CHAPTER 7

The International Monetary System and the Balance of Payments

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AFTER STUDYING THIS CHAPTER, YOU SHOULD BE ABLE TO:

1. Discuss the role of the international monetary system in promoting international trade and investment.
2. Explain the evolution and functioning of the gold standard.
3. Summarize the role of the World Bank Group and the International Monetary Fund in the post–World War II international monetary system established at Bretton Woods.
4. Explain the evolution of the flexible exchange rate system.
5. Describe the function and structure of the balance of payments accounting system.
6. Differentiate among the various definitions of a balance of payments surplus and deficit.

A GLOBAL CURRENCY WAR?

Some experts fear that a global war has erupted in the aftermath of the Global Recession of 2008–2009. The goal of such a war is not to spread an ideological agenda or to expand the size of the realm but to promote jobs and domestic economic growth. This war is not being fought with guns, but with exchange rates. Exchange rates—the value of a country's currency in terms of a second country's currency—have become the weapon of choice because they affect the competitiveness of a country's exporters, the intensity of threats to domestic firms vulnerable to foreign imports, and even a country's ability to attract foreign direct investment (FDI).

Politicians have long been concerned that foreign nations might manipulate the value of their currencies to the detriment of their home country. China, for instance, has long been accused of artificially lowering the value of the yuan. Such a policy would make Chinese goods more attractive for foreign consumers, foreign goods less attractive to Chinese consumers, and building factories in China more attractive, thereby creating more job opportunities for Chinese workers.

As a result of the Global Recession of 2008–2009, many governments adopted policies to try to reinvigorate their domestic economies. The United States ran trillion-dollar budget deficits to increase aggregate demand, and the U.S. Federal Reserve Bank pushed interest rates to near zero through its aggressive quantitative easing programs. The Bank of England and the European Central Bank both adopted similar easy money policies. One impact of low interest rates, however, is that it exerts downward pressure on a country's exchange rate. Low interest rates motivate investors to redeploy their capital to markets paying higher interest rates. As they do so, they sell off their holdings of investments in the low-interest rate countries (driving down the price of those currencies) and raising the demand for the currencies of countries with high interest rates. Brazil's government, for example, has criticized the quantitative easing policies of the Federal Reserve Bank. Brazil competes with the United States in many agricultural markets, so a fall in the U.S. dollar relative to the Brazilian real makes it easier for U.S. producers of goods such as orange juice, soybeans, and cotton to compete against their South American rivals. Yet it also raises the fears of creating new assets bubbles, such as the ones in the U.S., Spanish, and Irish housing markets, which contributed to the recent global recession. The Swiss National Bank, for instance, has imposed new capital requirements on its domestic mortgage market, fearing that foreign investors seeking a safe harbor for their monies in Switzerland will overwhelm the Swiss housing market.

Shinzo Abe, the prime minister of Japan's new government elected in December 2012, adopted similar approaches to address the long-term stagnation of the Japanese economy. Abe believed that Japan's domestic demand was being hurt by deflation. (If consumers think prices will fall in the future, then they will tend to postpone their purchases.) Abe thus wanted monetary easing so as to create mild inflation in Japan, thereby encouraging Japanese consumers to buy goods now rather than later. Gao Xiqing, head of China Investment Corp. (a sovereign wealth fund with $440 billion of assets), promptly admonished Abe, warning "Treating the neighbors as your garbage bin and starting a currency war would not only be dangerous for others but eventually be bad for yourself." He added, "I would hope that it doesn't do that as a responsible government." German Chancellor Angela Merkel also criticized Japan's actions, arguing "central banks are not there to clean up bad policy decisions and a lack of competitiveness." The U.S. Treasury chimed in with similar concerns, urging Japan not to suppress the value of the yen to stimulate Japanese exports. The new head of the Bank of Japan, Haruhiko Kuroda rejected the charges, asserting "BOJ's monetary policy is not at all targeted at pushing down the currency. By taking a bold monetary easing policy and exiting deflation as soon as possible, that's good not only for Japan, but for the economies of Asia and the rest of the world." Japan's actions put pressure on China, South Korea, and Taiwan, who compete with Japanese-made electronics goods in world markets. Russian and South Korean leaders have suggested that they are considering weakening their currencies in response to Japan's actions.

Central bankers and finance ministers may be caught between a rock and a hard place. The easy-money policies are designed to promote economic growth, which they all want. The easy-money policies may also trigger a currency war, which none of them want. Finding the right balance is one of the primary challenges they now face.[1] ■

As we discuss in this chapter, this is not the first time a global currency war had threatened the world's economy. The 1930s were marked by similar economic conflicts. Many international economists believe that the manipulation of their currencies' values by the United States, the United Kingdom, France, Switzerland, and Belgium deepened and elongated the Great Depression of that decade. Avoiding a currency war and ensuring that the international monetary system functions efficiently to promote world commerce is thus of great importance to world leaders, central bankers, and business people.

The international monetary system exists because most countries have their own currencies. A means of exchanging these currencies is needed if business is to be conducted across national boundaries. The **international monetary system** establishes the rules by which countries value

and exchange their currencies. It also provides a mechanism for correcting imbalances between a country's international payments and its receipts. Further, the cost of converting foreign money into a firm's home currency—a variable critical to the profitability of international operations—depends on the smooth functioning of the international monetary system.

International business people also monitor the international monetary system's accounting system, the balance of payments. The **balance of payments (BOP) accounting system** records international transactions and supplies vital information about the health of a national economy and likely changes in its fiscal and monetary policies. BOP statistics can be used to detect signs of trouble that could eventually lead to governmental trade restrictions, higher interest rates, accelerated inflation, reduced aggregate demand, and general changes in the cost of doing business in any given country.

History of the International Monetary System

Today's international monetary system can trace its roots to the ancient allure of gold and silver, both of which served as media of exchange in early trade between tribes and in later trade between city-states. Silver, for example, was used in trade among India, Babylon, and Phoenicia as early as the seventh century B.C.E.[2] As the modern nation-states of Europe took form in the sixteenth and seventeenth centuries, their coins were traded on the basis of their relative gold and silver content.

The Gold Standard

Ancient reliance on gold coins as an international medium of exchange led to the adoption of an international monetary system known as the gold standard. Under the **gold standard**, countries agree to buy or sell their paper currencies in exchange for gold on the request of any individual or firm and, in contrast to mercantilism's hoarding of gold, to allow the free export of gold bullion and coins. In 1821 the United Kingdom became the first country to adopt the gold standard. During the nineteenth century, most other important trading countries—including Russia, Austria-Hungary, France, Germany, and the United States—did the same.

The gold standard effectively created a fixed exchange rate system. An **exchange rate** is the price of one currency in terms of a second currency. Under a **fixed exchange rate system**, the price of a given currency does not change relative to each other currency. The gold standard created a fixed exchange rate system because each country tied, or **pegged**, the value of its currency to gold. The United Kingdom, for example, pledged to buy or sell an ounce of gold for 4.247 pounds sterling, thereby establishing the pound's **par value**, or official price in terms of gold. The United States agreed to buy or sell an ounce of gold for a par value of $20.67. The two currencies could be freely exchanged for the stated amount of gold, making £4.247 = 1 ounce of gold = $20.67. This implied a fixed exchange rate between the pound and the dollar of £1 = $4.867, or $20.67/£4.247.

As long as firms had faith in a country's pledge to exchange its currency for gold at the promised rate when requested to do so, many actually preferred to be paid in currency. Transacting in gold was expensive. Suppose Jardine Matheson, a Hong Kong trading company, sold £100,000 worth of tea to Twining & Company, a London distributor of fine teas. If it wanted to be paid in gold by Twining & Company on delivery of the tea, Jardine Matheson had to bear the costs of loading the gold into the cargo hold of a ship, guarding it against theft, transporting it, and insuring it against possible disasters. Moreover, because of the slowness of sailing ships, Jardine Matheson would be unable to earn interest on the £100,000 payment while the gold was in transit from London to Hong Kong. However, if Jardine Matheson was willing to be paid in British pounds, Twining could draft a check to Jardine Matheson and give it to the firm's London agent. The London agent could then either immediately deposit the check in Jardine Matheson's interest-bearing London bank account or transfer the funds via telegraph to the firm's account at its Hong Kong bank.

From 1821 until the end of World War I in 1918, the most important currency in international commerce was the British pound sterling, a reflection of the United Kingdom's emergence from the Napoleonic Wars as Europe's dominant economic and military power. Most firms worldwide were willing to accept either gold or British pounds in settlement of transactions. As a result, the

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The international monetary system was based on the gold standard in the century following Napoleon's 1815 defeat at Waterloo. Under the gold standard, each country pledged to buy or sell its own currency at a fixed price relative to gold.

international monetary system during this period is often called a **sterling-based gold standard**. The pound's role in world commerce was reinforced by the expansion of the British Empire. The Union Jack flew over so many lands (see Map 7.1)—for example, present-day Canada, Australia, New Zealand, Hong Kong, Singapore, India, Pakistan, Bangladesh, Kenya, Zimbabwe, South Africa, Gibraltar, Bermuda, and Belize—that the claim was made that "the sun never sets on the British Empire." In each colony British banks established branches and used the pound sterling to settle international transactions among themselves. Because of the international trust in British currency, London became the dominant international financial center in the nineteenth century, a position it still holds. The international reputations and competitive strengths of such British firms as Barclays Bank, Thomas Cook, and Lloyd's of London stem from the role of the pound sterling in the nineteenth-century gold standard.

The Collapse of the Gold Standard

During World War I, the sterling-based gold standard unraveled. With the outbreak of war, normal commercial transactions between the Allies (France, Russia, and the United Kingdom) and the Central Powers (Austria-Hungary, Germany, and the Ottoman Empire) ceased. The economic pressures of war caused country after country to suspend their pledges to buy or sell gold at their currencies' par values. After the war, conferences at Brussels (1920) and Genoa (1922) yielded general agreements among the major economic powers to return to the prewar gold standard. Most countries, including the United States, the United Kingdom, and France, readopted the gold standard in the 1920s despite the high levels of inflation, unemployment, and political instability that were wracking Europe.

The resuscitation of the gold standard proved to be short-lived, however, as a result of the economic stresses triggered by the worldwide Great Depression. The Bank of England, the United Kingdom's central bank, was unable to honor its pledge to maintain the value of the pound. On September 21, 1931, it allowed the pound to **float**, meaning that the pound's value would be determined by the forces of supply and demand and the Bank of England would no longer redeem British paper currency for gold at par value.

After the United Kingdom abandoned the gold standard, a "sterling area" emerged as some countries, primarily members of the British Commonwealth, pegged their currencies to the pound and relied on sterling balances held in London as their international reserves.

Other countries tied the value of their currencies to the U.S. dollar or the French franc. The harmony of the international monetary system degenerated further as some countries—including the United States, France, the United Kingdom, Belgium, Latvia, the Netherlands, Switzerland, and Italy—engaged in a series of competitive devaluations of their currencies. By deliberately and artificially lowering (devaluing) the official value of its currency, each nation hoped to make its own goods cheaper in world markets, thereby stimulating its exports and reducing its imports. Any such gains were offset, however, when other countries also devalued their currencies. (If two countries each devalue their currency by 20 percent, neither gains an advantage because each currency's value relative to the other remains the same.) Most countries also raised the tariffs they imposed on imported goods in the hope of protecting domestic jobs in import-competing industries. Yet as more and more countries adopted these **beggar-thy-neighbor policies**, international trade contracted, hurting employment in each country's export industries. More ominously, this international economic conflict was soon replaced by international military conflict—the outbreak of World War II in 1939.

The Bretton Woods Era

Many politicians and historians believe the breakdown of the international monetary system and international trade after World War I created economic conditions that helped bring about World War II. Inflation, unemployment, and the costs of rebuilding war-torn economies created political instability that enabled fascist and communist dictators to seize control of their respective governments. Determined not to repeat the mistakes that had caused World War II, Western diplomats desired to create a postwar economic environment that would promote worldwide peace and prosperity. In 1944 the representatives of 44 countries met at a resort in Bretton Woods, New Hampshire, with that objective in mind. The Bretton Woods conferees agreed to renew the gold standard on a greatly modified basis. They also agreed to the creation of two new international organizations that would assist in rebuilding the world economy and the international monetary system: the International Bank for Reconstruction and Development and the International Monetary Fund.

THE INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT The **International Bank for Reconstruction and Development (IBRD)** is the official name of the **World Bank**. Established in 1945, the World Bank's initial goal was to help finance reconstruction of the war-torn European economies. With the assistance of the Marshall Plan, the World Bank accomplished this task by the mid-1950s. It then adopted a new mission—to build the economies of the world's developing countries.

As its mission has expanded over time, the World Bank has created three affiliated organizations:

1. The International Development Association
2. The International Finance Corporation
3. The Multilateral Investment Guarantee Agency

Together with the World Bank, these constitute the **World Bank Group** (see Figure 7.1). The World Bank, which currently has $134 billion in loans outstanding, is owned by its 188 member countries. In reaching its decisions, the World Bank uses a weighted voting system that reflects the economic power and contributions of its members. The United States currently controls the largest bloc of votes (15.0 percent), followed by Japan (8.8 percent), Germany (4.7 percent), the United Kingdom (4.2 percent), France (4.2 percent), and China (3.2 percent). From time to time the voting weights are reassessed as economic power shifts or as new members join the World Bank. To finance its lending operations, the World Bank borrows money in its own name from international capital markets. Interest earned on existing loans it has made provides it with additional lending power. The World Bank made $20.6 billion in new loan commitments in 2012.

According to its charter, the World Bank may lend only for "productive purposes" that will stimulate economic growth within the recipient country. An example of such a loan is the $200 million provided to Indonesia to modernize its national highways and improve traffic safety. The World Bank cannot finance a trade deficit, but it can finance an infrastructure project, such as a new railroad or harbor facility, that will bolster a country's economy. It may lend only

A DOLLAR-BASED GOLD STANDARD The IMF and the World Bank provided the institutional framework for the post–World War II international monetary system. The Bretton Woods participants also addressed the problem of how the system would function in practice. All countries agreed to peg the value of their currencies to gold. For example, the par value of the U.S. dollar was established at $35 per ounce of gold. However, only the United States pledged to redeem its currency for gold at the request of a foreign central bank. Thus, the U.S. dollar became the keystone of the Bretton Woods system. Why this central role for the U.S. dollar? During the early postwar years, only the U.S. and Canadian dollars were **convertible currencies**, that is, ones that could be freely exchanged for other currencies without legal restrictions. Countries had faith in the U.S. economy and so were willing to accept U.S. dollars to settle their transactions. As the British pound sterling had been in the nineteenth century, the U.S. dollar became the preferred vehicle for settling most international transactions. The effect of the Bretton Woods conference was thus to establish a U.S. dollar–based gold standard.

Because each country established a par value for its currency, the Bretton Woods Agreement resulted in a fixed exchange rate system. Under the agreement each country pledged to maintain the value of its currency within ±1 percent of its par value. If the market value of its currency fell outside that range, a country was obligated to intervene in the foreign-exchange market to bring the value back within ±1 percent of par value. This stability in exchange rates benefited international businesses because the Bretton Woods system *generally* provided an assurance that the value of each currency would remain stable.

Note the use of the qualifier *generally.* Under extraordinary circumstances the Bretton Woods Agreement allowed a country to adjust its currency's par value. Accordingly, the Bretton Woods system is often described as using an **adjustable peg** because currencies were pegged to gold, but the pegs themselves could be altered under certain conditions. Under the system, for example, the British pound's par value was first set at $2.80. (Technically, the par value was pegged to an ounce of gold, which then could be translated into dollars at a rate of $35.00 per ounce. Most businesspeople ignored this technicality, however, and focused on the implicit par value of a currency in terms of the U.S. dollar.) Thus, the Bank of England was obligated to keep the pound's value between $2.772 and $2.828 (±1 percent of $2.80). In the event that pessimism about the British economy caused the pound's market price to fall to $2.76, the Bank of England would be required to defend the value of the pound by selling some of its gold or U.S. dollar holdings to buy pounds. This move would increase the demand for pounds, and the market price would return to within the legal range—from $2.772 to $2.828.

The End of the Bretton Woods System

This arrangement worked well as long as pessimism about a country's economy was temporary, but if a country suffered from structural macroeconomic problems, major difficulties could arise. For example, in the 1960s, Labour governments striving for social justice dominated British politics, and British unions secured higher wages, better working conditions, and protective work rules. At the same time, however, British productivity decreased relative to that of its major international competitors, and the pound's value weakened. The Bank of England had to intervene continually in the foreign currency market, selling gold and foreign currencies to support the pound. In so doing, however, the bank's holdings of official reserves, which were needed to back up the country's Bretton Woods pledge, began to dwindle. International currency traders began to fear the bank would run out of reserves. As that fear mounted, international banks, currency traders, and other market participants became unwilling to hold British pounds in their inventory of foreign currencies. They began dumping pounds on the market as soon as they received them. A vicious cycle developed: As the Bank of England continued to drain its official reserves to support the pound, the fears of the currency-market participants that the bank would run out of reserves worsened.

The situation resembles a run on a bank. Banks never have enough cash on hand to honor all their liabilities. However, as long as people trust that their bank will give them their money if they need it, no one worries. If people lose that trust and withdraw more of their money than the bank has on hand, the bank could be in trouble. The Bretton Woods system was particularly susceptible to speculative "runs on the bank" because there was little risk in betting against a currency in times of doubt. For example, speculators distrustful of the Bank of England's ability to honor the UK's Bretton Woods pledge could convert their pounds into dollars. If they guessed

TABLE 7.1 The Groups of Five, Seven, and Ten

	Group of Five	Group of Seven	Group of Ten*	Percentage of World GDP
	United States	United States	United States	21.4
	Japan	Japan	Japan	8.4
	Germany	Germany	Germany	5.1
	France	France	France	4.0
	United Kingdom	United Kingdom	United Kingdom	3.5
		Italy	Italy	3.1
		Canada	Canada	2.5
			Netherlands	1.2
			Switzerland	.9
			Sweden	.8
			Belgium	.7
Cumulative Percentage of World GDP	42.4	48.0	51.6	

*The Group of 10 has 11 members.

Performance of the International Monetary System Since 1971

Free-market forces disputed the new set of par values established by the Smithsonian conferees. Speculators sold both the dollar and the pound, believing they were overvalued, and hoarded currencies they believed were undervalued, such as the Swiss franc and the German mark. The Bank of England was unable to maintain the pound's value within the ±2.25 percent band and in June 1972 had to allow the pound to float downward. Switzerland let the Swiss franc float upward in early 1973. The United States devalued the dollar by 10 percent in February 1973. By March 1973 the central banks (see Table 7.2 for a list of the most important of today's central banks) conceded they could not successfully resist free-market forces and so established a flexible exchange rate system. Under a **flexible (or floating) exchange rate system**, supply and demand for a currency determine its price in the world market. Since 1973, exchange rates among many currencies have been established primarily by the interaction of supply and demand. We use the qualifier *primarily* because central banks sometimes try to affect exchange rates by buying or selling currencies on the foreign-exchange market. Thus, the current arrangements are often called a **managed float** (or, more poetically, a **dirty float**) because exchange rates are not determined purely by private sector market forces. "Bringing the World into Focus" discusses other differences between fixed and flexible exchange rates.

The new flexible exchange rate system was legitimized by an international conference held in Jamaica in January 1976. According to the resulting **Jamaica Agreement**, each country was free to adopt whatever exchange rate system best met its own requirements. The United States adopted a floating exchange rate. Other countries adopted a fixed exchange rate by pegging their

TABLE 7.2 Key Central Banks

Country	Bank
Canada	Bank of Canada
European Union (members using the euro)	European Central Bank
Japan	Bank of Japan
United Kingdom	Bank of England
United States	Federal Reserve Bank

currencies to the dollar, the French franc, or some other currency. Still others used **crawling pegs**, allowing the peg to change gradually over time.

Of particular note is the strategy adopted by European Union (EU) members in the belief that flexible exchange rates would hinder their ability to create an integrated European economy. In 1979 EU members created the **European Monetary System (EMS)** to manage currency relationships among themselves. Most EMS members chose to participate in the EU's **exchange rate mechanism (ERM)**. ERM participants pledged to maintain fixed exchange rates among their currencies within a narrow range of ±2.25 percent of par value and a floating rate against the U.S. dollar and other currencies. The exchange rate mechanism facilitated the creation of the EU's single currency, the euro, in 1999, a topic we will cover more thoroughly in Chapter 10.

The current international monetary system is an amalgam of fixed and flexible exchange rates. For example, as just discussed, most members of the EU have adopted a common currency, whereas other countries have voluntarily adopted a fixed exchange rate against the U.S. dollar, the euro, or some other currency. Still other countries, such as Canada, Japan, the United Kingdom, and the United States, have chosen to let their currencies float. Accordingly, under the current international monetary system, the currencies of one country grouping float against the currencies of other country groupings. For example, the U.S. dollar and currencies fixed to the U.S. dollar float against the euro and currencies fixed to it. The U.S. dollar and the euro in turn float against numerous independently floating currencies, such as the Canadian dollar, the Australian dollar, the British pound, and the Swiss franc.

OTHER POST–WORLD WAR II CONFERENCES The international monetary system that has grown out of the Jamaica Agreement has not pleased all of the world's central banks all the time. Since 1976, the central banks have met numerous times to iron out policy conflicts among themselves. For example, U.S. complaints that an overvalued dollar was hurting the competitiveness of U.S. exports and allowing cheap imports to damage U.S. industries prompted finance ministers of the Group of Five (see Table 7.1) to meet in September 1985 at the Plaza Hotel in New York City. The meeting led to the **Plaza Accord**, in which the central banks agreed to let the dollar's value fall on currency markets—and fall it did. From its peak in February 1985 the dollar plummeted almost 46 percent against the German mark and 41 percent against the yen by the beginning of 1987. Fearing that continued devaluation of the dollar would disrupt world trade, finance ministers from the Group of Five met again, this time at the Louvre in Paris in February 1987. The **Louvre Accord** signaled the commitment of these five countries to stabilizing the dollar's

BRINGING THE WORLD INTO FOCUS

FIXED VERSUS FLEXIBLE EXCHANGE RATES

The important difference between fixed and flexible exchange rate systems is the way they reach equilibrium. Under the fixed exchange rate system, such as the gold standard (1821 to 1914) and the Bretton Woods system (1945 to 1971), each country pledges to maintain the value of its currency against some standard, such as gold or another currency. If the value of the country's currency falls below par value, the country's central bank boosts the currency's price by buying it in the foreign-exchange market, selling off its gold reserves or stock of convertible currencies in the process. If the currency's value rises above par value, the central bank sells the currency in the foreign-exchange market, acquiring additional gold or foreign currency in the process. Long-run equilibrium is supposed to occur through the deflationary or inflationary impact of changes in the country's money supply attributable to the central bank's actions in the foreign-exchange market.

Although this automatic adjustment process worked reasonably well under the nineteenth-century gold standard, it did not work well under the Bretton Woods system. In practice, the adjustment process under the Bretton Woods system was asymmetric. A country with a BOP surplus did not need to do anything, provided it was willing to accumulate foreign exchange or gold. A country suffering a BOP deficit saw a continuing decrease in its official reserves. It had to cure its BOP problems well before it ran out of reserves. If the country did nothing, other countries (and investors), seeing its reserves dwindling, would begin to distrust the country's ability to honor its pledge to maintain its currency's par value. These foreigners would rush to sell their holdings of the currency, thereby worsening the drain on the country's reserves. Ultimately, the government would have to renege on its promise to convert at the fixed rate and would resort to devaluing its currency. This is what happened to the United Kingdom in 1967, France in 1969, and the United States in 1971.

Conversely, under a flexible exchange rate system, the exchange rate is determined by the forces of supply and demand for each currency. Assuming a country's central bank is willing to live with the outcome of these market forces, its official reserves need not be depleted because consumers and investors are determining the currency's value through their self-interested transactions.

BRINGING THE WORLD INTO FOCUS

SHOULD BRETTON WOODS BE RESTORED?

International policymakers have debated the value of resurrecting the Bretton Woods system. Proponents of the system believe fixed exchange rates offer international businesses several advantages. Exchange rates are not subject to wide daily, weekly, and monthly fluctuations. The riskiness of international trade transactions is thus reduced, and firms have greater assurance of stability in the values of foreign currencies. Also, fixed exchange rates are an important anti-inflationary tool because the loss of official reserves forces a country to counteract inflationary tendencies in its economy. Bretton Woods proponents also are distressed because the wild swings in the values of key currencies that occur in flexible exchange rate systems can disrupt sound international investment decision making.

Advocates of flexible exchange rates look at the other side of the coin. If BOP equilibrium can be reached through changes in exchange rates, then domestic policymakers are free to focus on domestic economic concerns without worrying about the BOP consequences of their actions. Flexible exchange rates also reduce the need for international coordination of domestic economic policies and allow each country to follow its own economic destiny. For example, if Mexico's monetary authorities choose more inflationary, growth-oriented economic policies than those adopted by its major trading partners, changes in exchange rates will bring about BOP equilibrium. Flexible exchange rates can absorb the impact of damaging external economic events, such as occurred during the two oil embargoes in the 1970s. Proponents of flexible exchange rates also suggest that fixed exchange rate systems are not invulnerable to disorderly changes in currency values and cite the depreciation of the pound in 1967, the French franc in 1969, and the U.S. dollar in 1971. Similarly, they point out the chaos and hardships created by the 1997–1998 collapse of the fixed exchange rate systems used by Thailand, Indonesia, and other Southeast Asian countries.

The latest financial crisis to plague the international capital market began with the so-called subprime meltdown, which resulted from the bursting of the U.S. housing bubble. The financial problems created by this collapse affected financial markets throughout the world and led to the Global Recession of 2008–2009. The incipient global currency war discussed in the chapter's opening case is the result of countries trying to resuscitate their economies in the aftermath of the global recession.

These crises did not come as a surprise to the analysts who had been monitoring the affected countries' BOP accounts for danger signs. The BOP accounting system provided clear warning of the deteriorating performance of the countries in crisis and the increasing riskiness of their overextended external debt positions. A careful reading of BOP statistics could have protected international bankers from bad investments and risky loans. Because the BOP accounting system provides such valuable economic intelligence information, the next section discusses it in detail.

In Practice

- There are two primary types of exchange rate systems, flexible exchange rate systems and fixed exchange rate systems.
- After the collapse of the Bretton Woods system, both types of exchange rate systems are in use.

For further consideration: Would you rather invest in a country that uses a fixed exchange rate or a flexible exchange rate?

The BOP Accounting System

Each year countries purchase trillions of dollars of goods, services, and assets from each other. The BOP accounting system is a double-entry bookkeeping system designed to measure and record all economic transactions between residents of one country and residents of all other countries during a particular time period. It helps policymakers understand the performance of each country's economy in international markets. It also signals fundamental changes in the competitiveness of countries and assists policymakers in designing appropriate public policies to respond to these changes.

International businesspeople need to pay close attention to countries' BOP statistics for several reasons, including the following:

1. BOP statistics help identify emerging markets for goods and services.
2. BOP statistics can warn of possible new policies that may alter a country's business climate, thereby affecting the profitability of a firm's operations in that country. For example, sharp rises in a country's imports may signal an overheated economy and portend a tightening of the domestic money supply. In this case attentive businesspeople will shrink their inventories in anticipation of a reduction in customer demand.
3. BOP statistics can indicate reductions in a country's foreign-exchange reserves, which may mean that the country's currency will depreciate in the future, as occurred in Thailand in 1997. Exporters to such a country may find that domestic producers will become more price competitive.
4. As was true in the international debt crisis, BOP statistics can signal increased riskiness of lending to particular countries.

Four important aspects of the BOP accounting system need to be highlighted:

1. The BOP accounting system records international transactions made during some time period, for example, a year.
2. It records only economic transactions, those that involve something of monetary value.
3. It records transactions between residents of one country and residents of all other countries. Residents can be individuals, businesses, government agencies, or nonprofit organizations, but defining residency is sometimes tricky. Persons temporarily located in a country—tourists, students, and military or diplomatic personnel—are still considered residents of their home country for BOP purposes. Businesses are considered residents of the country in which they are incorporated. Firms often conduct international business by locating either a branch or a subsidiary in a foreign country. A branch, which by definition is an unincorporated operation and thus not legally distinct from its parent corporation, is a resident of the parent's home country. A subsidiary, which by definition is a separately incorporated operation, is a resident of the country in which it is incorporated. In most cases the subsidiary is incorporated in the host country to take advantage of legally being a resident of the country in which it is operating.
4. The BOP accounting system is a double-entry system. Each transaction produces a credit entry and a debit entry of equal size. In most international business dealings the first entry in a BOP transaction involves the purchase or sale of something—a good, a service, or an asset. The second entry records the payment or receipt of payment for the thing bought or sold. Figuring out which is the BOP debit entry and which is the BOP credit entry is not a skill that most people are born with. Many experts compare a BOP accounting statement to a statement of sources and uses of funds. Debit entries reflect uses of funds; credit entries indicate sources of funds. Under this framework, buying things creates debits, and selling things produces credits.

The Major Components of the BOP Accounting System

The BOP accounting system can be divided conceptually into four major accounts. The first two accounts—the current account and the capital account—record purchases of goods, services, and assets by the private and public sectors. The official reserves account reflects the impact of central bank intervention in the foreign-exchange market. The last account—errors and omissions—captures mistakes made in recording BOP transactions.

CURRENT ACCOUNT The current account records four types of transactions among residents of different countries:

1. Exports and imports of goods (or merchandise)
2. Exports and imports of services
3. Investment income
4. Gifts (or unilateral transfers)

These reserves are used to intervene in the foreign-exchange market and in transactions with other central banks. Official reserves comprise four types of assets:

1. Gold
2. Convertible currencies
3. SDRs
4. Reserve positions at the IMF

Official gold holdings are measured using a par value established by a country's treasury or finance ministry. Convertible currencies are currencies that are freely exchangeable in world currency markets. The convertible currencies most commonly used as official reserves are the U.S. dollar, the euro, and the yen. The last two types of reserves—SDRs and reserve positions (quotas minus IMF borrowings) at the IMF—were discussed previously in this chapter.

ERRORS AND OMISSIONS The last account in the BOP accounting system is the errors and omissions account. One truism of the BOP accounting system is that the BOP must balance. In theory the following equality should be observed:

$$\text{Current Account} + \text{Capital Account} + \text{Official Reserves Account} = 0$$

However, this equality is never achieved in practice because of measurement errors. The errors and omissions account is used to make the BOP balance in accordance with the following equation:

$$\text{Current Account} + \text{Capital Account} + \text{Official Reserves Account} + \text{Errors and Omissions} = 0$$

The errors and omissions account can be quite large. In 2012, for example, the U.S. errors and omissions account totaled $5.9 billion. Experts suspect that a large portion of the errors and omissions account balance is the result of the underreporting of capital account transactions. Such innovations as instantaneous, round-the-clock foreign-exchange trading, sophisticated monetary swaps and hedges, and international money market funds have made it difficult for government statisticians to keep up with the growing volume of legal short-term money flowing between countries in search of the highest interest rate.

Sometimes, errors and omissions are due to deliberate actions by individuals who are engaged in illegal activities such as drug smuggling, money laundering, or evasion of currency and investment controls imposed by their home governments. Politically stable countries, such as the United States, are often the destination of **flight capital**, money sent abroad by foreign residents seeking a safe haven for their assets, hidden from the sticky fingers of their home governments. Given the often illegal nature of flight capital, persons sending it to the United States often try to avoid any official recognition of their transactions, making it difficult for government BOP statisticians to record such transactions. Residents of other countries who distrust the stability of their own currency may also choose to use a stronger currency, such as the dollar or the euro, to transact their business or keep their savings, as "Bringing the World into Focus" suggests.[9]

Some errors may crop up in the current account as well. Statistics for merchandise imports are generally thought to be reasonably accurate because most countries' customs services scrutinize imports to ensure that all appropriate taxes are collected. This scrutiny generates paper trails that facilitate the collection of accurate statistics. However, few countries tax exports, so customs services have less incentive to assess the accuracy of statistics concerning merchandise exports. Statistics for trade in services also may contain inaccuracies. Many service trade statistics are generated by surveys. For example, U.S. tourism exports are measured in part by surveying foreign tourists on how many days they spent in the United States and how many dollars they spent per day. If tourists underestimate their daily spending, then U.S. service exports are underestimated. To help you gain a better understanding of the BOP accounts, we next review the international transactions of the United States in 2012.

The U.S. BOP in 2012

The first component of the current account is merchandise (goods) exports and imports. As shown in Table 7.6, U.S. merchandise exports totaled $1,561.2 billion in 2012. Figure 7.3(a)

BRINGING THE WORLD INTO FOCUS

BEN FRANKLIN, WORLD TRAVELER

Who is the most well-known American outside the borders of the United States? Barack Obama? Brad Pitt? Beyoncé? A good argument can be made for Ben Franklin, whose face adorns the U.S. $100 bill. Economists and accountants at the U.S. Federal Reserve Bank (Fed) estimate that $454 billion of U.S. currency is held by foreigners. Most of this foreign-held currency is in $100 bills; U.S. consumers prefer to use smaller denomination bills.

Tracking down the total number of dollars held overseas is rather complex and is based on a mixture of sophisticated economic modeling, consumer surveys, and educated guesswork. A 1995 Fed survey of U.S. households could account for only 3 percent of the $100 bills printed by the U.S. government. Fed staffers also know that the Los Angeles and New York City branches of the Fed distribute enormous numbers of $100 bills relative to the other branches. From 1990 to 1996 these two branches accounted for 84 percent of the new $100 bills placed in circulation. Experts believe that most of this currency flows to citizens of countries where economic or political unrest is high. For instance, because of their country's struggle with controlling inflation, Vietnam residents hold an estimated $5 billion in U.S. currency secreted under floorboards or hidden in closets. Russia, other former Soviet Republics, the Middle East, and Latin America are also important destinations for U.S. dollar bills.

Another contributing factor is the increasing "dollarization" of Latin America. On New Year's Day 2001, El Salvador made the U.S. dollar legal tender there. El Salvador's Central Reserve Bank purchased $450 million worth of U.S. currency to implement this change. Ecuador adopted a similar policy in mid-2000, and Guatemala has taken steps to dollarize its economy as well.

These foreign holdings of U.S. paper currency provide an important benefit to the U.S. Treasury and ultimately to the U.S. taxpayer because they effectively serve as an interest-free loan. Normally, to fund the U.S. debt, the U.S. Treasury must float loans in the form of bonds, notes, and bills. Currency holdings substitute for such loans and reduce the amount the treasury must borrow. If 30-year treasury bonds bear an interest rate of 5 percent, then the U.S. Treasury saves $22.7 billion (5 percent times $454 billion) in interest payments annually as a result of foreign holdings of U.S. currency. This is one of the benefits U.S. citizens receive as a result of the country's economic and political stability. Other countries—particularly those members of the EU using the euro—also benefit from large holdings of their paper currencies by residents of other countries.

Sources: Based on *Survey of Current Business*, July 2013, p. 21; "Vietnam battles dark side of boom," *Wall Street Journal*, December 16, 2010, p. C1; "El Salvador switching to U.S. dollar," *Houston Chronicle*, December 30, 2000, p. 1C; "Dollar's share of world reserves grows," *Wall Street Journal*, September 10, 1997, p. A2; "Russia counts cost of change as U.S. set to issue new $100 bill," *Financial Times*, January 16, 1996, p. 20; "Where's the buck? Dollars make the world go around, Fed says," *Houston Chronicle*, October 13, 1995, p. 2C.

presents a more detailed picture of the leading U.S. exports. Automobiles and auto parts were the largest component of U.S. merchandise exports, generating $146.1 billion in sales. Of U.S. automobile exports, 40 percent were to Canada, a reflection of the integrated nature of North American automobile production that resulted from the 1965 Auto Pact between the United States and Canada. (Canada—meaning primarily GM, Ford, and Chrysler plants that are located in Canada—exported $64.7 billion in automobiles and auto parts to the United States.) The six industries shown in Figure 7.3(a) accounted for 45 percent of U.S. merchandise exports in 2012.

From Table 7.6, you can see that U.S. merchandise imports totaled $2,302.7 billion in 2012. From Figure 7.4(b) you can see that the leading import was petroleum products, at $433.9 billion, or 19 percent of imports. Six industries accounted for $1,226 billion, or 53 percent of total U.S. merchandise imports.

The second component of the current account is trade in services. U.S. exports of services totaled $649.3 billion in 2012, with travel and tourism being the largest portion ($165.6 billion). U.S. service imports equaled $442.5 billion, with travel and tourism again being the largest portion ($118.1 billion). The United States had a positive balance on services trade of $206.8 billion (see Table 7.6).

Figure 7.4 shows exports and imports for the major trading partners of the United States and includes trade in both goods and services. From this figure, you can see that the United States tends to import more goods from its major trading partners than it exports to them; you can also see that the United States tends to export more services to its trading partners than it imports from them.

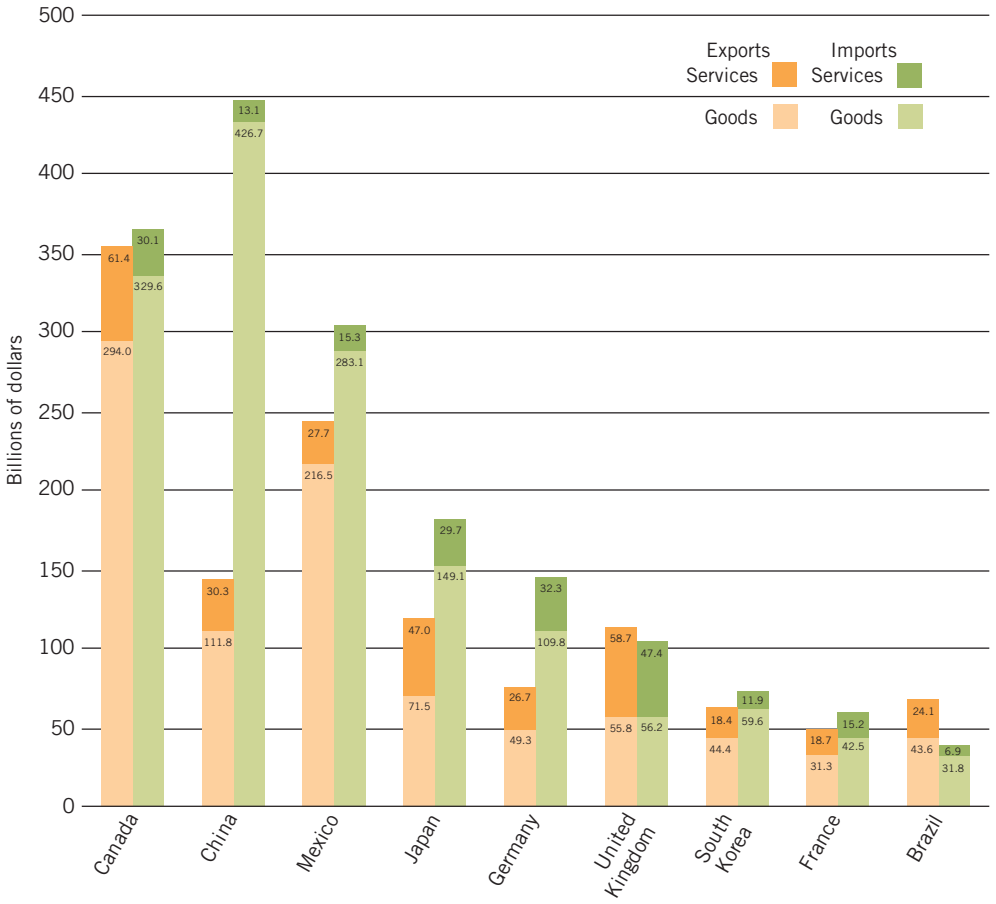
The third component of the current account is investment income (see Table 7.6). In 2012 U.S. residents received $776.4 billion from foreign investments and paid out $552.4 billion to foreigners for a net balance on investment income of $224.0 billion. The United States had a net deficit of $129.7 billion in the fourth component of the current account, unilateral transfers. Summing up the four components yielded a 2012 current account deficit of $440.4 billion.

The capital account is the second major BOP account (see Table 7.6). In 2012 new U.S. FDI abroad (outflows) totaled $388.3 billion, and new FDI in the United States (inflows) totaled $166.4 billion. New U.S. long-term international portfolio investments were $176.1 billion in 2012, while new foreign long-term portfolio investments in the United States were

FIGURE 7.4

Trade Between the United States and Its Major Trading Partners, 2012

Source: Based on *Survey of Current Business*, July 2013.



$707.7 billion. There was also a net inflow of short-term portfolio investment to the United States, totaling $141.1 billion. The capital account balance was $450.8 billion in 2012, as foreigners bought more U.S. assets than U.S. residents bought foreign assets.

U.S. official reserves account transactions were −$4.5 billion. If the BOP statistical data net were perfect, the current account balance plus the capital account balance plus the official reserves account balance should equal zero. Any discrepancy is put into the errors and omissions account. In 2012, there was a discrepancy of −$5.9 billion. Therefore, for the U.S. BOP in 2012 the following equation applies:

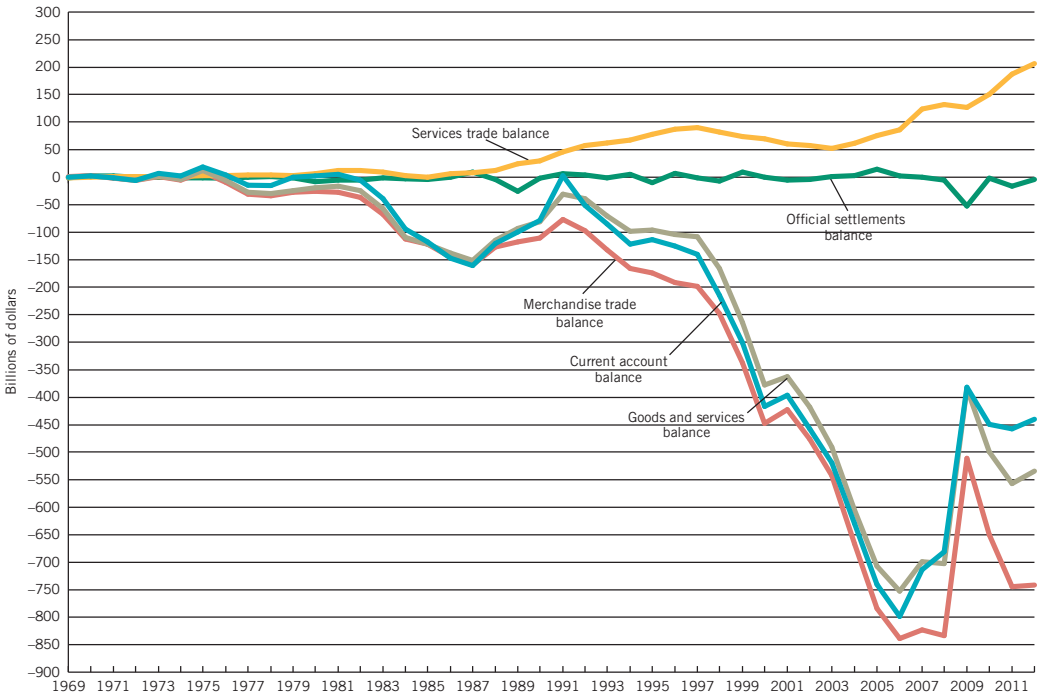
Current Account (−$440.4 billion)	+	Capital Account (+$450.8 billion)	+	Changes in Official Reserves (−$4.5 billion)	+	Errors and Omissions (−$5.9 billion)	= 0

Defining BOP Surpluses and Deficits

Every month the federal government reports the performance of U.S. firms in international markets when it releases the monthly BOP statistics. In most months during the past decade, newscasters have solemnly reported on the evening news that the U.S. BOP is in deficit.

What do the newscasters mean? We just said that the BOP always balances (equals zero), so how can there be a BOP deficit? In reality when knowledgeable people (or even newscasters) talk about a BOP surplus or deficit, they are referring only to a subset of the BOP accounts. Most newscasters are in fact reporting on the balance on trade in goods and services. When a country exports more goods and services than it imports, it has a trade surplus. When it imports more goods and services than it exports, it has a trade deficit.

FIGURE 7.5
The U.S. BOP According to Various Reporting Measures
Source: Based on *Survey of Current Business*, July 2013.



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CHAPTER REVIEW

Summary

In their normal commercial activities international businesses often deal with currencies other than those of their home countries. For international commerce to thrive, some system for exchanging and valuing different currencies, preferably at low cost, must exist. The international monetary system accomplishes this by establishing the rules for valuing and exchanging different currencies.

The economic growth of the nineteenth century is attributable in part to the success of the gold standard in providing a stable, reliable international monetary system based on fixed exchange rates. However, the gold standard broke down during World War I and could not be satisfactorily revived in the years between the two world wars.

The Bretton Woods Agreement of 1944 structured the post–World War II international monetary system. In addition to creating the International Bank for Reconstruction and Development (the World Bank) and the IMF, the agreement reinstituted a fixed exchange rate system, with the U.S. dollar playing a key role in international transactions. As the number of dollars held by foreigners increased, however, the marketplace began to distrust the ability of the United States to redeem its currency at $35 per ounce of gold as required by the agreement. After fending off waves of speculation against the dollar, the United States abandoned the Bretton Woods Agreement in August 1971.

Since then, the international monetary system has relied on a combination of fixed and flexible exchange rate systems. Some countries have allowed their currencies to float; others, such as the EU members, have attempted to maintain fixed exchange rates among their currencies. The system has proven responsive to major shocks to the world economy, such as the shift of wealth from oil-consuming to oil-producing countries after the 1973–1974 oil embargo, the 1980s international debt crisis, the 1997–1998 Asian currency crisis, and the Global Recession of 2008–2009.

The BOP accounting system, which is used to record international transactions, is important to international businesspeople. The BOP system provides economic intelligence data about the international competitiveness of a country's industries, likely changes in its fiscal and monetary policies, and its ability to repay its international debts.

The BOP accounting system comprises four accounts. The current account reflects exports and imports of goods, exports and imports of services, investment income, and gifts. The capital account records financial and capital transactions among countries and includes FDI and portfolio investments. Portfolio investments in turn can be divided into long-term

and short-term investments. The official reserves account is a record of changes in a country's official reserves, which include central bank holdings of gold, convertible currencies, SDRs, and reserves at the IMF. The errors and omissions account captures statistical discrepancies that often result from transactions that participants want to hide from government officials.

There are numerous ways to measure a balance of payments surplus or deficit. Each presents a different perspective on a country's global economic performance. The balance on merchandise trade measures the difference between a country's exports and imports of goods. The balance on services is growing in importance because of the rapid expansion of the service sector in many economies. The balance on goods and services measures a country's trade in goods and services. The current account balance reflects both trade in goods and trade in services, as well as net investment income and gifts. The official settlements balance shows changes in a country's official reserves.

Review Questions

7-1. What is the function of the international monetary system?
7-2. What has accelerated the collapse of the gold standard in the international monetary system?
7-3. Which are the main international institutions in international trade?
7-4. What is the IFC and what are its goals?
7-5. Why are quotas important to IMF members?
7-6. Why did the Bretton Woods system collapse in 1971?
7-7. Discuss the differences between the institutional duties of the World Bank and the International Monetary Fund.
7-8. List the four major accounts of the BOP accounting system and their components.
7-9. What factors cause measurement errors in the BOP accounts?
7-10. Identify the different types of balance of payments surpluses and deficits.

Questions for Discussion

7-11. What parallels exist between the role of the British pound in the nineteenth-century international monetary system and that of the U.S. dollar since 1945?
7-12. Did the key role that the dollar played in the Bretton Woods system benefit or hurt the United States?
7-13. Give an example of currency devaluation for achieving trade gains.
7-14. Are there any circumstances under which a country might want to increase its currency's value?
7-15. Hong Kong is an example of an economy with a fixed exchange rate system. Discuss how this affects its trade.
7-16. What connections exist between the current account and the capital account?

Building Global Skills

This exercise explains how U.S. governmental statisticians account for international transactions. You may want to refer to Tables 7.3 and 7.5 and to the definitions of capital inflows and capital outflows on page 226.

Example 1

Suppose Walmart imports $1 million worth of Blu-ray players from the Sony Corporation of Japan. The debit entry is a merchandise import of $1 million.

Here is the tough part. What is the offsetting credit entry? The answer is a capital inflow affecting the short-term portfolio account. Recall that a capital inflow occurs because of either an increase in foreign-owned U.S. assets or a decrease in U.S.-owned foreign assets. If Walmart pays Sony with a $1 million check that Sony deposits in its U.S. bank, foreign ownership of assets in the United States increases, which is a short-term capital inflow. If Walmart pays Sony in yen by drawing down a Walmart checking account balance at a Tokyo bank, a decrease of U.S.-owned assets in foreign countries occurs, which is also a short-term capital inflow. Either way, a short-term capital inflow occurs because the Blu-ray players are being exchanged for a change in a checking account balance.

What if Walmart pays Sony with a $1 million check, but Sony wants yen? Sony will take the check to its U.S. bank and ask the bank to convert the $1 million check to yen. The U.S. bank can accommodate Sony in one of two ways:

a. Give Sony yen that the U.S. bank already owns—this represents a decrease in U.S.-owned foreign assets.
b. Pass along the check to a Japanese bank that keeps the $1 million but gives Sony the equivalent in yen—this represents an increase in U.S. assets owned by foreigners (the Japanese bank).

In either case, a capital inflow occurs. Thus, Walmart's purchase of the Blu-ray players from Sony enters the U.S. BOP accounts as follows:

	Debit	Credit
Merchandise imports account	$1 million	
Short-term portfolio account		$1 million

The merchandise import account is debited to reflect a use of funds. The payment itself is credited because effectively a foreigner has purchased a U.S. asset (either an increase in foreign claims on the United States or a decrease in U.S. claims on foreigners). Note the linkage between the current account and the capital account.

Example 2

A North Korean restaurant owner in Los Angeles who escaped her homeland smuggles $1,000 in cash back to her relatives in Pyongyang. The U.S. BOP accounts should record this transaction as follows:

	Debit	Credit
Unilateral transfer account	$1,000	
Short-term portfolio account		$1,000

The transaction involves a unilateral transfer because the $1,000 is a gift. Because the gift is being given by a U.S. resident, it is a debit. The capital account is credited because foreigners have increased their claims on the United States. (A country's currency reflects a claim on its goods, services, and assets.) Had the restaurant owners sent a $1,000 stereo system instead of cash, the credit entry would have been a merchandise export.

Note the use of the qualifier *should* in the first paragraph. If U.S. governmental statisticians were omniscient, the transaction would be recorded as just explained. However, if the restaurant owner wished to hide her transaction from the government, it is unlikely U.S. statisticians would ever learn of it. When you consider the widespread usage of the dollar in countries suffering political turmoil, it is not surprising that the errors and omissions account is as large as it is.

Example 3

Mitsubishi buys 51 percent of Rockefeller Center for $846 million from a Rockefeller family trust. This transaction will be recorded in the U.S. BOP accounts as follows:

	Debit	Credit
FDI account		$846 million
Short-term portfolio account	$846 million	

In this transaction two assets are being exchanged. Japan is buying a long-term asset—Rockefeller Center—for purposes of control, and the United States is buying a short-term asset called an "increase of claims on foreigners or a decrease of foreign claims on the United States." The U.S. BOP is credited with a long-term FDI capital inflow of $846 million because foreign ownership of U.S. assets (for purposes of control) has increased. However, the actual payment of the $846 million is debited as a short-term capital outflow: Either Japanese-owned checking account balances in the United States declined by $846 million or U.S.-owned checking account balances in Japan rose by $846 million.

Unlike Examples 1 and 2, this transaction does not involve a current account entry and a capital account entry. Both the debit entry and the credit entry affect the capital account. However, a balance in someone's checking account is affected by this transaction, as was the case in Example 1.

Do the following exercises on your own. How will the following transactions be recorded in the U.S. BOP accounts?

7-17. A U.S. entrepreneur seeking to sell souvenirs at the 2012 summer Olympics in London pays British Airways, a UK carrier, $1,500 for a Los Angeles–London round-trip ticket.

7-18. The U.S. entrepreneur instead pays United Airlines (a U.S. airline) $1,500 for a Los Angeles–London round-trip ticket.

7-19. Ford Motor Company (U.S.) pays $2.5 billion to purchase all the common stock of the Jaguar Motor Co. (UK).

7-20. The U.S. government gives Rwanda $500 million worth of food to feed starving refugees.

CLOSING CASE Recent U.S. BOP Performance: Is the Sky Falling?

During the past decade the U.S. BOP performance could be characterized as follows:

- The U.S. current account recorded large annual deficits.
- The U.S. capital account recorded large annual surpluses of roughly the same magnitude as the current account deficits.
- Changes in the official reserves account were small relative to the magnitude of the current account deficits.

Two scenarios can be developed from the facts just cited:

- The sky is falling. U.S. industries are uncompetitive in international markets (as indicated by the first fact), and foreigners are taking over the country by buying up valuable U.S. assets and transforming the country into the largest debtor in international history (as indicated by the second fact).
- Everything is wonderful. Foreigners are so enthralled with the future prospects of the U.S. market, which is a showcase of economic democracy, that they are eagerly investing in the U.S. economy (the second fact). The only way they can do so, however, is by running a current account surplus with the United States (the first fact).

Needless to say, these two scenarios conflict, even though both are consistent with the data. They reflect a policy war that is occurring between protectionists and free traders, between unions and MNCs, between liberals and conservatives, and between firms threatened by foreign imports and export-oriented firms.

People who believe the sky is falling argue that the United States must reduce its balance of trade deficit. They argue that U.S. firms are increasingly uncompetitive in global markets and must be strengthened via aggressive government policies, such as those calling for worker-training programs, increased investment in infrastructure, and tax credits for R&D and investment expenditures. These people assert that U.S. firms are victimized by the unfair trade practices of foreign firms and governments. They propose stiffer tariffs and quotas on imported goods and believe that the federal government should do more to promote U.S. exports and restrict foreign ownership of U.S. assets.

People who believe everything is wonderful say the best policy is to continue to make the United States an attractive economy in which to invest. By keeping tax rates low and governmental regulation modest, the United States

will attract foreign capital. U.S. industries, consumers, and workers will then benefit from increased capital investment and the enhancements in productivity that will ensue from this investment. U.S. consumers will benefit from the availability of low-priced, high-quality imported goods and services. Moreover, U.S. firms will become "leaner and meaner" as they respond to foreign competitors.

A variant of this "everything is wonderful" argument has been offered by the late Nobel laureate Milton Friedman, the provocative free-market advocate from the University of Chicago. Friedman argued that foreign companies have been busily producing Blu-ray players, luxury automobiles, and smartphones in return for dollar bills from U.S. consumers. If these companies are happy voluntarily exchanging their goods for pieces of paper (that is, dollar bills), and U.S. citizens are happy voluntarily exchanging pieces of paper for goods, why should anyone worry?

As you ponder these divergent perspectives, recognize that they have developed because of two different views of what represents a BOP deficit. The "sky is falling" crowd is focusing on the balance on merchandise trade and assessing whether U.S. firms are able to sell as many goods to foreigners as foreigners sell to Americans. The "everything is wonderful" folks are focusing on voluntary transactions in the marketplace. In their view, if U.S. citizens find that being net buyers of foreign goods is in their self-interest and foreigners find that being net buyers of U.S. assets is in their self-interest, then what is the problem?

Because BOP statistics affect the ongoing domestic political battle over international trade policy, they are important to virtually every U.S. firm. Export-oriented firms and workers benefit from the free trade policies promoted by the "everything is wonderful" crowd, as do communities that benefit from jobs created by inward FDI. Firms and workers threatened by imported goods or by the output of new domestic factories built by foreign competitors are more likely to support the "sky is falling" view.

Case Questions

7-21. What is more important to an economy—exports or foreign capital inflows?

7-22. What is the connection between the U.S. current account deficit and capital account surplus?

7-23. Which of the following groups are likely to endorse the "sky is falling" view of the U.S. BOP?
- Import-threatened firms such as textile producers
- Textile workers
- A cash-starved California biotechnology company
- Merrill Lynch
- Boeing Aircraft, one of the country's largest exporters
- Consumers

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7-24. What were the key accomplishments of the Bretton Woods conference?

7-25. What are the primary accounts of the balance payments?

7-26. Mymanagementlab Only—comprehensive writing assignment for this chapter.

Endnotes

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