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**CHAPTER 3: BALANCE OF PAYMENTS**

1. **Balance of payments defined.** The measurement of all international economic transactions between the residents of a country and foreign residents is called the balance of payments (BOP). What institution provides the primary source of similar statistics for balance of payments and economic performance worldwide?

The primary source of similar statistics for balance of payments and economic performance worldwide is the International Monetary Fund, *Balance of Payments Statistics*.

2. **Importance of BOP.** Business managers and investors need BOP data to anticipate changes in host country economic policies that might be driven by BOP events. From the perspective of business managers and investors list three specific signals that a country's BOP data can provide.

- The BOP is an important indicator of pressure on a country's foreign exchange rate, and thus on the potential for a firm trading with or investing in that country to experience foreign exchange gains or losses. Changes in the BOP may predict the imposition or removal of foreign exchange controls.
- Changes in a country's BOP may signal the imposition or removal of controls over payment of dividends and interest, license fees, royalty fees, or other cash disbursements to foreign firms or investors.
- The BOP helps to forecast a country's market potential, especially in the short run. A country experiencing a serious trade deficit is not likely to expand imports as it would if running a surplus. It may, however, welcome investments that increase its exports.

3. **Economic activity.** What are the two main types of economic activity measured by a country's BOP?

- a) Current transactions having cash flows completed within one year, such as for the import or export of goods and services.
- b) Capital and financial transactions, in which investors acquire ownership of a foreign asset, such as a company, or a portfolio investment, such as bonds or shares of common stock.

4. **Balance.** Why does the BOP always "balance"?

The algebraic sum of all flows accounted for in the current account and the capital and financial accounts should, in theory, equal changes in a country's monetary reserves. Because data for the balance of payments is collected on a single entry basis and some data is missed, the equalization usually does not occur. The imbalance is plugged by an entry called "errors and omissions" which makes the accounts balance.

5. **BOP accounting.** If the BOP were viewed as an accounting statement, would it be a balance sheet of the country's wealth, an income statement of the country's earnings, or a funds flow statement of money into and out of the country?

A country's balance of payments is similar to a corporation's funds statement in that the balance of payments records events that cause the receipt (earnings) and disbursement (expenditures) of foreign exchange.

6. **Current account.** What are the main component accounts of the current account? Give one debit and one credit example for each component account for the United States.

The main components and possible examples are:

*Trade in goods:*

- Debit: U.S. firm purchases German machine tools.  
 Credit: Singapore Air Lines buys a Boeing jet.

*Trade in services:*

- Debit: An American takes a cruise on a Dutch cruise line.  
 Credit: The Brazilian tourist agency places an ad in *The New York Times*.

*Income payments and receipts:*

- Debit: The U.S. subsidiary of a Taiwan computer manufacturer pays dividends to its parent.  
 Credit: A British company pays the salary of its executive stationed in New York.

*Unilateral current transactions:*

- Debit: The U.S.-based International Rescue Committee pays for an American working on the Afghan border.  
 Credit: A Spanish company pays tuition for an employee to study for an MBA in the United States.

**7. Real versus financial assets. What is the difference between a “real” asset and a “financial” asset?**

Real assets are goods (merchandise) and useful services. Financial assets are financial claims, such as shares of stock or bonds.

**8. Direct versus portfolio investments. What is the difference between a direct foreign investment and a portfolio foreign investment? Give an example of each. Which type of investment is a multinational industrial company more likely to make?**

A direct investment is made with the intent that the investor will have a degree of control over the asset acquired. Typical examples are the building of a factory in a foreign country by the subsidiary of a multinational enterprise or the acquisition of more than 10% of the voting shares of a foreign corporation. A portfolio investment is the purchase of less than 10% of the voting shares of a foreign corporation or the purchase of debt instruments. Multinational enterprises are more likely to engage in direct foreign investment than in portfolio investment.

**9. Capital and financial accounts. What are the main components of the financial accounts? Give one debit and one credit example for each component account for the United States.**

The main components and possible examples are:

*Direct investment.*

- Debit: Ford Motor Company builds a factory in Australia.  
 Credit: Ford Motor Company sells its factory in Britain to British investors.

*Portfolio investment.*

- Debit: An American buys shares of stock of a European food chain on the Frankfurt Stock Exchange.  
 Credit: The government of Korea buys United States treasury bills to hold as part of its foreign exchange reserves.

*Other investment.*

- Debit: A U.S. firm deposits \$1 million in a bank balance in London.  
 Credit: A U.S. firm generates an account receivable for exports to Canada.

**10. Classifying transactions. Classify the following as a transaction reported in a sub-component of the current account or the capital and financial accounts of the two countries involved:**

- a) A U.S. food chain imports wine from Chile. Debit to U.S. goods part of current account, credit to Chilean goods part of current account.
- b) A U.S. resident purchases a euro-denominated bond from a German company. Debit to U.S. portfolio part of financial account; credit to German portfolio of financial account.
- c) Singaporean parents pay for their daughter to study at a U.S. university. Credit to U.S. current transfers in current account; debit to Singapore current transfers in current account.
- d) A U.S. university gives a tuition grant to a foreign student from Singapore. If the student is already in the United States, no entry will appear in the balance of payments because payment is between U.S. residents. (A student already in the U.S. becomes a resident for balance of payments purposes.)
- e) A British Company imports Spanish oranges, paying with eurodollars on deposit in London. A debit to the goods part of Britain's current account; a credit to the goods part of Spain's current account.
- f) The Spanish orchard deposits half the proceeds of its sale in a New York bank. A debit to the income receipts/payments part of Spain's current account; a credit to the income receipts/payments part of the U.S. current account.
- g) The Spanish orchard deposits half the proceeds in a eurodollar account in London. No recording in the U.S. balance of payments, as the transaction was between foreigners using dollars already deposited abroad. A debit to the income receipts/payments of the British current account; a credit to the income receipts/payments of the Spanish current account.
- h) A London-based insurance company buys U.S. corporate bonds for its investment portfolio. A debit to the portfolio investment section of the British financial accounts; a credit to the portfolio investment section of the U.S. balance of payments.
- i) An American multinational enterprise buys insurance from a London insurance broker. A debit to the services part of the U.S. current account; a credit to the services part of the British current account.
- j) A London insurance firm pays for losses incurred in the United States because of an international terrorist attack. A debit to the services part of the British current account; a credit to the services part of the U.S. current account.
- k) Cathay Pacific Airlines buys jet fuel at Los Angeles International Airport so it can fly the return segment of a flight segment back to Hong Kong. Hong Kong keeps its balance of payments separate from those of the People's Republic of China. Hence a debit to the goods part of Hong Kong's current account; a credit to the goods part of the U.S. current account.
- l) A California-based mutual fund buys shares of stock on the Tokyo and London stock exchanges. A debit to the portfolio investment section of the U.S. financial account; a credit to the portfolio investment section of the Japanese and British financial accounts.
- m) The U.S. army buys food for its troops in South Asia from vendors in Thailand. A debit to the goods part of the U.S. current account; a credit to the goods part of the Thai current account.
- n) A Yale graduate gets a job with the International Committee of the Red Cross working in Bosnia and is paid in Swiss francs. A debit to the income part of the Swiss current account; a credit to the income part of the Bosnia current account. This assumes the Yale graduate spends her earnings within Bosnia; should she deposit the sum in the United States then the credit would be to the income part of the U.S. current account.
- o) The Russian government hires a Dutch salvage firm to raise a sunken submarine. A debit to the service part of Russia's current account; a credit to the service part of the Netherlands's current account.
- p) A Colombian drug cartel smuggles cocaine into the United States, receives a suitcase of cash, and flies back to Colombia with that cash. This would not get captured in the goods part of the U.S. or the Colombian current accounts. Assuming the cash was "laundered" appropriately, from the point of view of the smugglers, bank accounts in the U.S. or somewhere else (probably not Colombia, possibly Switzerland) would be credited. This imbalance would end up in the errors and omissions part of the U.S. balance of payments.
- q) The U.S. government pays the salary of a foreign service officer working in the U.S. embassy in Beirut. Diplomats serving in a foreign country are regarded as residents of their home country, so this payment

would not be recorded in any balance of payments accounts. If or when the diplomat spent the money in Beirut, at that time a debit should be incurred in the goods or services part of the U.S. current account and a contrary entry in the Lebanon balance of payments. It is doubtful that the goods or services transaction would get reported or recorded, although on a net basis changes in bank balances would reflect half of the transaction.

- r) A Norwegian shipping firm pays U.S. dollars to the Egyptian government for passage of a ship through the Suez canal. If the Norwegian firm paid with dollar balances held in the U.S. and the Suez Canal Authority of Egypt redeposited the proceeds in the U.S. no entry would appear in the U.S. balance of payments. Norway would debit a purchase of services, and Egypt would credit a sale of services.
- s) A German automobile firm pays the salary of its business executive working for a subsidiary in Detroit. Germany would record a debit in the income payments/receipts in its current account; the U.S. would record a credit in the income payments/receipts in its current account.
- t) An American tourist pays for a hotel in Paris with his American Express card. A debit would be recorded in the services part of the U.S. current account; a credit would be recorded in the services part of the French current account.
- u) A French tourist from the provinces pays for a hotel in Paris with his American Express card. A French resident most likely has a French-issued credit card, issued by the French subsidiary of American Express. In this instance, no entry would appear in either country's balance of payments. If, later, the French subsidiary of American Express paid a dividend back to the U.S., that would be recorded in the income part of the current accounts.
- v) A U.S. professor goes abroad for a year and lives on a Fulbright grant. The current transfers section of the U.S. current account would be debited for the salary paid to a foreign resident. (Even though an American, the professor is a foreign resident during the time he lives abroad.) The current transfers section of the host country's current account would be credited.

**11. The Balance. What are the main summary statements of the balance of payments accounts and what do they measure?**

- a) The *balance on goods* (also called the *balance of trade*) measures the balance on imports and exports of merchandise.
- b) The *balance on current account* expands the balance on goods to include receipts and expenses for services, income flows, and unilateral transfers.
- c) The *basic balance* measures all of the international transactions (current, capital, and financial) that come about because of market forces. I.e., the balance resulting from all decisions made for private motives. (This includes international operating expenses of the government.)
- d) The *overall balance* (also called the *official settlements balance*) is the total change in a country's foreign exchange reserves caused by the basic balance plus any governmental action to influence foreign exchange reserves.

**12. Drugs and terrorists. Where in the balance of payments accounts do the flows of "laundered" money by drug dealers and international terrorist organizations flow?**

Quite obviously the merchandise involved in the import or export of marijuana, heroin, cocaine, or other drugs is not reported to customs officials and so does not appear in the goods section of the current account. For similar reasons, the cash payments used to finance terrorists are not reported in the current transfers section of the current account.

The opposite side to any of these transactions is changes in bank balances held by foreigners or foreign bank balances held by home country residents. These are usually reported, but only in the aggregate. That is, the total changes in holdings are reported by banks, but the parties to the millions and millions of individual transactions that lead to the total change are not reported. The imbalance shows up in the errors and omissions part of the

balance of payments.

- 13. Capital mobility – United States. The US dollar has maintained or increased its value over the past 20 years despite running a gradually increasing current account deficit. Why has this phenomenon occurred?**

The U.S. dollar has maintained or increased its value over the past 20 years despite running a gradually increasing current account deficit because the current account deficit has been more than offset by an inflow of dollars on capital and financial accounts.

- 14. Capital mobility – Brazil. Brazil has experienced periodic depreciation of its currency over the past 20 years despite occasionally running a current account surplus. Why has this phenomenon occurred?**

Brazil has experienced periodic depreciation of its currency because of speculative flights of capital out of Brazil in response to political and/or economic shocks, including periods of hyper-inflation.

- 15. Capital flight. Capital flight has historically weakened the currencies of many countries. What are five of the typical mechanisms by which flight capital can be moved from one currency to another?**

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 out 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 which are then managed in a way that hide the movement of money and its ownership.
  - 5) False invoicing of international trade transactions. Capital is moved through the under-invoicing of exports or the over-invoicing 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.
- 16. U.S. BOP and the U.S. dollar. With reference to the U.S. balance of payments shown in Exhibit 3.7, identify the specific accounts that enable the U.S. dollar to maintain its value.**

The United States, as shown by Exhibit 3.7, ran a current account deficit continuously between 1993 and 2000. This deficit category was, however, substantially offset in most years by a Financial Account surplus. The Financial Account surplus was continuously positive between 1993 and 2000. The biggest positive contribution to the Financial Account surplus was net portfolio investment (primarily debt securities), which made up a significant proportion of the surplus itself.

**MINI-CASE: TURKEY'S KRIZ (A): DETERIORATING BALANCE OF PAYMENTS**

- 1. Where in the Current Account would the imported telecommunications equipment be listed? Would this correspond to the increase in magnitude and timing of the Financial Account?**

The telecom equipment would appear in the *Current Account* as an import of goods. *Net other investment* would include financing by the vendors that sold TelSim the equipment. This and other imports of capital equipment probably accounted for most of the increase in net other investment and thus the large negative balance in the *Financial Account* in the year 2000.

- 2. Why do you think that net direct investment declined from \$571 million in 1998 to \$112 million in 2000?**

The decline was probably caused by a lack of confidence in Turkey's political stability and long-term growth prospects. Turkey's war on its own inflation during the period 1999 to early 2000 must have included high interest rates and other macroeconomic policies to slow down the rate of growth. A slower rate of growth, if maintained in the long run, would reduce expected returns and direct investment inflows.

- 3. Why do you think that TelSim defaulted on its payments for equipment imports from Nokia and Motorola?**

TelSim needed to invest heavily in capital equipment in order to create a modern high speed, high capacity network. Unfortunately, a considerable time gap typically exists between the time a network is created and its capacity is utilized by revenue-paying customers. Thus long-term financing rather than short-term trade financing is needed. The timing gap experienced by TelSim was also experienced by many other telecommunications companies worldwide, including the highly-publicized case of Global Crossing, which also went bankrupt.

Expectations for the telecom industry and its ability to "monetize its customer base," the ability to generate significant revenues from installed networks, proved overly optimistic. A worldwide overcapacity of telecommunications networks led to cutthroat price competition, adding to the shortfall in revenues experience worldwide. The overcapacity continued for several years, however, as firms attempted to survive by covering variable costs but not fixed capital costs of providing services.

Finally, there has been a continuing debate over the intentions and ethics of the Uzan family itself – the controlling interest group of TelSim. The press has run a number of stories raising the question as to whether the Uzan family had ever truly intended to repay the massive infrastructure financing provided by Motorola and Nokia. At the time of this writing, however, there is no proof that this was the case.