SUMMARY POINTS

- 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.
- Although the BOP must always balance in theory, in practice there are substantial imbalances as a result of statistical errors and misreporting of current account and financial/capital account flows.
- The two major sub-accounts of the balance of payments, the current account and the financial/capital account, summarize the current trade and international capital flows of the country respectively.
- The current account and financial/capital account are typically 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.
- Although merchandise trade is more easily observed (for example, goods flowing through ports of entry), the growth of services trade is more significant to the balance of payments for many of the world's largest industrialized countries today.
- Monitoring of the various sub-accounts of a country's balance of payment activity is helpful to decision makers and policy makers on all levels of government and industry in detecting the underlying trends and movements of fundamental economic forces driving a country's international economic activity.
- Changes in exchange rates change relative prices of imports and exports, and changing prices in turn result in changes in quantities demanded through the price elasticity of demand.
- A devaluation results initially in a further deterioration in the trade balance before an eventual improvement—the path of adjustment taking on the shape of a flattened "j".
- The ability of capital to move instantaneously and massively cross-border has been one of the major factors in the severity of recent currency crises. In a number of cases, such as Malaysia in 1997 and Argentina in 2001, the national governments concluded that they had no choice but to impose drastic restrictions on the ability of capital to flow.
- Although not limited to heavily indebted countries, the rapid and sometimes illegal transfer of convertible currencies 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.

MINI-CASE

Turkey's Kriz (A): Deteriorating Balance of Payments

It was only when optimistic Turks started snapping up imports that investors began to doubt that foreign capital inflows would be sufficient to fund both spendthrift consumers and the perennially penurious government.

—"On the Brink Again," *The Economist*, February 24, 2001.

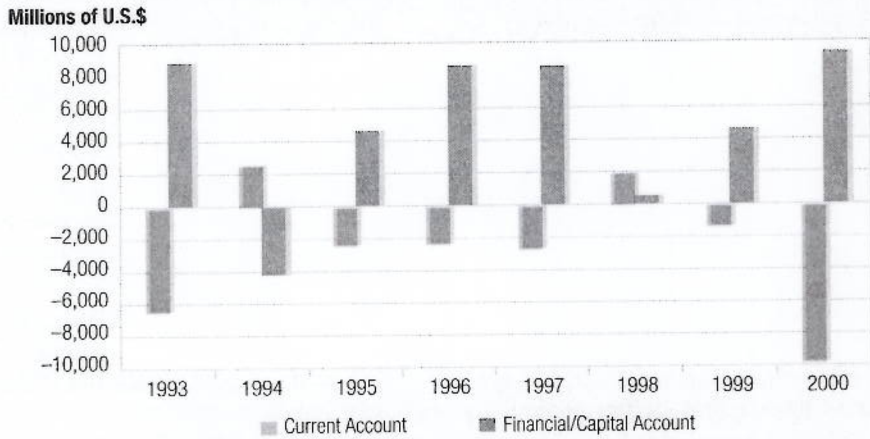
In February 2001 Turkey's rapidly escalating economic *kriz*, or crisis, forced the devaluation of the Turkish lira. The Turkish government had successfully waged war on the inflationary forces embedded in the country's economy in 1999 and early 2000. But just as the economy began to boom in the second half of 2000, pressures on the country's balance of payments and currency rose. The question asked by many analysts in the months following the crisis was whether the crisis had been predictable, and what early signs of deterioration should have been noted by the outside world.

The Accounts

Exhibit 1 presents the Turkish balance on current account and financial account between 1993 and 2000 (ending less than two months prior to the devaluation). Several issues are immediately evident:

- First, Turkey seemingly suffered significant volatility in the balances on key international accounts. The financial account swung between surplus

EXHIBIT 1 **Turkey's Balance of Payments, 1993–2000**



(1993) and deficit (1994), and back to surplus again (1995–1997). After plummeting in 1998, the financial surplus returned in 1999 and 2000.

- Second, as is typically the case, the current account behaved in a relatively inverse manner to the financial account, running deficits in most of the years shown. But significantly, the deficit on current account grew dramatically in 2000, to over $9.8 billion, from a deficit in 1999 of only $1.4 billion.

Many analysts are quick to point out that the sizable increase in the current account deficit should have been seen as a danger signal of imminent collapse. Others, however, point out quite correctly that most national economies experience rapid increases in trade and current account deficits during rapid periods of economic growth. And to add weight to the argument, the net surplus on the financial account seemed to indicate a growing confidence in the Turkish economy's outlook by foreign investors.

An examination of the subcomponents of these major account balances is helpful. As illustrated in Exhibit 2, the rapid deterioration of the current account in 2000 was largely the result of a rapid jump in imported goods and merchandise. The goods import bill rose from $39.8 billion

EXHIBIT 2 **Subaccounts of the Turkish Current Account, 1998–2000 (millions of U.S. dollars)**

	1998	1999	2000
Goods: exports	31,220	29,325	31,664
Goods: imports	–45,440	–39,768	–54,041
Balance on goods	–14,220	–10,443	–22,377
Services: credit	23,321	16,398	19,484
Services: debit	–9,859	–8,953	–8,149
Balance on services	13,462	7,445	11,335
Income: credit	2,481	2,350	2,836
Income: debit	–5,466	–5,887	–6,838
Balance on income	–2,985	–3,537	–4,002
Current transfers: credit	5,860	5,294	5,317
Current transfers: debit	–133	–119	–92
Balance on transfers	5,727	5,175	5,225
Balance on current account	1,984	–1,360	–9,819

Source: International Monetary Fund, *Balance of Payments Statistics Yearbook 2001*, p. 913.

in 1999 to over $54.0 billion in 2000, an increase of 36% in one year. At the same time, services trade and current income accounts, both credits and debits subcomponents, showed little change. Unfortunately, the statistics reported to the IMF provide little in additional detail as to the composition of these rapid imports, their industry or nature, and their financing.

A similar decomposition of the surplus on the financial account also allows us to identify where in the various inflows and outflows of capital in Turkey there was a significant change. Exhibit 3 provides this financial account decomposition. According to Exhibit 3, the doubling of the Turkish financial account surplus in 2000 was largely the result of a massive increase—over $7 billion—in "net other investment."

One very important determinant of these account balances was the telecommunications sector. Throughout 2000, TelSim, the national telecommunications provider in Turkey, imported billions of dollars worth of equipment from Nokia (Finland) and Motorola (United States). The equipment was purchased on trade credit, meaning that TelSim would repay Nokia and Motorola at a future date for the equipment, primarily from the proceeds of activating the equipment for telecommunications services. TelSim, however, defaulted on its payments, and Nokia and Motorola were left with billions of dollars in losses.

Case Questions

1. Where in the current account would the imported telecommunications equipment be listed? Would this location correspond to the increase in magnitude and timing of the financial account?
2. Why do you think that net direct investment declined from $573 million in 1998 to $112 million in 2000?
3. Why do you think that TelSim defaulted on its payments for equipment imports from Nokia and Motorola?

EXHIBIT 3 Subaccounts of the Turkish Financial Account, 1998–2000 (millions of U.S. dollars)

	1998	1999	2000
Net direct investment	573	138	112
Net portfolio investment	-6,711	3,429	1,022
Net other investment	6,586	1,103	8,311
Balance of financial account	448	4,670	9,445

Source: International Monetary Fund, *Balance of Payments Statistics Yearbook 2001*, p. 915.

QUESTIONS

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?
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.
3. **Economic Activity.** What are the two main types of economic activity measured by a country's BOP?
4. **Balance.** Why does the BOP always "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?
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.
7. **Real versus Financial Assets.** What is the difference between a "real" asset and a "financial" asset?
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?