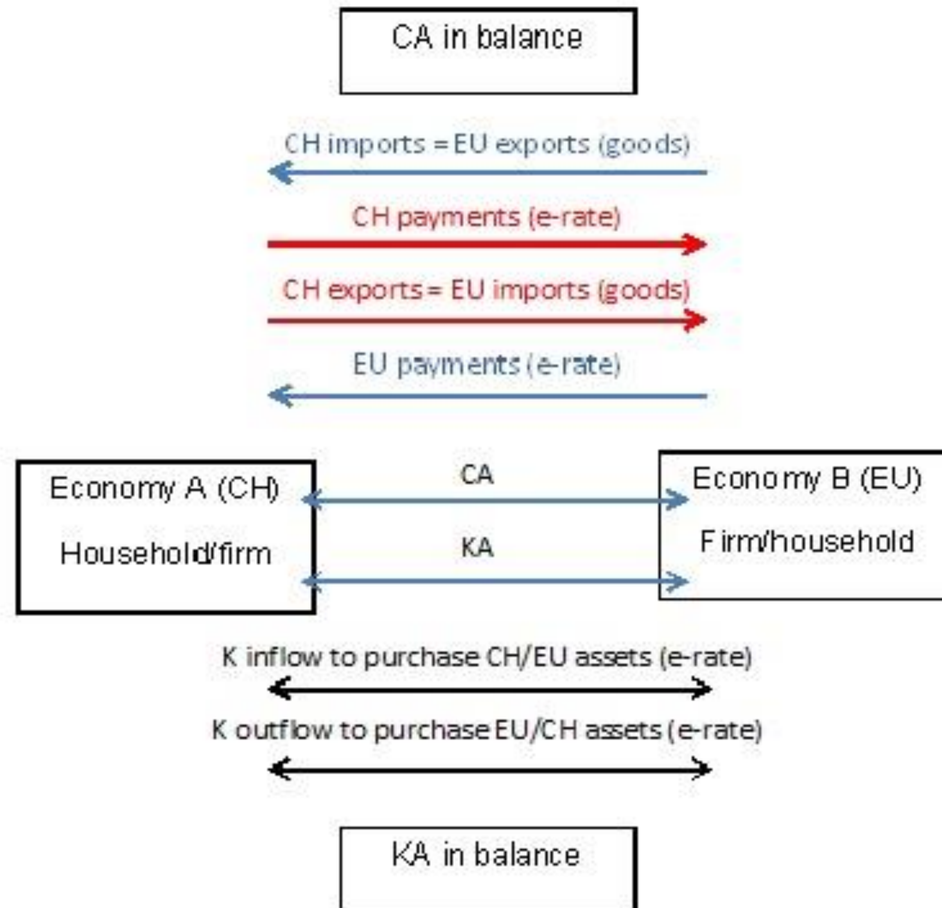


Figure 1

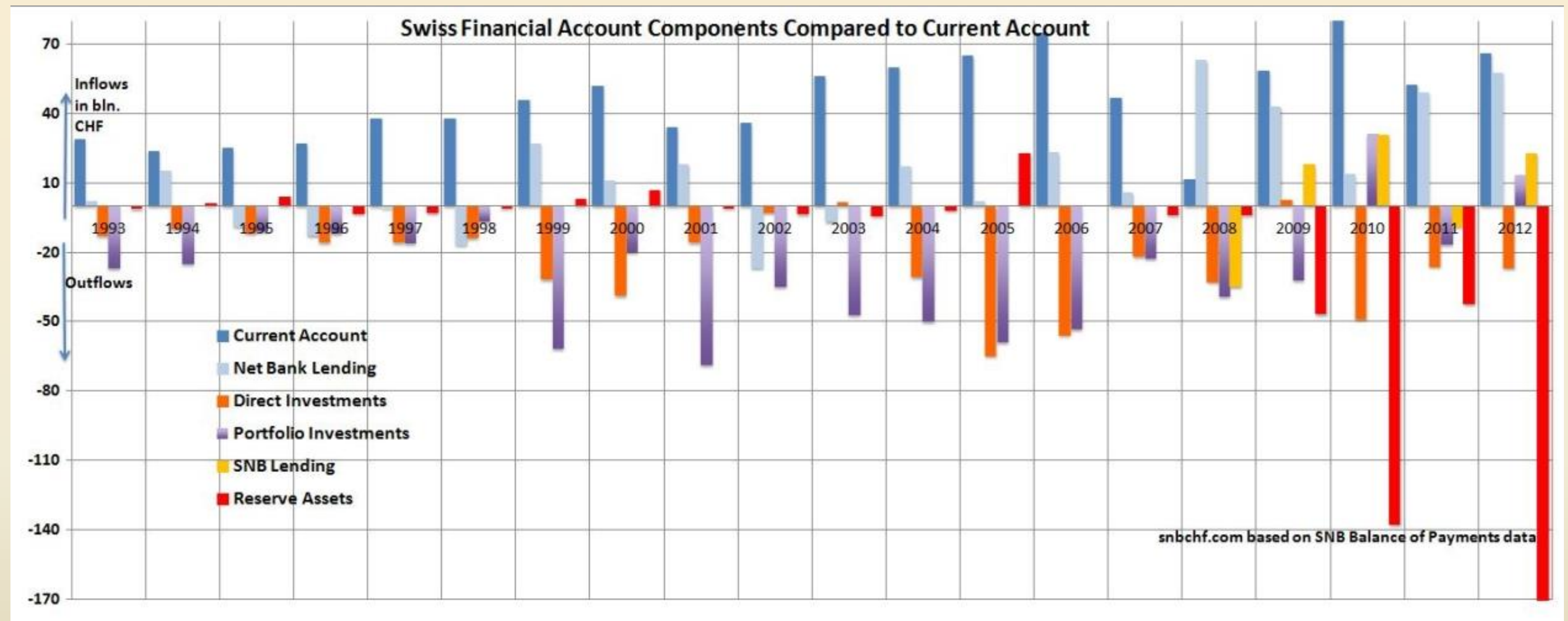
Imbalance

Thus a trade imbalance occurs when CAB > KAB or that CAB < KAB

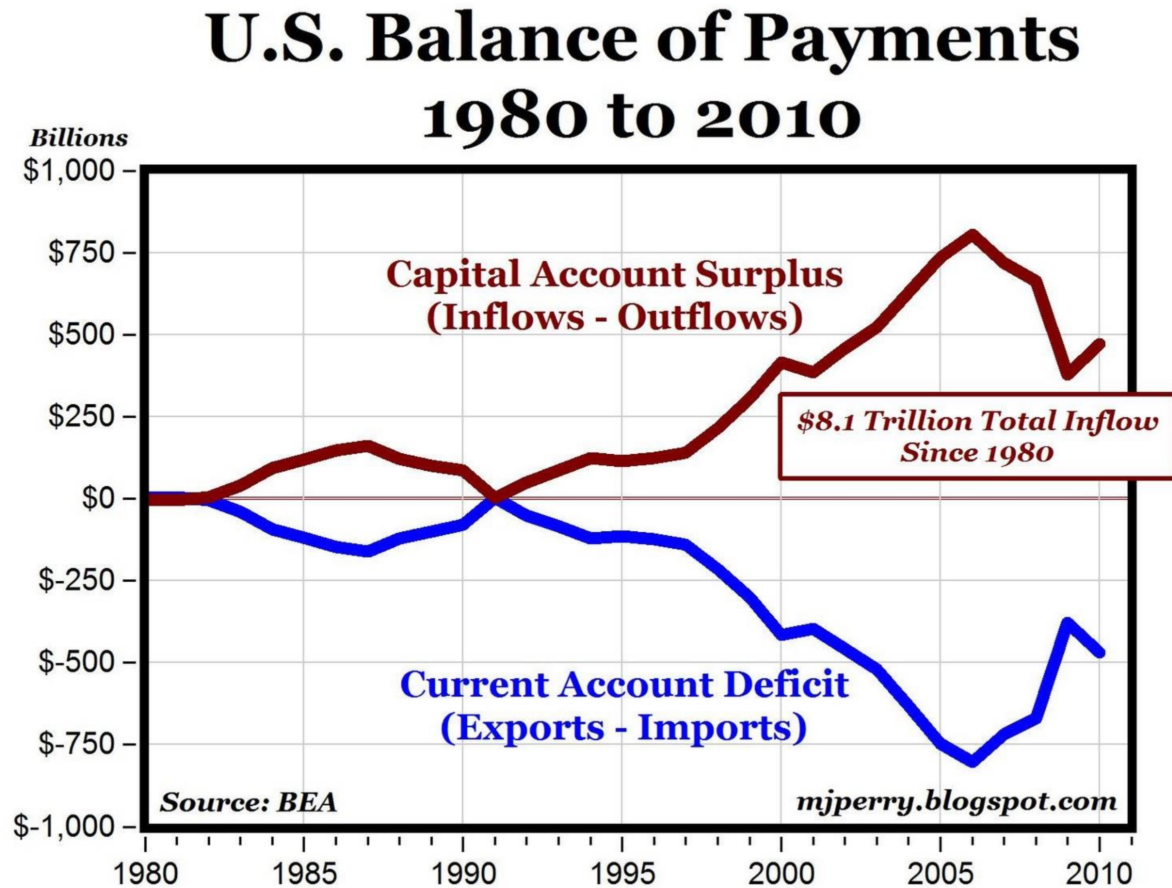
Correcting the imbalance implies selling or buying capital assets, respectively. Thus major importing economies (e.g. US) will tend to sell their assets to major exporting economies (e.g. China) and vice versa.

The BOP is in surplus when both CAB and KAB are in surplus, and in deficit when both accounts are in deficit

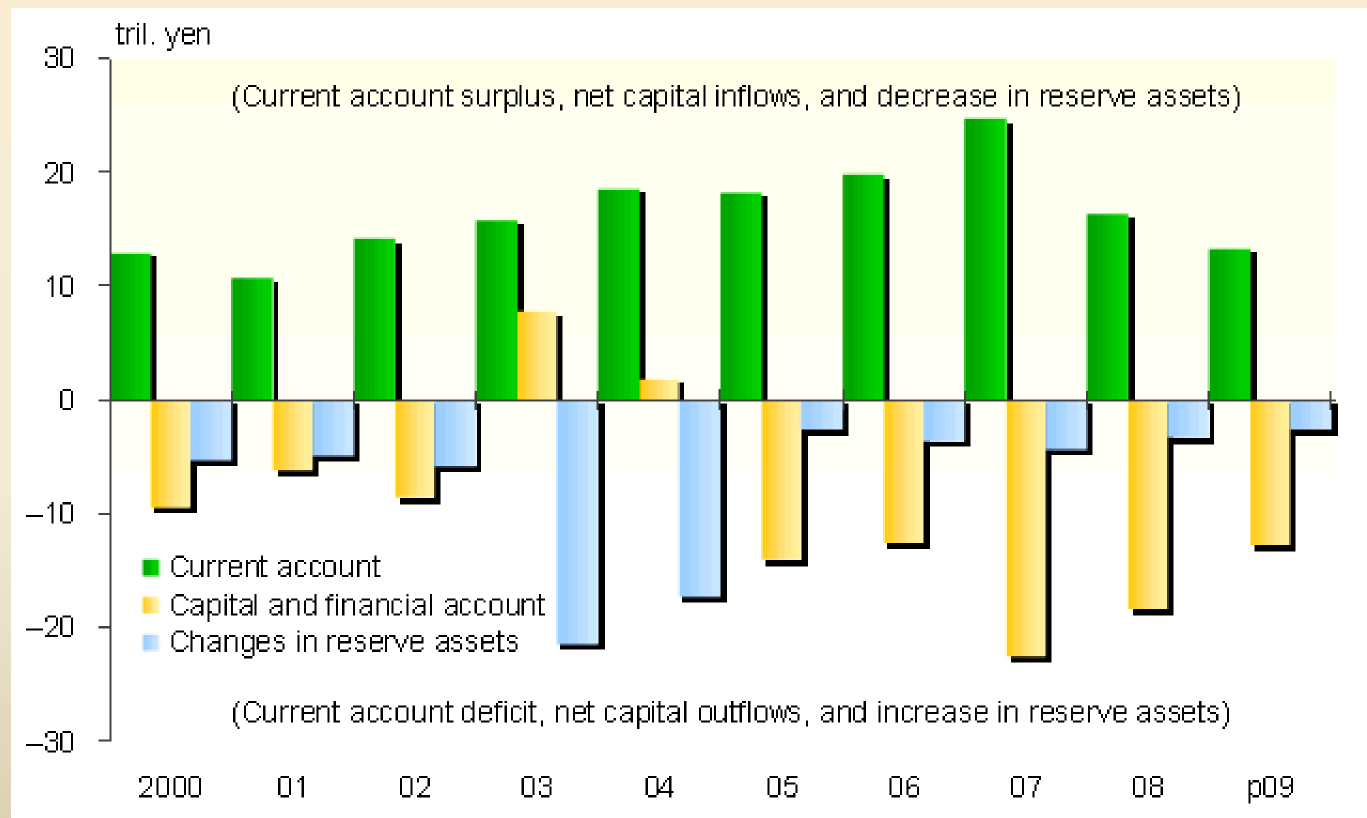
Example: CH



Example: US



Example: Japan



Example: Australia