

F O U R

THE BALANCE OF  
PAYMENTS AND  
INTERNATIONAL  
ECONOMIC LINKAGES

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*I had a trade deficit in 1986 because I took a vacation in France. I didn't worry about it; I enjoyed it.*

*Herbert Stein  
Chairman of the Council  
of Economic Advisors under  
Presidents Nixon and Ford*

*We have almost a crisis in trade and this is the year Congress will try to turn it around with trade legislation.*

*Lloyd Bentsen  
Former U.S. Senator from Texas*

*Despite all the cries for protectionism to cure the trade deficit, protectionism will not lower the trade deficit.*

*Phil Gramm  
U.S. Senator from Texas*

*A* key theme of this book is that companies today operate within a global marketplace, and they can ignore this fact only at their peril. In line with that theme, the purpose of this chapter is to present the financial and real linkages between the domestic and world economies and examine how these linkages affect business viability. The chapter identifies the basic forces underlying the flows of goods, services, and capital between countries and relates these flows to key political, economic, and cultural factors.

Politicians and the business press realize the importance of these trade and capital flows. They pay attention to the balance of payments, on which these flows are recorded, and to the massive and continuing U.S. trade deficits. As we saw in chapter 3, government foreign exchange policies are often geared toward dealing with balance-of-payments problems. However, as indicated by the three quotations that opened the chapter, many people disagree on the nature of the trade deficit problem and its solution. In the process of studying the balance of payments in this chapter, we will sort out some of these issues.

## 4.1 BALANCE-OF-PAYMENTS CATEGORIES

The **balance of payments** is an accounting statement that summarizes all the economic transactions between residents of the home country and residents of all other countries. Balance-of-payments statistics are published quarterly in the United States by the Commerce Department and include such transactions as trade in goods and services, transfer payments, loans, and short- and long-term investments. The statistics are followed closely by bankers and business people, economists, and foreign exchange traders; the publication affects the value of the home currency if these figures are more, or less, favorable than anticipated.

Currency inflows are recorded as *credits*, and outflows are recorded as *debits*. Credits show up with a plus sign, and debits have a minus sign. There are three major balance-of-payments categories:

- **Current account**, which records flows of goods, services, and transfers
- **Capital account**, which shows public and private investment and lending activities
- **Official reserves account**, which measures changes in holdings of gold and foreign currencies—*reserve assets*—by official monetary institutions.

Exports of goods and services are credits; imports of goods and services are debits. Interest and dividends are treated as services because they represent payment for the use of capital. Capital inflows appear as credits because the nation is selling (exporting) to foreigners valuable assets—buildings, land, stock, bonds, and other financial claims—and receiving cash in return. Capital outflows show up as debits because they represent purchases (imports) of foreign assets. The increase in a nation's official reserves also shows up as a debit item because the purchase of gold and other reserve assets is equivalent to importing these assets.

The balance-of-payments statement is based on double-entry bookkeeping; every economic transaction recorded as a credit brings about an equal and offsetting debit entry, and vice versa. According to accounting convention, a source of funds (either a decrease in assets or an increase in liabilities) is a credit, and a use of funds (either an increase in assets or a decrease in liabilities or net worth) is a debit. Suppose a U.S. company exports machine tools to Switzerland at a price of 2,000,000 Swiss francs (SFr). At the current exchange rate of SFr 1 = \$0.75, this order is worth \$1,500,000. The Swiss importer pays for the order with a check drawn on its Swiss bank account. A credit is recorded for the increase in U.S. exports (a reduction in U.S. goods—a source of funds)

and, because the exporter has acquired a Swiss franc deposit (an increase in a foreign asset—a use of funds), a debit is recorded to reflect a private capital outflow:

	<u>Credit</u>	<u>Debit</u>
U.S. exports	\$1,500,000	
Private foreign assets		\$1,500,000

Suppose the U.S. company decides to sell the Swiss francs it received to the Federal Reserve for dollars. In this case, a private asset would have been converted into an official (government) liability. This transaction would show up as a credit to the private asset account (as it is a source of funds) and a debit to the official assets account (as it is a use of funds):

	<u>Credit</u>	<u>Debit</u>
Private assets	\$1,500,000	
Official assets		\$1,500,000

Similarly, if a German sells a painting to a U.S. resident for \$1,000,000, with payment made by issuing a check drawn on a U.S. bank, a debit is recorded to indicate an increase in assets (the painting) by U.S. residents, which is a use of funds, and a credit is recorded to reflect an increase in liabilities (payment for the painting) to a foreigner, which is a source of funds:

	<u>Credit</u>	<u>Debit</u>
Private liabilities to foreigners	\$1,000,000	
U.S. imports		\$1,000,000

In the case of **unilateral transfers**, which are gifts and grants overseas, the transfer is debited because the donor's net worth is reduced, whereas another account must be credited: exports, if goods are donated; services, if services are donated; or capital, if the recipient receives cash or a check. Suppose the American Red Cross donates \$100,000 in goods for earthquake relief to Nicaragua. The balance of payments entries for this transaction would appear as follows:

	<u>Credit</u>	<u>Debit</u>
U.S. exports	\$100,000	
Unilateral transfer		\$100,000

Because double-entry bookkeeping ensures that debits equal credits, the sum of all transactions is zero. That is, the sum of the balance on the current account, the capital account, and the official reserves account must equal zero:

$$\begin{aligned} \text{Current account balance} + \text{Capital account balance} + \text{Official reserves account} \\ = \text{Balance of payments} = 0 \end{aligned}$$

These features of balance-of-payments accounting are illustrated in Exhibit 4.1, which shows the U.S. balance of payments for 1997, and in Exhibit 4.2, which gives examples of entries in the U.S. balance-of-payments accounts.

**EXHIBIT 4.1 The U.S. Balance of Payments for 1997<sup>1</sup> (U.S. \$ Billions)**

CREDITS		DEBITS	
a: Exports of civilian goods	\$678.3	b: Imports of civilian goods	\$877.3
c: Military sales abroad	15.2	d: Military purchases abroad	11.3
	Trade balance	= a + c - (b + d)	
		= Deficit of \$195.0	
e: Exports of services (investment income and fees earned, foreign tourism in United States, etc.)	474.1	f: Imports of services (investment income and fees paid out, U.S. tourism abroad, etc.)	406.9
	Services balance	= Surplus of \$67.2	
	Current-account balance	g: Net unilateral transfers (gifts)	38.5
		= a + c + e - (b + d + f + g)	
		Deficit of \$166.4	
h: Foreign private investment in the United States	672.3	i: U.S. private investment overseas	426.1
j: Foreign official lending in the United States	18.2	k: U.S. government lending overseas*	-0.2
	Capital-account balance	= h + j - (i + k)	
		= Surplus of \$264.6	
l: Net decrease in U.S. official reserves			1
	Official reserves balance	= Deficit of \$1.0	
m: Statistical discrepancy	-97.1		

<sup>1</sup> Balance of payments data are preliminary. Numbers may not sum exactly owing to rounding.

\*Negative sign indicates net repayment of U.S. government loans.

Source: Data from the Bureau of Economic Analysis, U.S. Department of Commerce, as published on their web page, April 17, 1998.

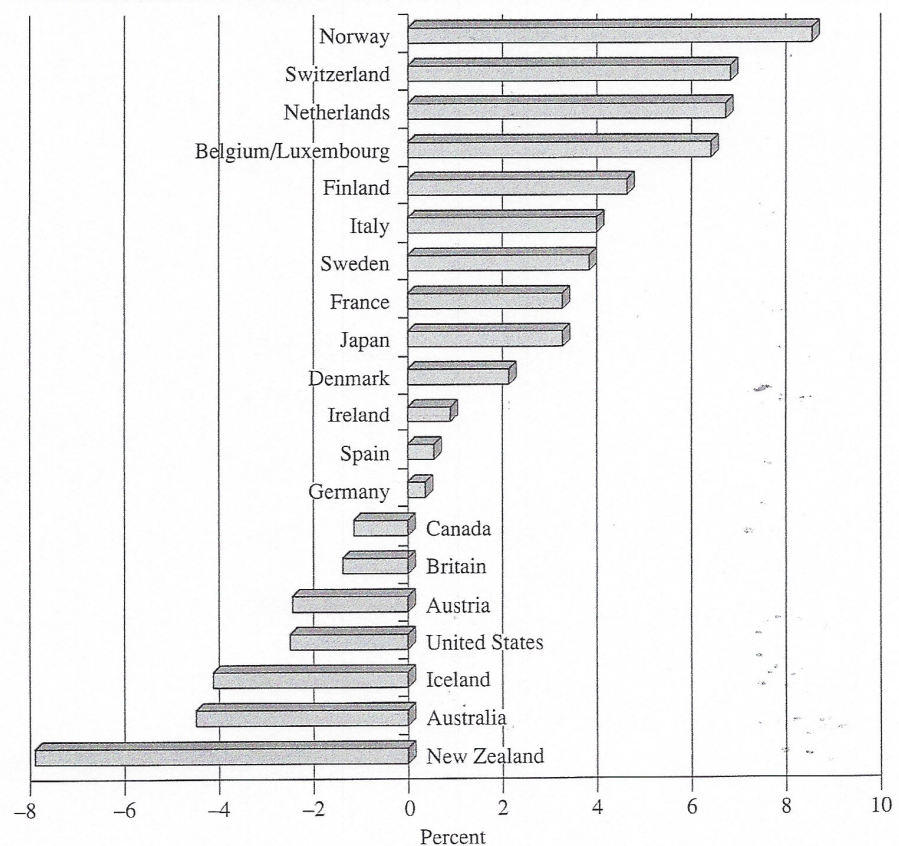
**EXHIBIT 4.2 Examples of Entries in the U.S. Balance-of-Payments Accounts**

CREDITS	DEBITS
<b>Current Account</b>	
a: Sales of wheat to Great Britain; sales of computers to Germany	b: Purchases of oil from Saudi Arabia; purchases of Japanese automobiles
c: Sales of Phantom jets to Canada	d: Payments to Filipino workers at U.S. bases in the Philippines
e: Interest earnings on loans to Argentina; profits on U.S.-owned auto plants abroad; licensing fees earned by Lotus 1-2-3; spending by Japanese tourists at Disneyland	f: Profits on sales by Nestlé's U.S. affiliate; hotel bills of U.S. tourists in Paris
	g: Remittances by Mexican Americans to relatives in Mexico; Social Security payments to Americans living in Italy; economic aid to Pakistan
<b>Capital Account</b>	
h: Purchases by the Japanese of U.S. real estate; increases in Arab bank deposits in New York banks; purchases by the French of IBM stock; investment in plant expansion in Ohio by Honda	i: New investment in a German chemical plant by Du Pont; increases in U.S. bank loans to Mexico; deposits in Swiss banks by Americans; purchases of Japanese stocks and bonds by Americans
j: Purchases of U.S. Treasury bonds by Bank of Japan; increases in holdings of New York bank deposits by Saudi Arabian government	k: Deposits of funds by the U.S. Treasury in British banks; purchases of Swiss-franc bonds by the Federal Reserve
<b>Official Reserve Account</b>	
	l: Purchases of gold by the U.S. Treasury; increases in holdings of Japanese yen by the Federal Reserve

### Current Account

The balance on current account reflects the net flow of goods, services, and unilateral transfers. It includes exports and imports of merchandise (trade balance), military transactions, and service transactions (invisibles). The service account includes investment income (interest and dividends), tourism, financial charges (banking and insurance), and transportation expenses (shipping and air travel). Unilateral transfers include pensions, remittances, and other transfers overseas for which no specific services are rendered. In 1997, for example, the U.S. balance of trade registered a deficit of \$195 billion, whereas the overall current-account deficit was \$166.4 billion. The difference was accounted for by a \$67.2 billion *surplus* on the services account and a \$38.5 billion deficit in unilateral transactions. Even more striking, in 1991 the U.S. trade deficit was \$73.4 billion, whereas the current-account deficit was \$3.7 billion. The difference of \$69.7 billion was largely

EXHIBIT 4.3 Current-Account Balances as a Percent of GDP (1998 estimated)



Source: OECD.

accounted for by the \$42 billion in contributions that the United States received from other countries to help pay for the Gulf War.

The U.S. current-account deficit at \$166.4 billion in 1997 was the world's largest, but as a percent of GDP, the deficit was just 2.1%—two-thirds of its peak value in 1987. However, as exhibit 4.3 shows, only three industrial countries were expected to have bigger deficits than the United States as a percent of GDP in 1998.

### *Capital Account*

Capital-account transactions affect a nation's wealth and net creditor position. These transactions are classified as either portfolio, direct, or short-term investments. *Portfolio investments* are purchases of financial assets with a maturity greater than one year; *short-term investments* involve securities with a maturity of less than one year. *Direct investments* are those where management control is exerted, defined under U.S. rules as ownership of at least 10% of the equity. Government borrowing and lending are included in the balance-on-capital account. As shown in Exhibit 4.1, the U.S. balance-on-capital account in 1997 was a surplus of \$264.6 billion.

### *Official Reserves Account*

The change in official reserves measures a nation's surplus or deficit on its current- and capital-account transactions by netting reserve liabilities from reserve assets. For example, a surplus will lead to an increase in official holdings of foreign currencies or gold or both; a deficit will normally cause a reduction in these assets. However, U.S. balance-of-payments deficits have not been matched exactly by net changes in reserve assets because foreigners have been willing to hold many billions of dollars (estimated at more than \$100 billion) for liquidity and other purposes. Instead of being converted into foreign currencies, many dollars have been placed on deposit in the Eurodollar market. For most countries, though, there is a close correlation between balance-of-payments deficits and reserve declines. A drop in reserves will occur, for instance, when a nation sells gold to acquire foreign currencies that it can then use to meet a deficit in its balance of payments. In 1997, the United States saw a decline in its official reserves even though it ran a surplus on its combined current- and capital-account balance. This oddity may stem from erroneous data, as reflected in the statistical discrepancy for that year.

### *Balance-of-Payments Measures*

There are several balance-of-payments definitions. The *basic balance* focuses on transactions considered to be fundamental to the economic health of a currency. Thus, it includes the balance on current account and long-term capital, but it excludes such ephemeral items as short-term capital flows—mainly bank deposits—that are heavily influenced by temporary factors—short-run monetary policy, changes in interest differentials, and anticipations of currency fluctuations.

The **net liquidity balance** measures the change in private domestic borrowing or lending that is required to keep payments in balance without adjusting official reserves. Nonliquid, private, short-term capital flows and errors and omissions are included in the balance; liquid assets and liabilities are excluded.

The **official reserve transactions balance** measures the adjustment required in official reserves to achieve balance-of-payments equilibrium. The assumption here is that official transactions are different from private transactions.

Each of these measures has shortcomings, primarily because of the increasing complexity of international financial transactions. For example, changes in the official reserve balance may now reflect investment flows as well as central bank intervention. Similarly, critics of the basic balance argue that the distinction between short- and long-term capital flows has become blurred. Direct investment is still determined by longer-term factors, but investment in stocks and bonds can be just as speculative as bank deposits and sold just as quickly. The astute international financial manager, therefore, must analyze the payments figures rather than rely on a single summarizing number.

### *The Missing Numbers*

In going over the numbers in Exhibit 4.1, you will note an item referred to as a **statistical discrepancy**. This number reflects errors and omissions in collecting data on international transactions. In 1997, that item was a mighty  $-\$97.1$  billion. (A negative figure reflects a mysterious outflow of funds; a positive amount reflects an inflow.)

Typically, the statistical discrepancy is positive. For example, in 1990 it was  $+\$66.8$  billion. This discrepancy coincided with such worrisome foreign events as the Iraqi invasion of Kuwait, turmoil in Iran, unrest in Central and Latin America, and the upheaval in the Soviet Union. Many experts believe that the statistical discrepancy in that year was primarily the result of foreigners' surreptitiously moving money into what they deemed to be a safe political haven—the United States.