

3.4: Some Further Complications

Learning objective

1. Recognize how the long-term consequences of trade deficits change when they are financed by equity rather than debt.

The analysis of trade imbalances is further complicated by the fact that not all financial flows are debt obligations or IOUs (i.e., I owe you). In the previous stories, we assumed that all financial account transactions corresponded to international lending or borrowing. In actuality, many international asset transactions involve sales or purchases of productive assets. For example, if a foreigner purchases shares of Microsoft stock in the U.S. market, the transaction would be recorded as a credit entry on the financial account and would add to a financial account surplus. However, in this case we could not claim that someone in the United States borrowed money from the rest of the world because there is no obligation to repay principal and interest in the future. Instead the foreign purchaser of the U.S. asset has purchased an ownership claim in a U.S. corporation that entitles him to the future stream of dividends plus capital gains if he sells the stock later at a higher price. If the company is profitable in the future, then the investors will earn a positive return. However, if the company suffers economic losses in the future, then the dividends may be discontinued and the stock's price may fall. Alternatively, the U.S. dollar could experience a significant depreciation. The end result could be losses for the foreign investor and a negative rate of return. In either case the foreign investor is not “entitled” to a return of his original investment or any additional return beyond. This same type of relationship arises for international real estate transactions and for foreign direct investment, which occurs when a foreign firm substantially owns and operates a company in another country.

To the extent that financial account flows correspond to asset purchases without repayment obligations, the stories above change somewhat. For example, suppose a country runs a trade deficit in period one and suppose further that the resulting financial account surplus corresponds to foreign purchases of U.S. real estate and businesses. In the first period, a country's standard of living could be raised above what is possible with balanced trade—not by borrowing money but by selling ownership claims on productive assets. In the second period, the country's standard of living need not be reduced since there is no repayment obligation.

This case is analogous to an individual who sells his watch at a pawnshop. In that period he is able to buy more than his income because he has divested some of his previously accumulated wealth. In the following period, he can once again make purchases equal to his income and thus need not suffer a reduction in his living standards.

The implication here is that nondebt asset flows may be less problematic than international loans because they do not require a reduction in living standards in the future. Of course, in this case, there is an additional concern that the country that sells off its assets may also be losing control of its productive assets and thus its citizens will not be the ones to earn positive returns on these domestic activities. This concern should be tempered for a few reasons. First, foreign-owned firms remain subject to the laws of the domestic country. Countries can prevent exorbitant profit taking by applying profit taxes. What's more, the foreign owners do not enjoy voting privileges and thus have less say over laws that might affect them. Second, foreign-owned firms generate employment opportunities for domestic citizens, and that serves to benefit the country. Finally, owners of firms, whether foreign or domestic, are generally motivated by similar desires—namely, to make the business successful— and successful businesses generally benefit the owners, the employees, and the consumers of the product.

As an example, consider the purchase in the 1980s of Rockefeller Center in New York City by a group of Japanese investors. Rockefeller Center is a centrally located building in New York City whose owners lease office space to businesses that wish to locate their offices there. Any owner of the building must compete with other businesses leasing office space throughout the city and thus must provide as high a quality and as low a price as possible. If the owners manage the property well and provide quality services, then they will have a lot of tenants and they will make a profit. If they provide poor services, then businesses will move out and the owners will lose money. Thus it really shouldn't matter to the tenants whether the owners are American or Japanese, only whether they are good managers of the office space. Similarly, the owners, regardless of nationality, will hire workers to maintain the facilities. These workers will benefit if the management is good and will suffer if it is poor, regardless of the owners' nationality. Finally, if the owners of the building are successful, then they deserve to earn a profit or return on their investment. If they provide poor services at high prices, then they will deserve to make a loss. Indeed, it shouldn't matter to anyone whether the owners are American or Japanese nationals.

Key Takeaways

- A trade deficit financed by sales of equity rather than debt does not require a repayment in the future or a subsequent decline in consumption. However, it does imply that a flow of the profits from domestic activities will accrue to foreigners rather than domestic residents.

Exercise

1. **Jeopardy Questions.** As in the popular television game show, you are given an answer to a question and you must respond with the question. For example, if the answer is “a tax on imports,” then the correct question is “What is a tariff?”
 - The full form of the abbreviation “IOU.”
 - The terms representing the two broad types of assets; one is related to borrowing and lending and the other is related to ownership.
 - The type of asset represented by a bank certificate of deposit.
 - The type of asset represented by a common or preferred share of stock.
 - The type of asset represented by a checking account deposit.
 - The type of asset represented by the deed to a private golf course.
 - International purchases of this type of asset require repayment of principal and interest in the future.
 - International purchases of this type of asset do not require repayment of principal and interest.

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