Why Do Balance of Payments Problems Occur?

Balance of payments difficulties can arise—and, in the worst case, build into crises—even in the face of strong prevention efforts. The IMF assists countries in restoring economic stability by helping devise programs of corrective policies and providing loans to support them.

Bad luck, inappropriate policies, or a combination of the two may create balance of payments difficulties in a country—that is, a situation where sufficient financing on affordable terms cannot be obtained to meet international payment obligations. In the worst case, the difficulties can build into a crisis. The country's currency may be forced to depreciate rapidly, making international goods and capital more expensive, and the domestic economy may experience a painful disruption. These problems may also spread to other countries.

The causes of such difficulties are often varied and complex. Key factors have included weak domestic financial systems, large and persistent fiscal deficits, high levels of external and/or public debt, exchange rates fixed at inappropriate levels, natural disasters, or armed conflicts or a sudden and strong increase in the price of key commodities such as food and fuel. Some of these factors can directly affect a country's trade account, reducing exports or increasing imports. Others may reduce the financing available for international transactions; for example, investors may lose confidence in a country's prospects, leading to massive asset sales, or "capital flight." In either case, diagnoses of, and responses to, crises are complicated by linkages between various sectors of the economy. Imbalances in one sector can quickly spread to other sectors, leading to widespread economic disruption.

Source: "Factsheet, October 2008: How The IMF Helps to Resolve Balance of Payments Difficulties," http://www.imf.org/external/np/exr/facts/crises.htm, accessed September 2009.

International business transactions occur in many different forms over the course of a year. The measurement of all international economic transactions between the residents of a country and foreign residents is called the **balance of payments (BOP)**.[1] Government policymakers need such measures of economic activity to evaluate the general competitiveness of domestic industry, to set exchange-rate or interest-rate policies or goals, and for many other purposes. Individuals and businesses use various BOP measures to gauge the growth and health of specific types of trade or financial transactions by country and regions of the world against the home country.

balance of payments (BOP) A statement of all transactions between one country and the rest of the world during a given period; a record of flows of goods, services, and investments across borders.

International transactions take many forms. Each of the following examples is an international economic transaction that is counted and captured in the U.S. balance of payments.

- U.S. imports of Honda automobiles, which are manufactured in Japan.
- A U.S.-based firm, Bechtel, is hired to manage the construction of a major water-treatment facility in the Middle East.
- The U.S. subsidiary of a French firm, Saint Gobain, pays profits (dividends) back to the parent firm in Paris.
- An American tourist purchases a hand-blown glass figurine in Venice, Italy.
- The U.S. government provides grant financing of military equipment for its NATO (North Atlantic Treaty Organization) military ally, Turkey.
- A Canadian dentist purchases a U.S. Treasury bill through an investment broker in Cleveland, Ohio.

current account An account in the BOP statement that records the results of transactions involving merchandise, services, and unilateral transfers between countries.

These are just a small sample of the hundreds of thousands of international transactions that occur each year. The balance of payments provides a systematic method for the classification of all of these transactions. There is one rule of thumb that will always aid in the understanding of BOP accounting: Watch the direction of the movement of money.

financial account An account in the BOP statement that records transactions involving borrowing, lending, and investing across borders.

The balance of payments is composed of a number of subaccounts that are watched quite closely by groups as diverse as investors on Wall Street, farmers in Iowa, politicians on Capitol Hill, and people in boardrooms across America. These groups track and analyze the two major subaccounts, the **current account** and the **financial account**, on a continuing basis. Before describing these two subaccounts and the balance of payments as a whole, it is necessary to understand the rather unusual features of how balance of payments accounting is conducted.

FUNDAMENTALS OF BALANCE OF PAYMENTS ACCOUNTING

1. To understand the fundamental principles of how countries measure international business activity, the balance of payments

The balance of payments must balance. If it does not, something has either not been counted or counted properly. It is therefore improper to state that the BOP is in disequilibrium. It cannot be. The supply and demand for a country's currency may be imbalanced, but that is not the same thing. Subaccounts of the BOP, such as the merchandise trade balance, may be imbalanced, but the entire BOP of a single country is always balanced.

There are three main elements to the process of measuring international economic activity: (1) identifying what is and is not an international economic transaction; (2) understanding how the flow of goods, services, assets, and money creates debits and credits to the overall BOP; and (3) understanding the bookkeeping procedures for BOP accounting, called double entry.

DEFINING INTERNATIONAL ECONOMIC TRANSACTIONS

Identifying international transactions is ordinarily not difficult. The export of merchandise, goods such as trucks, machinery, computers, telecommunications equipment, and so forth, is obviously an international transaction. Imports such as French wine, Japanese cameras, and German automobiles are also clearly international transactions. But this merchandise trade is only a portion of the thousands of different international transactions that occur in the United States or any other country each year.

Many other international transactions are not so obvious. The purchase of a glass figure in Venice, Italy, by an American tourist is classified as a U.S. merchandise import. In fact, all expenditures made by American tourists around the globe that are for goods or services (meals, hotel accommodations, and so forth) are recorded in the U.S. balance of payments as imports of travel services in the current account. The purchase of a U.S. Treasury bill by a foreign resident is an international financial transaction and is dutifully recorded in the capital account of the U.S. balance of payments.

THE BOP AS A FLOW STATEMENT

The BOP is often misunderstood because many people believe it to be a balance sheet, rather than a cash flow statement. By recording all international transactions over a period of time, it is tracking the continuing flow of purchases and payments between a country and all other countries. It does not add up the value of all assets and liabilities of a country like a balance sheet does for an individual firm.

There are two types of business transactions that dominate the balance of payments:

1. **Real assets:** The exchange of goods (e.g., automobiles, computers, watches, textiles) and services (e.g., banking services, consulting services, travel services) for other goods and services (barter) or for the more common type of payment, money.
2. **Financial assets:** The exchange of financial claims (e.g., stocks, bonds, loans, purchases or sales of companies) in exchange for other financial claims or money.

Although assets can be separated as to whether they are real or financial, it is often easier to simply think of all assets as being goods that can be bought and sold. An American tourist's purchase of a handwoven area rug in a shop in Bangkok is not all that different from a Wall Street banker buying a British government bond for investment purposes.

BOP ACCOUNTING: DOUBLE-ENTRY BOOKKEEPING

The balance of payments employs an accounting technique called **double-entry bookkeeping**. Double-entry bookkeeping is the age-old method of accounting in which every transaction produces a debit and a credit of the same amount. Simultaneously. It has to. A debit is created whenever an asset is increased, a liability is decreased, or an expense is increased. Similarly, a credit is created whenever an asset is decreased, a liability is increased, or an expense is decreased.

double-entry bookkeeping Accounting methodology where each transaction gives rise to both a debit and a credit of the same currency amount. It is used in the construction of the balance of payments.

An example clarifies this process. A U.S. retail store imports from Japan $2 million worth of consumer electronics. A negative entry is made in the merchandise-import subcategory of the current account in the amount of $2 million. Simultaneously, a positive entry of the same $2 million is made in the capital account for the

transfer of $2 million to the Japanese manufacturer. Obviously, the result of hundreds of thousands of such transactions and entries should theoretically result in a perfect balance.

That said, it is now a problem of application, and a problem it is. The measurement of all international transactions in and out of a country over a year is a daunting task. Mistakes, errors, and statistical discrepancies will occur. The primary problem is that although double-entry bookkeeping is employed in theory, the individual transactions are recorded independently. Current and capital account entries are recorded independent of one another, not together as double-entry bookkeeping would prescribe. It must then be recognized that there will be serious discrepancies (to use a nice term for it) between debits and credits, and the possibility in total that the balance of payments may not balance!

The following section describes the various balance of payment accounts, their meanings, and their relationships, using the United States as the example. The chapter then concludes with a discussion—and a number of examples—of how different countries with different policies or levels of economic development may differ markedly in their balance of payment accounts.

THE ACCOUNTS OF THE BALANCE OF PAYMENTS

2. To examine the similarities of the current and capital accounts of the balance of payments

The balance of payments is composed of two primary subaccounts, the *Current Account* and the *Financial/Capital Account*. In addition, the *Official Reserves Account* tracks government currency transactions, and a fourth statistical subaccount, the *Net Errors and Omissions Account*, is produced to preserve the balance in the BOP. The international economic relationships between countries do, however, continue to evolve, as the recent revision of the major accounts within the BOP discussed later indicates.[2]

THE CURRENT ACCOUNT

The *Current Account* includes all international economic transactions with income or payment flows occurring within the year, the *current* period. The *Current Account* consists of four subcategories:

1. **Goods trade:** This is the export and import of goods. Merchandise trade is the oldest and most traditional form of international economic activity. Although many countries depend on imports of many goods (as they should according to the theory of comparative advantage), they also normally work to preserve either a balance of goods trade or even a surplus.
2. **Services trade:** This is the export and import of services. Some common international services are financial services provided by banks to foreign importers and exporters, travel services of airlines, and construction services of domestic firms in other countries. For the major industrial countries, this subaccount has shown the fastest growth in the past decade.
3. **Income:** This category is predominantly *current income* associated with investments that were made in previous periods. If a U.S. firm created a subsidiary in South Korea to produce metal parts in a previous year, the proportion of net income that is paid back to the parent company in the current year (the dividend) constitutes current investment income. Additionally, wages and salaries paid to nonresident workers is also included in this category.

4. **Current transfers:** Transfers are the financial settlements associated with the change in ownership of real resources or financial items. Any transfer between countries that is one-way, a gift, or a grant, is termed a *current transfer*. A common example of a current transfer would be funds provided by the United States government to aid in the development of a less-developed nation. Transfers associated with the transfer of fixed assets are included in a new separate account, the Capital Account, which now follows the Current Account. The contents of what previously had been called the capital account are now included within the *Financial Account*.

All countries possess some amount of trade, most of which is merchandise. Many smaller and less-developed countries have little in the way of service trade, or items that fall under the income or transfers subaccounts.

The Current Account is typically dominated by the first component described—the export and import of merchandise. For this reason, the *balance on trade* (BOT), which is so widely quoted in the business press in most countries, refers specifically to the balance of exports and imports of goods trade only. For a larger industrialized country, however, the BOT is somewhat misleading because service trade is not included; it may be opposite in sign on net, and it may actually be fairly large as well.

Table 4.1 summarizes the Current Account and its components for the United States for the 2002–2008 period. As illustrated, the U.S. goods trade balance has consistently been negative, but has been partially offset by the continuing surplus in services trade.

Goods Trade

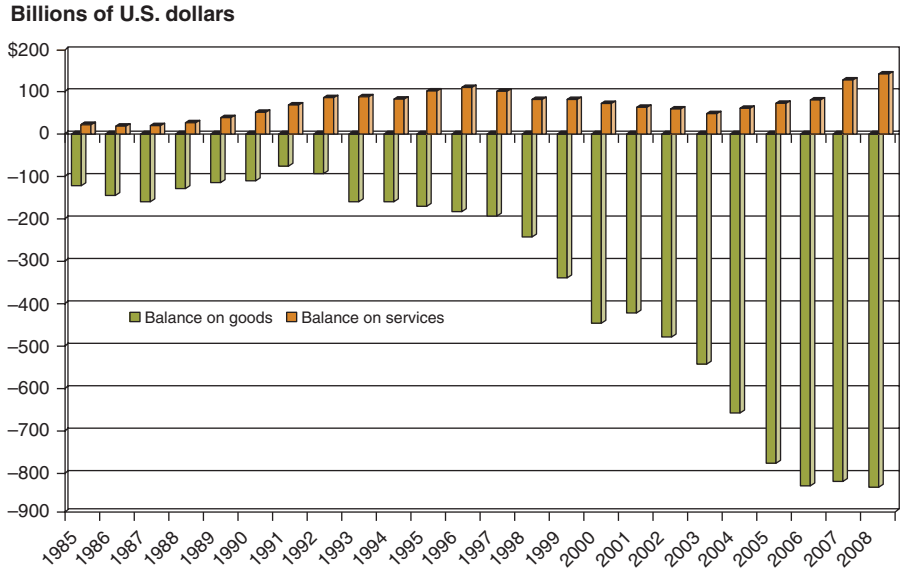
Figure 4.1 places the Current Account values of Table 4.1 in perspective over time by dividing the Current Account into its two major components: (1) goods trade and (2) services trade. The first and most striking message is the magnitude of the goods trade deficit in 2006, 2007, and 2008 (a continuation of a position created in the early 1980s). The balance on services and income, although not large in comparison to net goods trade, has generally run a surplus over the past two decades.

Table 4.1 The U.S. Current Account, 2002–2008 (billions of U.S. dollars)

	2002	2003	2004	2005	2006	2007	2008
Goods exports	686	717	811	898	1020	1142	1281
Goods imports	−1167	−1264	−1477	−1682	−1863	−1969	−2117
Goods trade balance (BOT)	−481	−548	−666	−783	−844	−827	−836
Services trade credits	289	301	350	385	432	501	546
Services trade debits	−231	−250	−291	−314	−349	−375	−405
Services trade balance	58	51	58	72	83	125	140
Income receipts	281	320	414	535	682	819	765
Income payments	−254	−275	−347	−463	−634	−728	−646
Income balance	27	45	67	72	48	91	118
Current transfers, credits	12	15	20	19	26	23	22
Current transfers, debits	−77	−87	−105	−109	−117	−139	−150
Net transfers	−65	−72	−84	−90	−91	−116	−128
Current Account Balance	−461	−523	−625	−729	−804	−727	−706

Source: Derived from International Monetary Fund, *International Financial Statistics*, imf.org, September 2009.

Figure 4.1 U.S. Trade Balances on Goods and Services, 1985–2008



Source: International Monetary Fund, *International Financial Statistics,* imf.org, September 2009.

The deficits in the BOT of the past decade have been an area of considerable concern for the United States. Merchandise trade is the original core of international trade. It has three major components: manufactured goods, agriculture, and fuels. The manufacturing of goods was the basis of the industrial revolution, and the focus of the theory of international trade described in the previous chapter. The U.S. goods trade deficit of the 1980s and 1990s was mainly caused by a decline in traditional manufacturing industries that have over history employed many of America's workers. Declines in the net trade balance in areas such as steel, automobiles, automotive parts, textiles, shoe manufacturing, and others caused massive economic and social disruption. The problems of dealing with these shifting trade balances will be discussed in detail in a later chapter.

The most encouraging news for U.S. manufacturing trade is the growth of exports in recent years. A number of factors contributed to the growth of U.S. exports, such as the weaker dollar (which made U.S.-manufactured goods cheaper in terms of the currencies of other countries), more rapid economic growth in Europe, and a substantial increase in agricultural exports. Understanding merchandise import and export performance is much like understanding the market for any single product. The demand factors that drive both imports and exports are income, the economic growth rate of the buyer, and price (the price of the product in the eyes of the consumer after passing through an exchange rate). For example, U.S. merchandise imports reflect the income level and growth of American consumers and industry. As income rises, so does the demand for imports.

Exports follow the same principles but in the reversed position. U.S. merchandise exports depend not on the incomes of U.S. residents, but on the incomes of the buyers of U.S. products in all other countries around the world. When these economies are growing, the demand for U.S. products will also rise. However, the recent economic crises in Asia now raise questions regarding U.S. export growth in the immediate future.

The service component of the U.S. Current Account is one of mystery to many. As illustrated in both Table 4.1 and Figure 4.1, the U.S. has consistently achieved a

surplus in services trade income. The major categories of services include travel and passenger fares, transportation services, expenditures by U.S. students abroad and foreign students pursuing studies in the United States, telecommunications services, and financial services.

THE CAPITAL AND FINANCIAL ACCOUNT

The *Capital and Financial Account* of the balance of payments measures all international economic transactions of financial assets. It is divided into two major components, the *Capital Account* and the *Financial Account*.

- **The Capital Account:** The Capital Account is made up of transfers of financial assets and the acquisition and disposal of nonproduced/nonfinancial assets. The magnitude of capital transactions covered is of a relatively minor amount, and will be included in principle in all of the following discussions of the financial account.
- **The Financial Account:** The financial account consists of three components: *direct investment*, *portfolio investment*, and *other asset investment*. Financial assets can be classified in a number of different ways, including the length of the life of the asset (its maturity) and by the nature of the ownership (public or private). The Financial Account, however, uses a third way. It is classified by the degree of control over the assets or operations the claim represents: *portfolio investment*, where the investor has no control, or *direct investment*, where the investor exerts some explicit degree of control over the assets. (The contents of the Financial Account are for all intents and purposes the same as those of the Capital Account under the IMF's BOP accounting framework used prior to 1996. We will refer, from this point on, almost exclusively to the Financial Account.)

Table 4.2 shows the major subcategories of the U.S. capital account balance from 2002–2008: *direct investment*, *portfolio investment*, *financial derivatives*, and *other investment*.

Table 4.2 The U.S. Financial Account and Components, 2002–2008 (billions of U.S. dollars)

	2002	2003	2004	2005	2006	2007	2008
Direct Investment							
Direct investment abroad	−154	−150	−316	−36	−245	−399	−332
Direct investment in the U.S.	84	64	146	113	243	276	320
Net direct investment	−70	−86	−170	76	−2	−123	−12
Portfolio Investment							
Assets, net	−49	−123	−177	−258	−499	−396	117
Liabilities, net	428	550	867	832	1127	1155	528
Net portfolio investment	379	427	690	575	628	759	645
Financial derivatives, net					30	6	−29
Other Investment							
Other investment assets	−88	−54	−510	−267	−544	−677	219
Other investment liabilities	283	244	520	303	695	699	−313
Net other investment	195	190	10	36	151	22	−94
Net Financial Account Balance	504	532	530	687	807	664	510

Source: Derived from International Monetary Fund, *International Financial Statistics*, imf.org, September 2009.

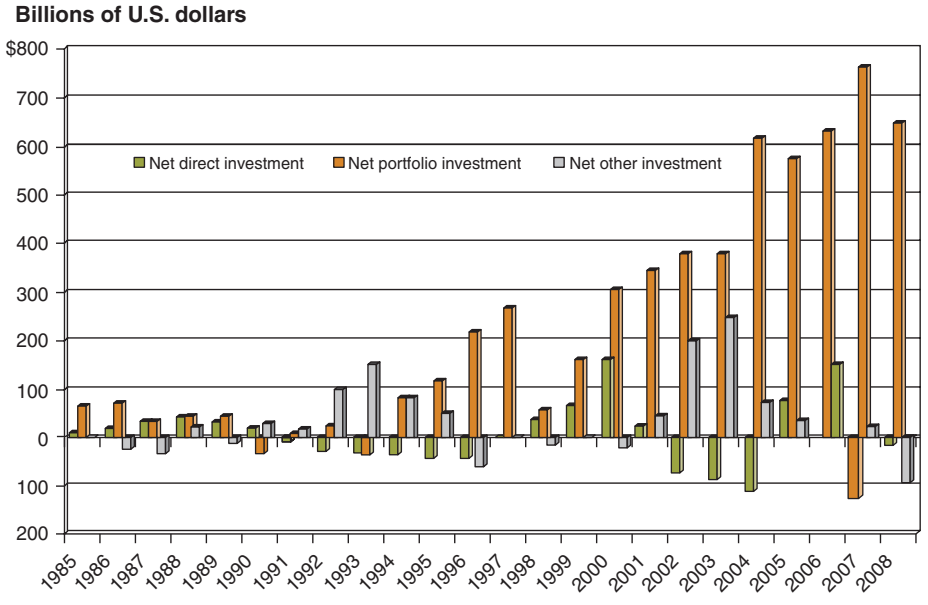
1. **Direct investment:** This is the net balance of capital dispersed out of and into the United States for the purpose of exerting control over assets. For example, if a U.S. firm either builds a new automotive parts facility in another country or actually purchases a company in another country, this would fall under *direct investment* in the U.S. balance of payments accounts. When the capital flows out of the United States, it enters the balance of payments as a negative cash flow. If, however, foreign firms purchase firms in the United States (e.g., Sony of Japan purchased Columbia Pictures in 1989) it is a capital inflow and enters the balance of payments positively. Whenever 10 percent or more of the voting shares in a U.S. company is held by foreign investors, the company is classified as the U.S. affiliate of a foreign company, and a *foreign direct investment*. Similarly, if U.S. investors hold 10 percent or more of the control in a company outside the United States, that company is considered the foreign affiliate of a U.S. company.
2. **Portfolio investment:** This is net balance of capital that flows in and out of the United States but does not reach the 10 percent ownership threshold of direct investment. If a U.S. resident purchases shares in a Japanese firm, but does not attain the 10 percent threshold, it is considered a *portfolio investment* (and in this case an outflow of capital). The purchase or sale of debt securities (like U.S. Treasury bills) across borders is also classified as *portfolio investment* because debt securities by definition do not provide the buyer with ownership or control.
3. **Financial derivatives:** Financial derivatives are financial instruments that are linked to a specific financial instrument, indicator, or commodity—the instrument's underlying asset. The value of a financial derivative derives from the price of an underlying item, such as an asset or index. Financial derivatives are used for a number of purposes, including risk management, hedging, arbitrage between markets, and speculation. Financial derivatives were previously reported as a subcategory of Portfolio Investment (section 2), but, as a result of a revision by the IMF in 2002, they are now required to be reported on their own if the country deems them to be of significant size.
4. **Other investment assets/liabilities:** This final category consists of various short-term and long-term trade credits, cross-border loans from all types of financial institutions, currency deposits and bank deposits, and other accounts receivable and payable related to cross-border trade.

Direct Investment

Figure 4.2 shows how the major subaccounts of the U.S. capital account—*net direct investment*, *portfolio investment*, and *other investment*—have changed since 1985.

The boom in foreign investment into the United States, or foreign resident purchases of assets in the United States, during the 1980s was extremely controversial. The source of concern over foreign investment in any country, including the United States, focuses on two topics—control and profit. Most countries possess restrictions on what foreigners may own in their country. This is based on the premise that domestic land, assets, and industry in general should be held by residents of the country. For example, up until 1990 it was not possible for a foreign firm to own more than 20 percent of any company in Finland. This rule is the norm, rather than the exception. The United States has traditionally had few restrictions on what foreign residents or firms can own or control in the United States; most restrictions that remain today are related to national security concerns. As opposed to many of the traditional debates over whether international trade should be free or not, there is not the same

Figure 4.2 The U.S. Financial Account, 1985–2008



Source: International Monetary Fund, *International Financial Statistics,* imf.org, September 2009.

consensus that international investment should necessarily be free. This is a question that is still very much a domestic political concern first, and an international economic issue second.

The second major source of concern over foreign direct investment is who receives the profits from the enterprise. Foreign companies owning firms in the United States will ultimately profit from the activities of the firms, or put another way, from the efforts of American workers. In spite of evidence that foreign firms in the United States reinvest most of the profits in the United States (in fact at a higher rate than domestic firms), the debate has continued on possible profit drains. Regardless of the actual choices made, workers of any nation feel the profits of their work should remain in the hands of their own citizens. Once again, this is in many ways a political and emotional concern rather than an economic one.

The choice of words used to describe foreign investment can also influence public opinion. If these massive capital inflows are described as "capital investments from all over the world showing their faith in the future of American industry," the net capital surplus is represented as decidedly positive. If, however, the net capital surplus is described as resulting in "the United States as the world's largest debtor nation," the negative connotation is obvious. Both are essentially spins on the economic principles at work. Capital, whether short-term or long-term, flows to where it believes it can earn the greatest return for the level of risk. Although in an accounting sense that is "international debt," when the majority of the capital inflow is in the form of direct investment and a long-term commitment to jobs, production, services, technological, and other competitive investments, the impact on the competitiveness of American industry (an industry located within the United States) is increased. The "net debtor" label is misleading in that it inappropriately invites comparison with large debt crisis conditions suffered by many countries in the past, like Mexico and Brazil.

Portfolio Investment

Portfolio investment is capital invested in activities that are purely profit-motivated (return), rather than ones made in the prospect of controlling or

managing the investment. Investments that are purchases of debit securities, bonds, interest-bearing bank accounts, and the like are only intended to earn a return. They provide no vote or control over the party issuing the debt. Purchases by foreign investors of debt issued by the U.S. government (U.S. Treasury bills, notes, and bonds) constitute net portfolio investment in the United States.

As illustrated in Figure 4.2, portfolio investment has shown a much more volatile behavior than net direct investment over the past decade. Many U.S. debt securities, such as U.S. Treasury securities and corporate bonds, were in high demand in the late 1980s, while surging emerging markets in both debt and equities caused a reversal in direction in the 1990s. The motivating forces for portfolio investment flows are always the same, *return* and *risk*. This theoretical fact, however, does not make them any the more predictable.

Current and Financial Account Balance Relationships

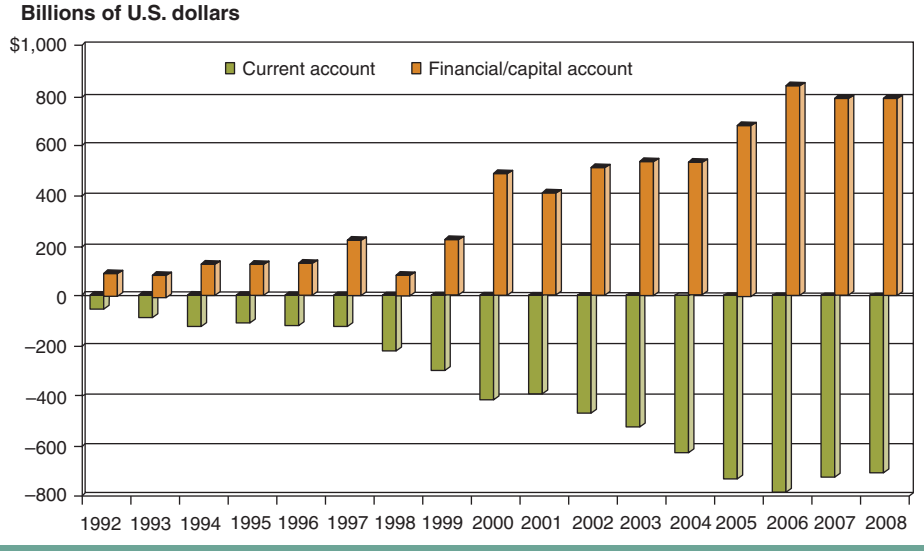
Figure 4.3 (A, B, and C) illustrates the current and financial account balances for Germany, Japan, and the United States over recent years. What the figure shows is one of the basic economic and accounting relationships of the balance of payments: *the inverse relationship between the Current and Financial accounts*. (The only exception is Germany in 1999, the year in which the euro was introduced.) This inverse relationship is not accidental. The methodology of the balance of payments, double-entry bookkeeping, requires that the current and financial accounts be offsetting. Countries experiencing large current account deficits "finance" these purchases through equally large surpluses in the financial account and vice versa.

NET ERRORS AND OMISSIONS

net errors and omissions account Makes sure the balance of payments (BOP) actually balances.

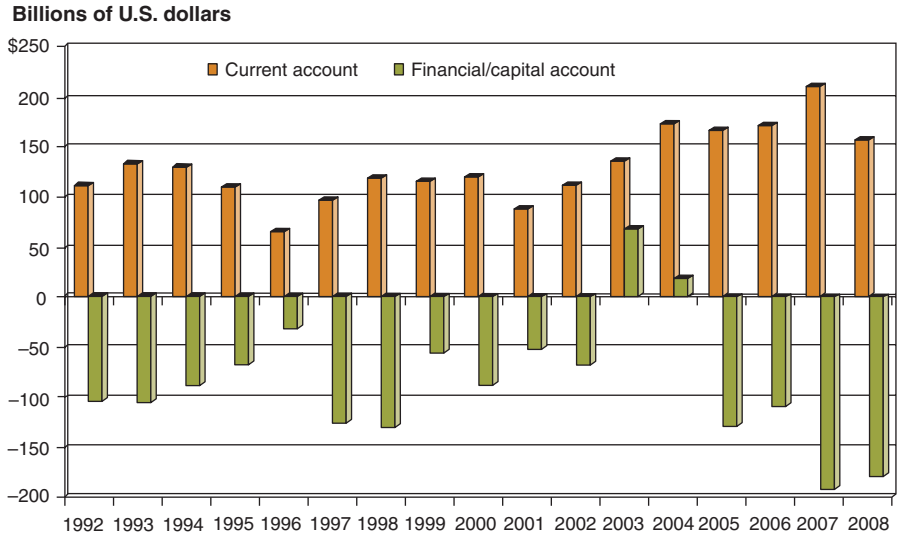
As noted before, because Current Account and Financial Account entries are collected and recorded separately, errors or statistical discrepancies will occur. The **net errors and omissions account** (this is the title used by the International Monetary Fund) makes sure that the BOP actually balances.

Figure 4.3(A) Current and Combined Financial/Capital Account Balances for the United States, 1992–2008



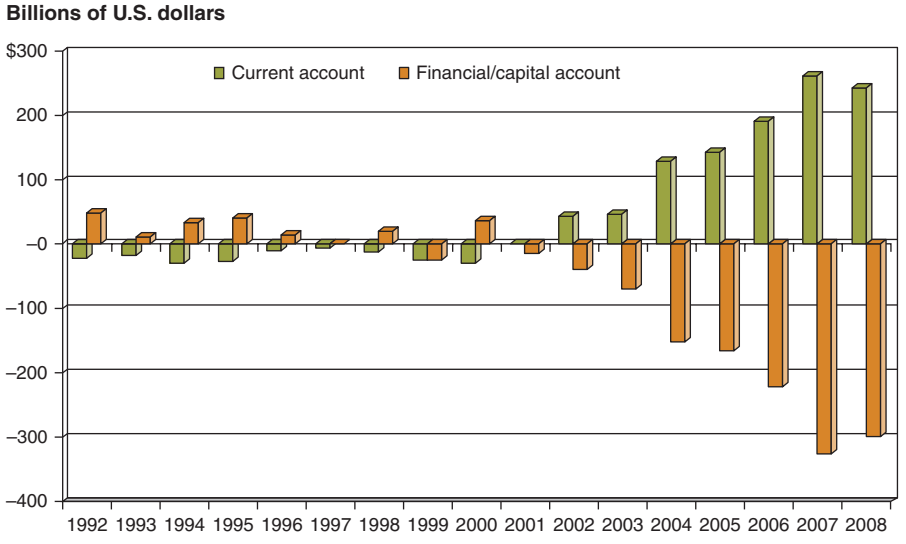
Source: International Monetary Fund, *International Financial Statistics,* imf.org, October 2009.

Figure 4.3(B) Current and Combined Financial/Capital Account Balances for Japan, 1992–2008



Source: International Monetary Fund, *International Financial Statistics,* imf.org, October 2009.

Figure 4.3(C) Current and Combined Financial/Capital Account Balances for Germany, 1992–2008



Source: International Monetary Fund, *International Financial Statistics,* imf.org, October 2009.

OFFICIAL RESERVES ACCOUNT

The **official reserves account** is the total currency and metallic reserves held by official monetary authorities within the country. These reserves are normally composed of the major currencies used in international trade and financial transactions (so-called hard currencies like the U.S. dollar, German mark, and Japanese yen) and gold.

official reserves account An account in the BOP statement that shows (1) the change in the amount of funds immediately available to a country for making international payments and (2) the borrowing and lending that has taken place between the monetary authorities of different countries either directly or through the International Monetary Fund.

fixed-exchange-rate The government of a country officially declares that its currency is convertible into a fixed amount of some other currency.

floating-exchange-rate Under this system, the government possesses no responsibility to declare that its currency is convertible into a fixed amount of some other currency; this diminishes the role of official reserves.

The significance of official reserves depends generally on whether the country is operating under a **fixed-exchange-rate** regime or a **floating-exchange-rate** system. If a country's currency is fixed, this means that the government of the country officially declares that the currency is convertible into a fixed amount of some other currency. For example, for many years the South Korean won was fixed to the U.S. dollar at 484 won equal to 1 U.S. dollar. It is the government's responsibility to maintain this fixed rate (also called *parity rate*). If for some reason there is an excess supply of Korean won on the currency market, to prevent the value of the won from falling, the South Korean government must support the won's value by purchasing won on the open market (by spending its hard currency reserves, its *official reserves*) until the excess supply is eliminated. Under a floating-rate system, the government possesses no such responsibility and the role of official reserves is diminished.

THE BALANCE OF PAYMENTS IN TOTAL

3. To understand the critical differences between trade in merchandise and services, and why international investment activity has recently been controversial in the United States

Table 4.3 provides the official balance of payments for the United States as presented by the International Monetary Fund (IMF), the multinational organization that collects these statistics for more than 160 different countries around the globe. Now that the individual accounts and the relationships among the accounts have been discussed, Table 4.3 gives a comprehensive overview of how the individual accounts are combined to create some of the most useful summary measures for multinational business managers.

The current account (line A in Table 4.3), the capital account (line B), and the financial account (line C) combine to form the *basic balance (Total, Groups A through C)*. This is one of the most frequently used summary measures of the BOP. It is used to describe the international economic activity of the nation as determined by market forces, not by government decisions (such as currency market intervention). The U.S. *basic balance* totaled a deficit of –$196 billion in 2008. A second frequently used summary measure, the overall balance, also called the official settlements balance (*Total of Groups A through D* in Table 4.3), was at a surplus of $4 billion in 2008.

The meaning of the balance of payments has changed over the past 30 years. As long as most of the major industrial countries were still operating under fixed exchange rates, the interpretation of the BOP was relatively straightforward. A surplus in the BOP implied that the demand for the country's currency exceeded the supply, and that the government should then allow the currency value to increase *(revalue)* or to intervene and accumulate additional foreign currency reserves in the Official Reserves Account. This would occur as the government sold its own currency in exchange for other currencies, thus building up its stores of hard currencies. A deficit in the BOP implied an excess supply of the country's currency on world markets, and the government would then either *devalue* the currency or expend its official reserves to support its value. But the transition to floating exchange rate regimes in the 1970s (described in the following chapter) changed the focus from the total BOP to its various subaccounts like the Current and Financial Account balances. These are the indicators of economic activities and currency repercussions to come. The crises in Mexico (1994), Asia (1997), Turkey (2001), and Argentina and Venezuela (2002) highlight the continuing changes in the role of the balance of payments.

Table 4.3 The U.S. Balance of Payments, Analytic Presentation, 1998–2008 (billions of U.S. dollars)

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
A. Current Account	**−213**	**−300**	**−417**	**−385**	**−461**	**−523**	**−625**	**−729**	**−804**	**−727**	**−706**
Goods: exports fob	672	686	775	722	686	717	811	898	1020	1142	1281
Goods: imports fob	−917	−1030	−1227	−1148	−1167	−1264	−1477	−1682	−1863	−1969	−2117
Balance on Goods	−245	−344	−452	−426	−481	−548	−666	−783	−844	−827	−836
Services: credit	261	280	296	283	289	301	350	385	432	501	546
Services: debit	−181	−199	−224	−222	−231	−250	−291	−314	−349	−375	−405
Balance on Goods and Services	−165	−263	−380	−365	−424	−497	−608	−712	−760	−701	−696
Income: credit	262	294	351	291	281	320	414	535	682	819	765
Income: debit	−258	−280	−330	−259	−254	−275	−347	−463	−634	−728	−646
Balance on Goods, Services, and Income	−160	−249	−359	−333	−396	−452	−541	−639	−712	−611	−578
Current transfers: credit	10	9	11	9	12	15	20	19	26	23	22
Current transfers: debit	−63	−59	−69	−60	−77	−87	−105	−109	−117	−139	−150
B. Capital Account	**−1**	**−5**	**−1**	**−1**	**−1**	**−3**	**−2**	**−4**	**−4**	**−2**	**1**
Capital account: credit	1	1	1	1	1	1	1	1	1	2	5
Capital account: debit	−2	−6	−2	−2	−2	−4	−3	−5	−5	−4	−4
Total Groups A plus B	***−214***	***−305***	***−418***	***−386***	***−463***	***−527***	***−627***	***−733***	***−807***	***−728***	***−705***
C. Financial Account	**77**	**227**	**478**	**405**	**504**	**532**	**530**	**687**	**807**	**664**	**509**
Direct investment	36	65	162	25	−70	−86	−170	76	−2	−123	−12
Direct investment abroad	−143	−225	−159	−142	−154	−150	−316	−36	−245	−399	−332
Direct investment in United States	179	289	321	167	84	64	146	113	243	276	320
Portfolio investment assets	−130	−122	−128	−91	−49	−123	−177	−258	−499	−396	117
Equity securities	−101	−114	−107	−109	−17	−118	−85	−187	−137	−148	−1
Debt securities	−29	−8	−21	18	−32	−5	−93	−71	−362	−248	119
Portfolio investment liabilities	188	286	437	428	428	550	867	832	1127	1155	528
Equity securities	42	112	194	121	54	34	62	89	145	276	110
Debt securities	146	173	243	307	374	516	806	743	981	879	417

(*continued*)

Table 4.3 (Continued)

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
Financial derivatives, net	0	0	0	0	0	0	0	0	30	6	−30
Other investment assets	−74	−166	−273	−145	−88	−54	−510	−267	−544	−677	219
Monetary authorities	0	0	0	0	0	0	0	0	0	−24	−530
General government	0	3	−1	0	0	1	2	6	5	2	0
Banks	−36	−71	−133	−136	−38	−26	−359	−151	−343	−494	356
Other sectors	−38	−98	−139	−9	−50	−29	−153	−121	−207	−161	393
Other investment liabilities	57	165	280	187	283	244	520	303	695	699	−313
Monetary authorities	7	25	−11	35	70	11	13	8	2	−11	29
General government	−3	−1	−2	−2	0	−1	0	0	3	5	9
Banks	30	67	123	88	118	136	347	232	344	466	−268
Other sectors	23	74	171	66	96	98	160	62	346	238	−83
Total, Groups A through C	***−138***	***−77***	***60***	***19***	***41***	***5***	***−98***	***−46***	***−1***	***−65***	***−196***
D. Net Errors and Omissions	**144**	**69**	**−59**	**−14**	**−38**	**−6**	**95**	**32**	**−2**	**65**	**200**
Total, Groups A through D	***7***	***−9***	***0.31***	***4.88***	***3.71***	***−1.33***	***−2.80***	***−14.10***	***−2***	***0***	***4***
E. Reserves and Related Items	**−7**	**9**	**0**	**−5**	**−4**	**2**	**3**	**14**	**2**	**0**	**−5**

Note: Totals may not match original source due to rounding.

Source: International Monetary Fund, *International Financial Statistics*, imf.org, September 2009.

THE BALANCE OF PAYMENTS AND ECONOMIC CRISES

4. To review the mechanical steps of how exchange rate changes are transmitted into altered trade prices and eventually trade volumes

The sum of cross-border international economic activity—the balance of payments—can be used by international managers to forecast economic conditions and, in some cases, the likelihood of economic crises. The mechanics of international economic crisis often follow a similar path of development:

1. A country that experiences rapidly expanding current account deficits will simultaneously build financial account surpluses (the inverse relationship noted previously in this chapter).
2. The capital that flows into a country, giving rise to the financial account surplus, acts as the "financing" for the growing merchandise/services deficits—the constituent components of the current account deficit.
3. Some event, whether it be a report, a speech, an action by a government or business inside or outside the country, raises the question of the country's economic stability. Investors of many kinds, portfolio and direct investors in the country, fearing economic problems in the near future, withdraw capital from the country rapidly to avoid any exposure to this risk. This is prudent for the individual, but catastrophic for the whole if all individuals move similarly.
4. The rapid withdrawal of capital from the country, so-called capital flight, results in the loss of the financial account surplus, creating a severe deficit in the country's overall balance of payments. This is typically accompanied by rapid currency depreciation (if a floating-rate currency) or currency devaluation (if a fixed-rate currency).

International debt and economic crises have occurred for as long as there have been international trade and commerce. And they will occur again. Each crisis has its own unique characteristics, but all follow some of the economic fundamentals described earlier (the one additional factor that differentiates many of the crises is whether inflation is a component). The Asian economic crisis was a devastating reminder of the tenuousness of international economic relationships.

THE ASIAN CRISIS

The roots of the Asian currency crisis extended from a fundamental change in the economics of the region—the transition of many Asian nations from net exporters to net importers. Starting as early as 1990 in Thailand, the rapidly expanding economies of the Far East began importing more than they exported, requiring major net capital inflows to support their currencies. As long as the capital continued to flow in—for manufacturing plants, dam projects, infrastructure development, and even real estate speculation—the pegged exchange rates of the region could be maintained. When the investment capital inflows stopped, however, crisis was inevitable.

The most visible roots of the crisis were the excesses in capital flows into Thailand in 1996 and early 1997. With rapid economic growth and rising profits forming the backdrop, Thai firms, banks, and finance companies had ready access to capital on the international markets, finding cheap U.S. dollar loans offshore. Thai banks continued to raise capital internationally, extending credit to a variety of domestic investments and enterprises beyond the level that the Thai economy could support. Capital flows into the Thai market hit record rates, pouring into investments of all kinds, including manufacturing, real estate, and even equity market margin-lending. As the investment "bubble" expanded, some participants raised questions about the

economy's ability to repay the rising debt. The baht came under sudden and severe pressure.

Currency Collapse

The Thai government and central bank intervened in the foreign exchange markets directly (using up precious hard currency reserves) and indirectly (by raising interest rates to attempt to stop the continual out-flow). The Thai investment markets ground to a halt, causing massive currency losses and bank failures. On July 2, 1997, the Thai central bank, which had been expending massive amounts of its limited foreign exchange reserves to defend the baht's value, finally allowed the baht to float (or sink in this case). The baht fell 17 percent against the U.S. dollar and more than 12 percent against the Japanese yen in a matter of hours. By November, the baht had fallen from Baht25/US$ to Baht40/US$, a fall of about 38 percent. As illustrated in Table 4.4, Thailand was not alone in creating massive current account deficits in the period leading up to 1997. In fact, with the rather special exceptions of China and Singapore, all of East Asia was in current account deficit beginning in 1994.

Within days, a number of neighboring Asian nations, some with and some without characteristics similar to Thailand, came under speculative attack by currency traders and capital markets. The Philippine peso, the Malaysian ringgit, and the Indonesian rupiah all fell within months, as shown in Figure 4.4. In late October, Taiwan caught the markets off balance with a surprise competitive devaluation of 15 percent. The Taiwanese devaluation seemed only to renew the momentum of the crisis. Although the Hong Kong dollar survived (at great expense to the central bank's foreign exchange reserves), the Korean won was not so lucky. In November the historically stable Korean won also fell victim, falling from Won900/US$ to more than Won1100/US$. By the end of November the Korean government was in the process of negotiating a US$50 billion bailout of its financial sector with the International Monetary Fund (IMF). The only currency that had not fallen besides the Hong Kong dollar was the Chinese renminbi, which was not freely convertible. Although the renminbi had not been devalued, there was rising speculation that the Chinese government would devalue it for competitive reasons. Figure 4.4 shows the change in exchange rates for four of these Asian economies.

Causal Complexities

The Asian economic crisis—for the crisis was more than just a currency collapse—had many roots besides the traditional balance of payments difficulties. The causes are different in each country, yet there are specific underlying similarities that allow comparison: corporate socialism, corporate governance, and banking stability and management.

Corporate Socialism Although Western markets have long known the cold indifference of the free market, the countries of post–World War II Asia have largely known only the good. Because of the influence of government and politics in the business arena, even in the event of failure, government would not allow firms to fail, workers to lose their jobs, or banks to close. When the problems reached the size seen in 1997, the business liability exceeded the capacities of governments to bail business out. Practices that had persisted for decades without challenge, such as lifetime employment, were now no longer sustainable. The result was a painful lesson in the harshness of the marketplace.

Corporate Governance An expression largely unused until the 1990s, corporate governance refers to the complex process of how a firm is managed and operated,

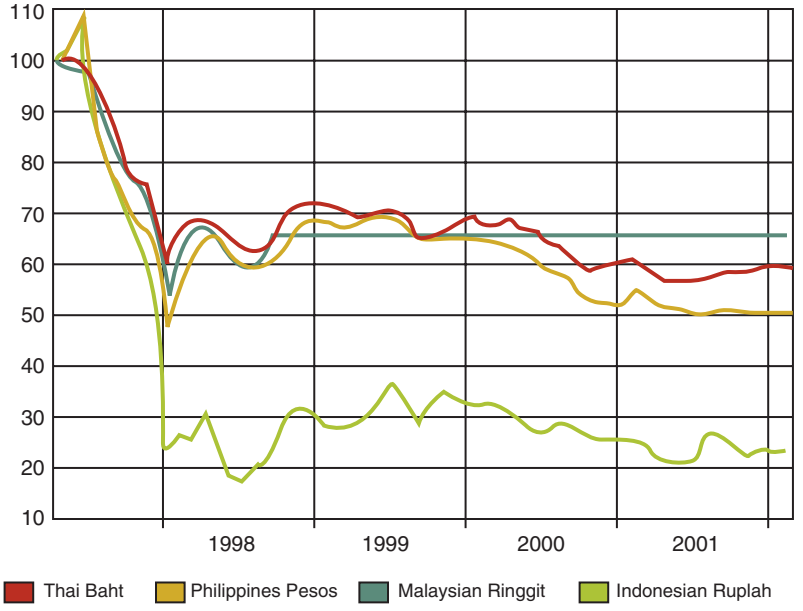
Table 4.4 Current Account Balances of East Asian Countries, 1988–1999 (millions of U.S. dollars)

	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Deficit Countries												
Indonesia	−1,397	−1,108	−2,988	−4,260	−2,780	−2,106	−2,792	−6,431	−7,663	−4,889	4,096	5,785
Korea	14,538	5,387	−1,745	−8,291	−3,944	990	−3,867	−8,507	−23,006	−8,167	40,365	24,477
Malaysia	1,867	315	−870	−4,183	−2,167	−2,991	−4,520	−8,644	−4,462	−5,935	9,529	12,606
Philippines	−390	−1,456	−2,695	−1,034	−1,000	−3,016	−2,950	−1,980	−3,953	−4,351	1,546	7,910
Thailand	−1,654	−2,498	−7,281	−7,571	−6,303	−6,364	−8,085	−13,554	−14,691	−3,021	14,243	12,428
Subtotal	**12,964**	**640**	**−15,579**	**−25,339**	**−16,194**	**−13,487**	**−22,214**	**−39,116**	**−53,775**	**−26,363**	**68,779**	**63,206**
Surplus Countries												
China	−3,802	−4,317	11,997	13,272	6,401	−11,609	6,908	1,618	7,243	36,963	31,472	15,667
Singapore	1,882	2,923	3,097	4,884	5,915	4,211	11,400	14,436	13,898	16,912	21,025	21,254
Subtotal	**−1,920**	**−1,394**	**15,094**	**18,156**	**12,316**	**−7,398**	**18,308**	**16,054**	**21,141**	**53,875**	**52,497**	**36,921**
										Asian Crisis		

"Deficit Countries" are those with current account balances that were negative for the 1994 to 1997 period, leading up to the Asian Crisis.
"Surplus Countries" are those with current account balances that were positive for the 1994 to 1997 period. Hong Kong and Taiwan are not listed, as they are not individually reported by the IMF.
The Asian Crisis actually began with the devaluation of the Thai baht on July 1, 1997. However, given annual balance of payments statistics, it is shown here between the 1997 and 1998 calendar years.

Source: Data abstracted from the International Monetary Fund, *Balance of Payments Statistics Yearbook 2000*.

Figure 4.4 Dollar Index



Source: Pacific Exchange Rate Service, http://fx.sauder.ubc.ca © 2002 by Prof. Werner Antweiler, University of British Columbia, Vancouver B.C., Canada. Time period shown in diagram: April 1, 1997 through February 1, 2002. Reproduced with permission.

who it is accountable to, and how it reacts to changing business conditions. There is little doubt that many firms operating within the Far Eastern business environments were often largely controlled by either families or groups related to the governing party or body of the country. The interests of stockholders and creditors were often secondary at best to the primary motivations of corporate management. Without focusing on "the bottom line," the bottom line deteriorated.

Banking Liquidity and Management Banking is one of those sectors that has definitely fallen out of fashion in the past two decades. Bank regulatory structures and markets have been deregulated nearly without exception around the globe. The central role played by banks in the conduct of business, however, was largely ignored and underestimated. As firms across Asia collapsed, as government coffers were emptied, as speculative investments made by the banks themselves failed, banks closed. Without banks, the "plumbing" of business conduct was shut down. Firms could not obtain the necessary working capital financing they needed to manufacture their products or provide their services. This pivotal role of banking liquidity was the focus of the International Monetary Fund's bail-out efforts.

The Asian economic crisis had global impact. What started as a currency crisis quickly became a regionwide recession (or depression, depending on definitions).[3] The slowed economies of the region quickly caused major reductions in world demand for many products, commodities especially. World oil markets, copper markets, and agricultural products all saw severe price falls as demand fell. These price falls were immediately noticeable in declining earnings and growth prospects for other emerging economies.

The post-1997 period has been one of dramatic reversal for the countries of East Asia. As Table 4.4 illustrates, beginning in 1998, every nation within East Asia listed has run a current account surplus as a result of massive recession (imports fell voluntarily, as well as being restricted by governments), significant domestic currency devaluation (resulting in significantly lower purchasing power, hence the countries

could no longer afford to purchase imports), and rising exports (as currency devaluation made their merchandise relatively cheaper for countries in other parts of the world to purchase). Unfortunately, the adjustment period has been one of massive unemployment, social disruption, and economic reconstruction with high human cost.

CAPITAL MOBILITY

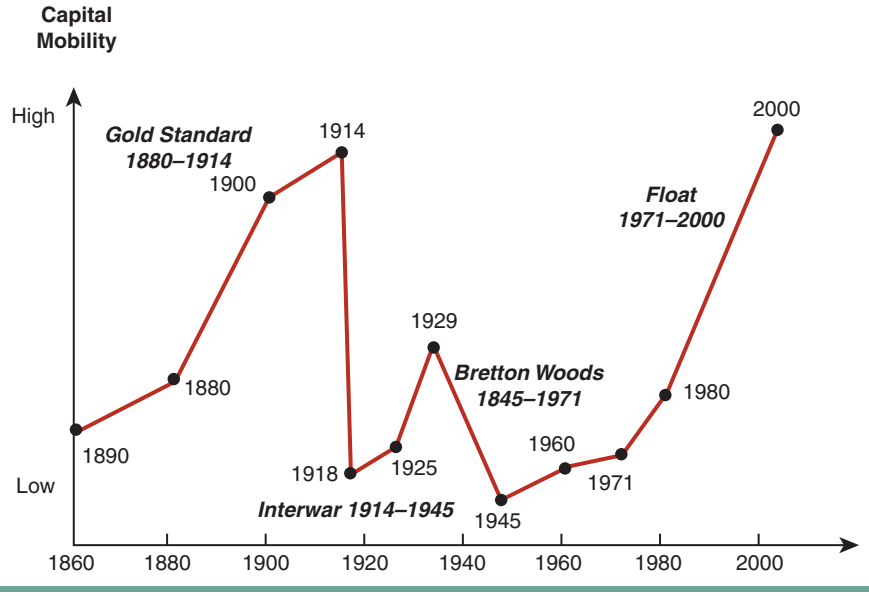
5. To understand how countries with different government policies toward international trade and investment, or different levels of economic development, differ in their balance of payments

As we have seen, the degree to which capital moves freely cross-border is critically important to a country's balance of payments. We have already seen how the United States, while experiencing a deficit in its Current Account balance over the past 20 years, has simultaneously enjoyed a Financial Account surplus. But the ability of capital to move involves both economic and political factors. The openness of the U.S. economy, the depth and breadth of its financial markets, and its relative political stability, have all contributed to making the United States an attractive nation for capital investment of all kinds. Other countries, however, depending on their economic prospects and their political openness, may not always attract capital.

Before leaving our discussion of the balance of payments we need to gain additional insights into the history of capital mobility and the contribution of capital inflows and capital outflows (so-called *capital flight*) to the balance of payments of selected countries in recent years.

Has capital always been free to move in and out of a country? Definitely not. The ability of foreign investors to own property, buy businesses, or purchase stocks and bonds in other countries has been controversial. Obstfeld and Taylor (2001) studied the globalization of capital markets and concluded that the pattern illustrated in Figure 4.5 is a fair representation of the "conventional wisdom" on the openness of

Figure 4.5 A Stylized View of Capital Mobility in Modern History



Source: "Globalization and Capital Markets," Maurice Obstfeld and Alan M. Taylor, NBER Conference Paper, May 4–5, 2001, p. 6.

global capital markets in recent history.[4] Since 1860, the gold standard in use prior to World War I and the post-1971 period of floating-exchange-rates have seen the greatest ability of capital to flow cross-border. Note that Figure 4.5 uses no specific quantitative measure of mobility. The diagram uses only a stylized distinction between "low" and "high," combining two primary factors, the exchange rate regimes and the state of international, political, and economic relations.

Obstfeld and Taylor argue that the post-1860 era can be subdivided into four distinct periods.

1. The first, 1860–1914, was a period characterized by continuously increasing capital openness as more and more countries adopted the gold standard and expanded international trade relations.
2. The second period, 1914–1945, was a period of global economic destruction. The combined destructive forces of two world wars and a worldwide depression led most nations to move toward highly nationalistic and isolationist political and economic policies, effectively eliminating any significant movement of capital between countries.
3. The third period, 1945–1971, the Bretton Woods era, saw a great expansion of international trade in goods and services. This time also saw the slow but steady recovery of capital markets. The fixed-exchange-rate regime of Bretton Woods may have failed because the sheer forces of global capital could no longer be held in check.
4. The fourth and current period, 1971–2000 [2002], is a period characterized by floating-exchange-rates and economic volatility, but rapidly expanding cross-border capital flows. The major industrial countries either no longer try, no longer need, or no longer can control the movement of capital. Because currency markets are free to reflect underlying economic fundamentals and investor sentiments about the future, capital movements increased in response to this openness.

Of course, this is a stylized global view, and the situations of the individual countries always have their own characteristics. The currency crises of the latter half of the 1990s and of the early twenty-first century may result in the reversal of this freedom of cross-border capital movement; it is still too early to tell. It is clear, however, that the ability to move instantaneously and massively cross-border has been one of the major factors in the severity of recent currency crises.

CAPITAL FLIGHT

Many recent global and financial crises have been characterized by sudden and shocking outflows of capital from the national economy, *capital flight*. Although no single accepted definition of capital flight exists, the term is traditionally used to describe sudden capital withdrawals by investors from countries in which they perceive a political, economic, or currency crisis to be forthcoming. The capital is typically portfolio investments and bank deposits (a component of "other investment" within the Financial Accounts in the balance of payments), and may be owned or controlled by both domestic and foreign investors. Much like a bank run, it is typically characterized by nearly irrational or panic behavior, as no one wants to be the last one in line to try to take their money out of a falling economy.

The rapid and sometimes illegal transfer of capital out of a country poses significant economic and political problems. Many heavily indebted countries have suffered significant capital flight, which has compounded their problems of debt service.

Five primary mechanisms exist by which capital may be moved from one country to another.

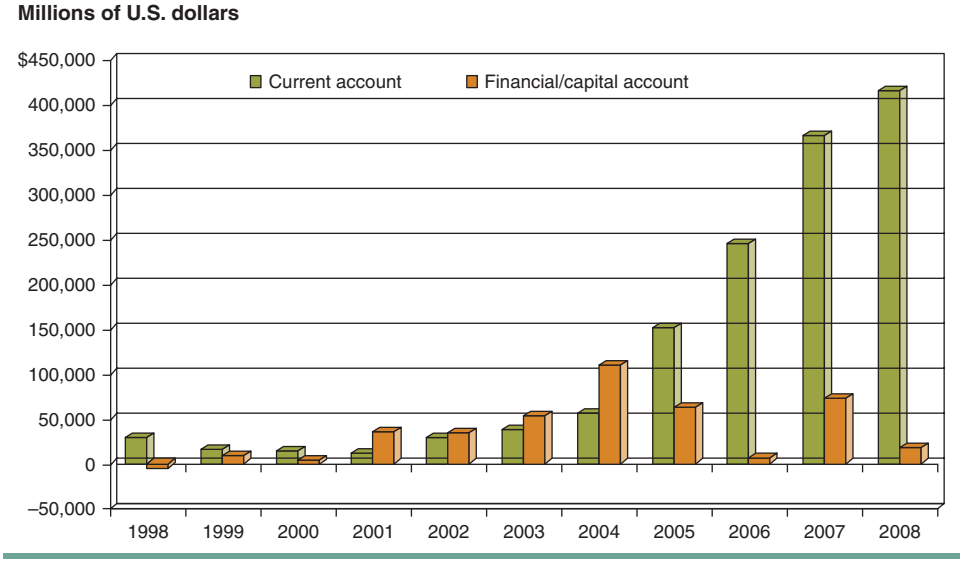
1. Transfers via the usual international payments mechanisms, regular bank transfers, are obviously the easiest and lowest cost, and are legal. Most economically healthy countries allow free exchange of their currencies, but of course for such countries "capital flight" is not a problem.
2. Transfer of physical currency by bearer (the proverbial smuggling of cash in the false bottom of a suitcase) is more costly and, for transfers out of many countries, illegal. Such transfers may be deemed illegal for balance of payments reasons or to make difficult the movement of money from the drug trade or other illegal activities.
3. The transfer of cash into collectibles or precious metals, which are then transferred across borders.
4. *Money laundering*, the cross-border purchase of assets that are then managed in a way that hides the movement of money and its ownership.
5. False invoicing of international trade transactions. Capital is moved through the underinvoicing of exports or the overinvoicing of imports, where the difference between the invoiced amount and the actually agreed-upon payment is deposited in banking institutions in a country of choice.

The concern over capital movements—both in and out of a country—has led many countries to institute a variety of capital controls at different times in history.

Capital Inflows: The Case of China

The Chinese balance of payments serves as an interesting example of one country's ongoing efforts to manage its current and financial accounts. As illustrated in Figure 4.6, China was the recipient of massive capital inflows between 1993 and 1997. This reflected a return to political norms following the Tiananmen Square events of 1989, and the perceived growing promise of the Chinese marketplace. Simultaneously, the country enjoyed a small but positive current account surplus. Both accounts, however, were heavily managed through complex Chinese regulation and intervention. Capital inflows are through a permit process, with foreign investors

Figure 4.6 Current and Combined Financial/Capital Account Balances for China, 1998–2008



Source: International Monetary Fund, *International Financial Statistics,* imf.org, September 2009.

FOCUS ON POLITICS

MY BIG FAT GREEK DEBT (*KRISIS*)

The Greek debt crisis (*krisis* in Greek, the language which gave us the term "crisis") of 2010, and its contagious spread to the value of the euro and the members of the European Union, although not a traditional Greek tragedy, is certainly a challenge to the political economy of Europe. The problem, however, is that the problem is a bit tricky with Greece's membership within the EU.

The Greek government has for many years spent more than it took in, running a government (fiscal) deficit. And like so many other governments before it, it prints pieces of paper and sells this paper, government bonds, to the global public. These Greek government bonds, also termed sovereign debt, are denominated in euros. The growing possibility of the Greek government's inability to pay these debts in a timely manner has led to a series of loans by both the EU and the international community to Greece to allow it time to get its house in order.

The threat to Greece's balance of payments from the debt crisis arises more from the country's credit rating, however, than the actual debt service payments. Greek companies of all kinds, including those that produce products for export, need to be able to borrow money from banks to help fund their working capital—their receivables and inventories—in everyday operations. When Greece's credit rating was downgraded to junk bond status in the spring of 2010, it dramatically increased the cost of borrowing for Greece on the global market. But even more critically, it meant that Greek commercial banks could no longer use Greek bonds as collateral to borrow more money from the European Central Bank. If the banks could not borrow, they could not lend. If they could not lend, Greek businesses of all kinds, including exporters, would grind to a halt.

The European Central Bank, sensing the crisis, took the politically dangerous move of changing its rules, allowing junk bond credit quality issues to now be used as collateral, a highly controversial move to keep the Greek banks open and operating. Although all agree that it will not be enough to right the sinking Greek ship, it may save Greek business another day to fight the good fight, and give it time to cut public spending and decrease its ever-growing budget deficit.

Source: "Greek Debt Restructuring to Avoid Euro Tragedy Could Become Script," John Dizard, *Financial Times*, May 8, 2010, p. 14; "ECB Suspends Rating Limits on Greek Debt," Geoffrey T. Smith, *Wall Street Journal*, May 3, 2010; "Leaders: Acropolis Now; Europe's Soverign Debt Crisis," *The Economist*, May 1, 2010, p. 11; "Neither a Borrower nor a Lender Be: Germany and Greece," *The Economist*, May 1, 2010, p. 65; "Greek Debt Downgraded to Junk," Peter Whoriskey and Dina ElBoghdady, *The Washington Post*, April 28, 2010, p. A1.

being largely limited to joint venture investments within the country. At the same time, the Chinese government has aggressively promoted exports of many products while exercising extreme control over imports, both in content and quantity.

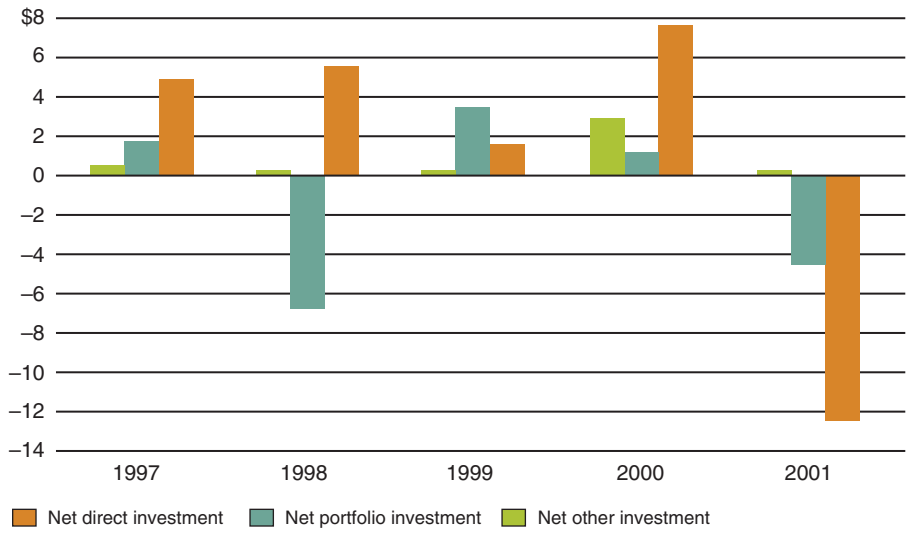
The onslaught of the Asian Crisis in 1997, however, clearly brought the capital inflows to a halt (India suffered a similar fate as well). The Chinese financial account balance fell back, suffering a deficit in 1998, and near zero balances in 1999 and 2000. But with the new millennium (remember, the official start of the new century was January 1, 2001, not 2000), China's attractiveness returned, as it was the recipient of more than $35 billion in capital inflows in 2001 alone. This massive capital injection by global investors—primarily multinational corporations—was indicative of the perceived attractiveness of the Chinese economy for future economic growth and the renewed comfort these investors felt with the current Chinese political regime.

Capital Outflows: The Case of Turkey

Turkey's economic and financial crisis of 2000–2001 serves as a prime example of how a country's balance of payments can deteriorate—or essentially collapse—in a very short period of time. Although there were a series of political, economic, and social ills that combined during the height of the crisis, a very large part of Turkey's crisis arose from capital flight. Figure 4.7 illustrates some of Turkey's financial accounts and how they deteriorated suddenly in 2001.

In the late 1990s many of Turkey's largest and most powerful banks borrowed large quantities of U.S. dollars on the international financial markets. The capital was not used for loans or development in Turkey, but rather on speculation related to Turkish government bonds. Bank funds and financing is listed in the "net other investment" subcategory of the balance of payments, and Turkey's net inflows 1997–2000 are obvious from Figure 4.7. However, a political crisis in February 2001 initiated a series of economic crises in Turkey, including the collapse of its currency. With this crisis, the capital that had so readily flowed into Turkey in the previous

Figure 4.7 Turkey's Financial Accounts in Crisis, 1997–2001 (billions of U.S. dollars)



Source: International Monetary Fund, *Balance of Payments Statistics Yearbook*, 2002.

years now flew out. The devastating amount in 2001, more than $12 billion, resulted in a structural collapse of the Turkish banking system.

SUMMARY

The balance of payments is the summary statement of all international transactions between one country and all other countries. The balance of payments is a flow statement, summarizing all the international transactions that occur across the geographic boundaries of the nation over a period of time, typically a year. Because of its use of double-entry bookkeeping, the BOP must always balance in theory, though in practice there are substantial imbalances as a result of statistical errors and misreporting of current account and capital account flows.

The two major subaccounts of the balance of payments, the current account and the capital account, summarize the current trade and international capital flows of the country. Due to the double-entry bookkeeping method of accounting, the current account and capital account are always inverse on balance, one in surplus while the other experiences deficit. Although most nations strive for current account surpluses, it is not clear that a balance on current or capital account, or a surplus on current account, is either sustainable or desirable. The monitoring of the various subaccounts of a country's balance of payments activity is helpful to decision makers and policymakers at all levels of government and industry in detecting the underlying trends and movements of fundamental economic forces driving a country's international economic activity.

KEY TERMS

balance of payments (BOP) 96
current account 96
financial account 96
double-entry bookkeeping 97
net errors and omissions account 104
official reserves account 105
fixed-exchange-rate 106
floating-exchange-rate 106

QUESTIONS FOR DISCUSSION

1. Why must a country's balance of payments always be balanced in theory?
2. What is the difference between the merchandise trade balance (BOT) and the current account balance?
3. What is service trade?
4. Why is foreign direct investment so much more controversial than foreign portfolio investment? How did this relate to Mexico in the 1990s?