Balance-of-Payments Concepts—What Do They Really Mean?

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THE Advisory Committee on Balance-of-Payments Statistics Presentation of the Office of Management and Budget is currently holding meetings on the usefulness of current balance-of-payments concepts. The Committee is interested in hearing suggestions regarding ways in which international data may be presented in a more useful format. These hearings reflect a growing concern in government, academia, and the business community over the meaning of balance-of-payments data as currently reported.

While the subject of balance-of-payments reporting techniques has been debated since the inception of the practice, the debates have intensified lately as a result of a number of factors. On the one hand, there has been a surge of interest in what has been called the monetary approach to the balance of payments.[1] This approach to payments theory views international transactions within a framework that differs significantly from the current conventional wisdom.[2] If one views international transactions within this monetary framework, the currently employed balance-of-payments concepts have little meaning. On the other hand, the problems of interpreting current balance-of-payments concepts have further intensified as a result of the evolution of a system of floating exchange rates among the world's major trading countries and the rapid accumulation of international reserves by the members of the Organization of Petroleum Exporting Countries (OPEC).

This article discusses the general concept of the balance of payments as well as the appropriateness of various measures of this concept. Its aim is to foster a better understanding of the balance of payments and the meaning of the various measures of this concept that are currently used. In light of the issues raised in this discussion, some proposals for the reform of the method of presenting data relating to international transactions will be made. The discussion will allude to the following propositions:

1) There is a widespread misunderstanding of the forces that give rise to, and the impact of, balance-of-payments deficits and surpluses and exchange rate movements.

2) This misunderstanding has led to undue concern on the part of policymakers, inducing costly recommendations for trade restrictions, controls on capital movements, and export promotion in order to solve balance-of-payments and exchange rate "problems" which simply do not exist.

3) The way balance-of-payments statistics are currently reported serves to exacerbate these misunderstandings.

4) The above propositions apply under both fixed and floating exchange rates. However, the problems alluded to are particularly acute now that we have switched from one exchange rate regime to another.

NOTE: The author acknowledges the helpful comments on earlier drafts from Allan H. Meltzer and Wilson E. Schmidt. They are, of course, blameless for any remaining errors.

[1]For a discussion of this approach, see Donald S. Kemp, "A Monetary View of the Balance of Payments," this *Review* (April 1975), pp. 14-22.

[2]The monetary approach is concerned with the impact of the *balance of payments* on the domestic economy via its impact on the money supply. In contrast, the current conventional wisdom in payments theory (the elasticities and absorption approaches) is concerned primarily with the *balance of trade* alone and assumes that either there are no monetary consequences associated with international transactions or, to the extent the potential for such consequences exists, they can be and are neutralized by domestic monetary authorities.

This is because the implications of the switch are confusing in themselves and because many of the ways in which balance-of-payments statistics are reported have been made completely obsolete as a result of the switch.

FUNDAMENTAL MISUNDERSTANDING

The fundamental misunderstanding alluded to in the first proposition stems from the fact that most balance-of-payments analyses focus on either the current or the capital account separately. In order to place the balance of payments in its proper perspective, it is necessary that all accounts be considered simultaneously. In addition, one must recognize that the transactions recorded in balance-of-payments statistics bear the same relationship to foreign and domestic monetary policies as do purely domestic transactions to domestic monetary policy.

Viewed within a monetary framework, balance-of-payments surpluses and deficits and movements in exchange rates are the result of a disparity between the demand for and supply of money. The exact process by which the disparity is corrected is a technical issue and subject to alternative interpretations.[3] Basically, however, when such a disparity exists, spending units attempt to draw down (build up) their money balances through the purchase (sale) of real and/or financial assets. In so doing they increase (decrease) the demand for all assets. Under alternative situations the exact pattern by which spending units adjust their money balances in this fashion will be different. The pattern will depend on, at a minimum, the cause of the change in the quantity of money supplied relative to the quantity demanded, the initial conditions under which the change occurred, and the impact of other exogenous events on spending units. However, the point is that an excess supply of or demand for money will be cleared through the markets for goods, services, and securities. Furthermore, and what is crucial for an understanding of the balance of payments, in an open economy (one in which there are international trade and capital transactions) the markets through which money balances are adjusted extend beyond national boundaries.[4]

[3]For a thorough discussion of the process by which such a disparity is corrected, see Roger W. Spencer, "Channels of Monetary Influence: A Survey," this *Review* (November 1974), pp. 8-26.

[4]The existence of free international markets for goods, services, and securities is a fundamental assertion of the monetary approach to the balance of payments. See Kemp, "A Monetary View of the Balance of Payments," p. 16.

Suppose, for example, that the domestic monetary authorities increase the money supply in country j, which leads to an increase in the demand for goods, services, and securities in that country. Any such increase in domestic demand will result in a tendency for prices of domestic real and financial assets in country j to rise, in the short run, relative to those in foreign markets. As a result, spending units in country j will simultaneously reduce their purchases of domestic real and financial assets in favor of foreign assets while domestic suppliers of these assets will seek to sell more at home and less abroad. At the same time, foreign spending units will decrease their purchases of the assets of country j and foreign suppliers will attempt to sell more of their own assets in country j. All of these factors work in favor of an increase in the demand for imports and a decrease in the demand for exports in country j.[5]

Adjustment Under a System of Fixed Exchange Rates

Under a system of fixed exchange rates, the adjustments described above will result in an accumulation of money balances by foreigners in return for the real and financial assets they sell to spending units in country j. This exchange of money balances for real and financial assets will be captured in the balance-of-payments statistics as an overall deficit in the trade and capital accounts.[6] The foreign recipients of these money balances have the option of converting them into their own currencies at their respective central banks. These foreign central banks will then present the balances they accumulate through such conversions to the central bank in country j in return for primary reserve assets. Since these primary reserve assets are one of the components of a country's monetary base (and thus a determinant of its money supply), the effect of this transaction will be a decrease in the money supply of country j back towards its initial level and an increase in the money supplies of its surplus trading partners.

[5]The terms "imports" and "exports" refer to more than just imports and exports of goods and services. It includes all transactions which involve the purchase or sale of domestic assets (real and financial) in foreign markets. For example, the purchase of a foreign security by a U.S. citizen would be considered an import.

[6]A deficit in the trade account reflects an exchange of money balances for real assets (goods and services). A deficit in the capital account reflects the exchange of money balances for financial assets. In order to determine the total accumulation of money balances by foreigners, it is necessary to combine all of the trade and capital accounts.

Under a system of fixed exchange rates, the primary channel by which international trade and capital transactions can have an impact on aggregate economic activity is via the international reserve flows described above and their subsequent impact on the money supply (both foreign and domestic).[7] However, one is unable to gauge the magnitude of this impact by looking at either the trade or the capital accounts separately. For example, the effects on aggregate economic activity of a deficit in the merchandise trade account *alone* could be partially or fully neutralized by a surplus in one of the capital accounts. If such a situation arose, the negative aggregate demand effects resulting from an increase in imports of goods would be partially or fully offset by an inflow of capital and a resulting increase in investment demand. If the two effects fully offset each other, there would be no gain or loss of international reserves and the money supply would not be affected by the international trade and capital transactions.

In light of the above considerations, the crucial balance-of-payments concept is that which captures all transactions reflecting the adjustment of the supply of money to the level demanded. That is, the balance-of-payments concept which is most useful as a measure of the impact of international transactions on the domestic economy is one in which the only transactions considered "below the line" are those which have an influence on domestic and foreign money supplies.[8] Henceforth, we will refer to this balance as the *money account.* For the United States this account would be composed of a composite of changes in U.S. primary reserve assets (gold and holdings of foreign currency balances) and changes in foreign deposits at Federal Reserve Banks.[9]

Adjustment Under a System of Freely Floating Exchange Rates

Under a system of freely floating exchange rates the balance of payments (on a money account basis) is always in equilibrium (total imports equal total exports) and there are no money supply changes associated with foreign transactions. In this case the adjustment to the disparity between the supply of and demand for money is accomplished by changes in domestic prices and exchange rates (which change concomitantly with, and accommodate, the required movement in domestic price levels).

In order to analyze the process by which the required adjustment takes place under freely floating exchange rates, it is necessary to begin with an analysis of the market for foreign exchange. The demand for imports determines the demand for foreign exchange and the demand for exports determines the supply of foreign exchange. The exchange rate will always seek the level at which the quantities of foreign exchange supplied and demanded are equal, and thus also the level at which the value of import demand equals the value of export demand. Thus, in value terms, imports will always equal exports and there is never either a surplus or a deficit in the balance of payments (on a money account basis).

[7]Within the monetary approach framework there are other channels through which international transactions can have an impact on aggregate economic activity. For example, some changes in the terms of trade and in the volume of trade and capital flows can affect the productive capacity of a given economy. However, it should be noted that both of these channels relate to the concept of the gains from trade, which is distinctly different from the concept of the balance of payments. The only other channel through which international transactions can have an impact on aggregate economic activity is through their impact on the ownership of the total money stock. For example, the size of the total U.S. money stock (as currently measured) is not affected by changes in foreign-owned deposits at U.S. commercial banks. However, the distribution of the total U.S. money stock between U.S. and foreign ownership is affected by such changes. This source of international influence on the U.S. economy would be significant only if the volume of foreign-owned deposits was large and if the behavior pattern of foreign dollar owners differed significantly from that of domestic dollar owners. The evidence relating to this issue is, as yet, highly tentative. However, the consensus seems to be that the influence of foreign-owned deposits on the U.S. economy is minimal. For a discussion of the concept of a domestically owned money stock, see Albert E. Burger and Anatol Balbach, "Measurement of the Domestic Money Stock," this *Review* (May 1972), pp. 10-23.

[8]Balance-of-payments accounting is based on the principle of double entry bookkeeping. Total debits must equal total credits, and therefore it is impossible for the entire balance of payments to show either a deficit or a surplus. The only way we can observe a difference between credits and debits is to select certain items out of the balance of payments and compare credits and debits for the given subset of items. A particular subset is usually chosen because the net of the transactions included therein is significant, for some reason, in sign and amount. According to current usage, an imaginary line is drawn through the balance of payments so that the items selected for a subset appear "above the line" and the remaining items are said to be "below the line." For a more thorough discussion of standard balance-of-payments statistics presentation, see John Pippenger, "Balance-of-Payments Deficits: Measurement and Interpretation," this *Review* (November 1973), pp. 6-14.

[9]The *money account* captures the net impact of all international transactions on the U.S. money supply. Of all international transactions, the only ones that affect the money supply are those that affect some component of the monetary base. Since U.S. holdings of gold and foreign currency balances (primary reserve assets) and foreign deposits at Federal Reserve Banks are the only components of the monetary base that are affected by international transactions, the entire impact of these transactions on the money supply can be captured by observing the changes in these items. As such, the *money account* includes changes in only these items below the line.

Let us now return to the previous example in which there is an increase in the quantity of money supplied relative to the quantity demanded. As in our previous example, there will be an increase in the demand for imports (the demand for foreign exchange) and a decrease in the demand for exports (the supply of foreign exchange). Under freely floating exchange rates, the inevitable consequence will be a rise in the exchange rate (the price of foreign currencies in terms of the domestic currency).[10] As such, a rise in the exchange rate is the natural consequence of the existing money stock exceeding the quantity of money demanded.

The upshot of the foregoing analysis is that under fixed exchange rates the crucial balance-of-payments concept for gauging the impact of international trade and capital transactions on the domestic economy is the balance in the money account. Furthermore, exchange rate movements and money account deficits and surpluses are merely part of the adjustment mechanism by which a disparity between the existing supply of and demand for money is being corrected. They are symptoms of a problem, but they themselves are not the problem. The fact is that equality between the supply of and demand for money must and will be restored, and the money account deficits and surpluses and exchange rate movements are merely a mechanism by which the required adjustment is accommodated.

Most furor over balance-of-payments statistics and exchange rate movements stems from the failure to recognize the above proposition. For example, the belief is widespread that deficits in the trade account are "bad" because they represent a net drain on demand for the output produced in the deficit country. In reality, however, one is unable to gauge the impact of international transactions on domestic demand by focusing on the trade account alone. Even if a trade account deficit is not offset by a surplus in the capital account, the resultant deficit in the money account merely reflects the fact that the stock of money exceeds the quantity of money demanded. Somehow this disparity must be and is corrected. In a regime of fixed exchange rates, the money stock will be decreased automatically through the outflow of international reserves which is associated with the money account deficit.

In a similar fashion, most concern over the depreciation of a currency in a regime of floating exchange rates is also misdirected. It is curious that the belief is widely held that the depreciation of a nation's currency is a cause of domestic inflation. To the contrary, depreciations are not the source, but are the result of inflationary pressures. The depreciation occurs for the same reason that money account deficits occur with fixed exchange rates — that is, because there exists a disparity between the supply of and demand for money which must be corrected.

When such a disparity exists under floating exchange rates, the excess supply of money itself will result in an increase in the demand for domestically supplied real and financial assets as well as for foreign exchange (the demand for foreign supplies of real and financial assets). Consequently, all prices (the price of foreign exchange included) will rise. As with all increases in the price level, the result will be an increase in the demand for money as spending units attempt to maintain the real value of that proportion of their wealth that they elect to hold in the form of money balances. In short, the original disparity between the demand for and supply of money will be corrected via a rise in domestic prices and a depreciation in the foreign value of the domestic currency (a rise in the price of foreign exchange).

In view of the foregoing analysis, balance-of-payments deficits and surpluses and exchange rate movements should *not* be viewed as evils that are to be avoided at all costs. They are not problems in themselves, but are one of the means by which other problems are corrected. In fact, in light of the nature of the forces which give rise to them, they are, in a sense, desirable.

BALANCE-OF-PAYMENTS CONCEPTS

Since they are summaries, balance-of-payments data are presented in categories composed of similar types of international transactions (for example, merchandise trade, long-term capital, etc.). The transactions grouped together in any particular category are similar in that, given the existing institutional framework within which they occur, the forces giving rise to, and the impact of, them is supposed to be similar.[11] To the extent that any set of groupings ever was appropriate or informationally useful, this usefulness can be greatly diminished if there are changes in the forces which give rise to, or the impact of, that

[10]That is, the domestic currency will depreciate in value relative to other currencies. Other currencies will now be worth more units of domestic currency than before.

[11]See Exhibit I and Table I for an outline of the groupings currently employed in balance-of-payments data presentation. These illustrations will be useful references for the remainder of this article.

Exhibit I

SUMMARY EXPLANATION OF U.S. BALANCE OF PAYMENTS

(To be used in conjunction with Table I)

The U.S. balance of payments is a summary record of all international transactions by the Government, business, and private U.S. residents occurring during a specified period of time.

As a series of accounts and as a measure of economic behavior, balance of payments transactions are grouped into seven categories: merchandise trade, services, transfer payments, long-term capital, short-term private capital, miscellaneous, and liquid private capital. We successively add the net balances of the above categories in order to obtain:

- Merchandise Trade Balance
- Goods and Services Balance
- Current Account Balance
- Basic Balance
- Net Liquidity Balance
- Official Settlements Balance

Below the dashed line there are two additional categories, U.S. liabilities to foreign official holders and U.S. reserve assets. These serve to finance the transactions recorded above the dashed line.

There are interrelationships between these accounts. For example, the credit entry associated with an export of goods could result from the debit entry of a private bank loan, a Government grant, a private grant, or an increase in U.S. holdings of foreign currency or gold.

Merchandise Trade: Exports and imports are a measure of physical goods which cross U.S. boundaries. The receipt of dollars for exports is recorded as a plus and the payments for imports are recorded as a minus in this account.

Services: Included in this account are the receipt of earnings on U.S. investments abroad and the payments of earnings on foreign investments in the U.S. Sales of military equipment to foreigners and purchases from foreigners for both military equipment and for U.S. military stations abroad are also included in this category.

Transfer Payments: Private transfers represent gifts and similar payments by Americans to foreign residents. Government transfers represent payments associated with foreign assistance programs and may be utilized by foreign governments to finance trade with the United States.

Long-term Capital: Long-term private capital records all changes in U.S. private assets and liabilities to foreigners, both real and financial. Private U.S. purchases of foreign assets are recorded as payments of dollars to foreigners, and private foreign purchases of U.S. assets are recorded as receipts of dollars from foreigners. Government capital transactions represent long-term loans of the U.S. Government to foreign governments.

Short-term Private Capital: Nonliquid liabilities refers to capital inflows, such as loans by foreign banks to U.S. corporations, and nonliquid claims refers to capital outflows, such as U.S. bank loans to foreigners. These items represent trade financing and cash items in the process of collection which have maturities of less than three months. The distinction between short-term private capital and liquid private capital is that the transactions recorded in the former account are considered not readily transferable.

Miscellaneous: Allocations of special drawing rights (SDRs) represent the receipt of the U.S. share of supplemental reserve assets issued by the International Monetary Fund. SDRs are recorded here when they are initially received by the United States. The category errors and omissions is the statistical discrepancy between all specifically identifiable receipts and payments. It is believed to be largely unrecorded short-term private capital movements.

Liquid Private Capital: This account records changes in U.S. short-term liabilities to foreigners, and changes in U.S. short-term claims reported by U.S. banks on foreigners.

NOTE: For analytical purposes the dashed line below the official settlements balance could be moved. For example, if this line were placed under one of the balances above, then all transactions below that line would serve as financing, or offsetting, items for the balance above.

Table I

U. S. BALANCE OF PAYMENTS, 1974p

(Billions of Dollars)

		Net Balance	Cumulative Net Balance
Merchandise Trade:			
Exports	+ 97.1		
Imports	–103.0		
Merchandise Trade Balance		– 5.9	– 5.9
Services:			
Military Receipts	+ 3.0		
Military Payments	– 5.1		
Income on U. S. Investments Abroad	+ 29.9		
Payments for Foreign Investments in U. S.	– 16.7		
Receipts from Travel & Transportation	+ 10.2		
Payments for Travel & Transportation	– 12.7		
Other Services (net)	+ 0.3		
Balance on Services		+ 9.1	
Goods and Services Balance			+ 3.2
Transfer Payments:			
Private	– 1.1		
Government	– 6.1		
Balance on Transfer Payments		– 7.2	
Current Account Balance			– 4.0
Long-term Capital:			
Direct Investment Receipts	+ 2.3		
Direct Investment Payments	– 6.8		
Portfolio Investment Receipts	+ 1.2		
Portfolio Investment Payments	– 2.0		
Government Loans (net)	+ 1.0		
Other Long-term (net)	– 2.4		
Balance on Long-term Capital		– 6.7	
Basic Balance			–10.6
Short-term Private Capital:			
Nonliquid Liabilities	+ 1.7		
Nonliquid Claims	– 14.7		
Balance on Short-term Private Capital		–13.0	
Miscellaneous:			
Allocation of Special Drawing Rights (SDR)	*		
Errors and Omissions	+ 5.2		
Balance on Miscellaneous Items		+ 5.2	
Net Liquidity Balance			–18.3
Liquid Private Capital:			
Liabilities to Foreigners	+ 15.7		
Claims on Foreigners	– 5.5		
Balance on Liquid Private Capital		+10.3	
Official Settlements Balance			– 8.1
The Official Settlements Balance is Financed by Changes in:			
U. S. Liabilities to Foreign Official Holders:			
Liquid Liabilities	+ 8.3		
Readily Marketable Liabilities	+ 0.6		
Special Liabilities	+ 0.7		
Balance on Liabilities to Foreign Official Holders		+ 9.5	
U. S. Reserve Assets:			
Gold	0.0		
Special Drawing Rights	– 0.2		
Convertible Currencies	0.0		
IMF Gold Tranche	– 1.3		
Balance on Reserve Assets		– 1.4	
Total Financing of Official Settlements Balance			+ 8.1

*There was no SDR allocation for 1974.
P — Preliminary
NOTE: Figures may not add because of rounding.

particular set of transactions, or if there are changes in the institutional framework within which these transactions occur. Thus, given the changes which have occurred in the field of international trade and finance in the last few years, it would not be at all surprising to find that some previously meaningful balance-of-payments groupings had become almost meaningless.

Foremost among these changes has been the movement of the world's major trading nations from a fixed to a floating exchange rate regime and the surge in the accumulation of official reserves by OPEC members. In this section the current methods of presenting balance-of-payments statistics will be analyzed in light of these changes. Each individual account will be discussed in terms of its relevance prior to these changes and, where appropriate, in light of the movement to floating exchange rates and the rapid growth of OPEC reserves.

Current Account

The current account measures the extent to which the United States is a net borrower from, or net lender to, foreign countries as a group. With the exception of unilateral transfers (gifts and similar payments by American governmental units and private citizens to foreign residents), all of the transactions recorded above the line in this account represent the transfer of real assets (goods and services) between the United States and its trading partners.[12] The transactions recorded below the line in this account represent the means by which the United States is able to finance the purchase of net imports from other countries or, in the case of a surplus, how net exports have been financed by our trading partners. For example, the United States had a $4 billion deficit on current account in 1974. This means that, on balance, the United States received $4 billion more in goods and services (imports) than it gave up (exports) in return. The United States was able to do this by borrowing $4 billion from foreigners. The borrowing was financed through a net of all of the transactions which appear below the line in the current account. Thus, for the purpose of balance-of-payments analysis, the value of the current account balance lies in its usefulness as a measure of the net transfer of real resources between the United States and the rest of the world. Another way of viewing this balance is that it measures the change in our net foreign investment. In other words, in 1974 foreigners invested (made loans amounting to) $4 billion in the United States.

This balance carries additional significance in that it is a component of the nation's GNP accounts. It is included in the GNP accounts because it is *supposed* to capture the contribution of foreigners to domestic aggregate demand. However, it alone tells us very little about the impact of international transactions on domestic economic activity. It only measures the magnitude of foreign demand for current output (goods and services) and completely ignores the impact of foreign investment decisions on U.S. economic activity. As mentioned previously, transactions in the capital account could offset completely the impact of current account transactions on the U.S. money supply. As such, implications drawn from the current account regarding the domestic impact of foreign transactions can be highly misleading.

These same objections are equally appropriate, if not more so, to the two more narrowly defined balance-of-payments concepts — the merchandise trade balance and the goods and services balance. While these balances are among those which receive the greatest amount of attention, their implications for the domestic economy are greatly overstated.

Basic Balance

The basic balance isolates long-term capital transactions above the line along with all of the transactions included in the current account. All capital flows involving assets whose original maturity exceeds one year are defined as long term, and therefore "basic" transactions. The original theoretical justification for the basic balance seems to be that it catches the *persistent* forces at work in the balance of payments and thus could be a leading indicator of long-run trends.

However, this is clearly not the case. Both portfolio investments and long-term private loans are included in long-term capital, and both are now highly sensitive to short-run changes in interest rates and changes in expectations about relative inflation rates, monetary policies, and growth. The meaningfulness of the long-term capital concept might have some appeal on a theoretical basis, but data problems make its em-

[12]The current account excludes earnings on direct investments which are both earned and reinvested abroad. However, these reinvested earnings are no different than other sources of U.S. income from abroad in the sense that they represent a transfer of command over real resources. In recent years these reinvested earnings have been quite large. For example, in 1971 they amounted to $3.2 billion, while in 1972 and 1973 they amounted to $4.7 billion and $8.1 billion, respectively.

pirical counterpart extremely difficult to construct and, therefore, it is not very useful.

Net Liquidity Balance

The net liquidity balance may be thought of as a measure of the total of U.S. dollars which accrue to foreigners, during an accounting period, as a result of all of the transactions recorded above the line — that is, imports and exports of goods and services, unilateral transfers, inflows and outflows of long-term capital, and nonliquid short-term capital. Below the line it combines the changes in our reserve assets and the changes in our liquid liabilities to both private and official foreigners. The original intent of this balance was to measure the change in *potential* pressure on our reserve assets. The thinking was that official institutions could use their dollar assets to buy our reserve assets; private holdings of dollars were a potential threat if private foreigners sold their dollars to central banks, who could in turn use them to buy our reserve assets.

There are a number of problems with this measure which make its relevance and usefulness highly questionable. These problems are both theoretical and empirical and are greatly magnified by the recent institutional changes which have occurred in international finance.

The main empirical problem with this measure is that it attempts to distinguish between liquid and nonliquid liabilities. Every U.S. liability to foreigners has a combination of attributes, some of which qualify them for classification as liquid and some of which qualify them for classification as nonliquid. As a result, the classification of many assets as liquid or nonliquid must be somewhat arbitrary. For example, foreign portfolio investments in the United States are classified as nonliquid liabilities. However, these liabilities of the United States are readily convertible into liquid form — that is, they may be sold at any moment in time for cash or a demand deposit. Thus, the exchange market implications of the growth of foreign portfolio investments in the United States are not much different from those of a growth in foreign-held bank deposits (which are classified as liquid).

Suppose, however, that all liabilities to foreigners could be meaningfully subdivided into liquid and nonliquid categories. It would still be inaccurate to declare that all liquid liabilities to foreigners represent potential pressure on our reserve assets. There are many reasons why foreigners wish to hold liquid claims against the United States, not the least of which is for transactions purposes. The U.S. dollar is indeed an international currency which may be used in transactions throughout the world. Only those foreign-held claims which are in excess of those desired for transactions purposes can be rightfully considered as a potential source of pressure on our reserve assets.

While it is surely impossible, for empirical as well as theoretical reasons, to determine what proportion of total U.S. liabilities are being held for transactions purposes, the proportion is probably large. In order to determine accurately potential pressures on our reserve assets, it would be necessary to further subdivide U.S. liquid liabilities to foreigners into those held for transactions purposes and those held for speculative (or other) purposes. Indeed, it is only this latter category of liquid claims that represent potential pressures on our reserve assets.

The above problems have become decidedly more acute in the wake of the quadrupling of petroleum prices and the surge in the dollar holdings of OPEC members. Since the transacting currency of OPEC members is the U.S. dollar, the role of the dollar as an international medium of exchange, and thus its transactions demand, has been greatly enhanced. At the same time, many OPEC members have been accumulating extensive dollar denominated liquid claims. While this may be only a short-run phenomenon, the fact is that these liquid U.S. liabilities do not represent a potential threat to our reserve assets. Rather, these liabilities represent only a short-term depository for OPEC receipts while they decide how they wish to extend the maturity distribution of their claims into long-term (and therefore nonliquid in balance-of-payments parlance) investments.

To the extent that there ever did exist a conceptual basis for trying to measure the net liquidity balance, that basis no longer exists as a result of the shift from a system of fixed to one of floating exchange rates. With floating exchange rates there is no potential pressure on our primary reserve assets because the dollar is no longer convertible into them.[13]

[13]Under fixed exchange rates the United States stood ready to buy and sell foreign currencies in order to support the value of the dollar at a specific price in terms of other currencies. Primary reserve assets (international reserves) are stocks of gold and foreign currencies held by the U.S. Government in the event that such market intervention became necessary. For example, a decrease in the demand for dollars vis-a-vis gold or foreign currencies was accommodated by the purchase of dollars in return for foreign currencies or gold from the stocks of reserve assets. Thus, the dollar was said to be readily convertible into our reserve assets. How-

Official Settlements Balance

The official settlements balance is intended to measure the change in dollar balances which accrue to foreign official institutions only. In this balance-of-payments concept all private transactions are counted above the line, whereas in the net liquidity balance some private transactions (liquid private capital flows) are counted below the line. The original intent of this balance was to measure *directly* the net exchange pressure on the dollar and on U.S. reserve assets.[14] Since only those dollar denominated U.S. liabilities which are held by foreign official institutions could be exchanged for reserve assets, this balance focuses on only those transactions which give rise to changes in these liabilities.

The usefulness of this balance has always rested on the questionable distinction between private and official transactions. The idea is that all transactions listed above the line are the result of market-determined private (autonomous) actions and all transactions below the line are the result of official (accommodating) actions undertaken in support of fixed exchange rates. The thinking was that all official transactions could be considered as accommodating and all private transactions as autonomous. This probably never was the case and certainly is not the case now, given recent institutional changes in international finance.

The rapid accumulation of reserves by official agencies of OPEC members are included below the line in this balance, but they are clearly not the result of official action aimed at stabilizing exchange rates. These OPEC reserves largely represent investment decisions by OPEC members which are based on considerations of income, liquidity, and risk. In other words, many official transactions are clearly autonomous and not accommodating, and should therefore be included with other autonomous transactions above the line.

While the above discussion relates to the blurred distinction between autonomous and accommodating transactions, there are other problems which blur the distinction between private and official transactions. For example, many foreign official institutions invest their dollar balances in the Eurodollar market. The result of such transactions on the balance-of-payments accounts is to increase private (Eurodollar bank) claims on the United States and reduce official claims. However, in reality, since the foreign official institution still maintains ownership and control of a claim against the United States, there has been no reduction in official claims against it.

To the extent that the official settlements balance ever did measure what it was supposed to measure, the relevance of this concept has disappeared as a result of the shift to floating exchange rates. As a result of this shift, exchange rate authorities are no longer *obligated* to prevent movements in exchange rates through official intervention in the foreign exchange market. The net exchange pressure on the dollar is no longer captured by changes in reserve asset holdings.

PROPOSALS FOR REFORM

In view of the considerations aired in the foregoing discussion, it is often the case that the present method of presenting balance-of-payments data is more misleading than useful. In some instances the balances currently reported have absolutely no economic meaning and often do not give an accurate measure of the impact of international trade and capital transactions on aggregate economic activity. This is because none of the currently reported balances capture the effects of international transactions on the money supply, and it is primarily through their effects on the money supply that these transactions have any appreciable impact on aggregate economic activity.

Under fixed exchange rates there is only one really meaningful balance — the balance in the money account. This account is the only one that captures the effect of international transactions on the money supply. However, at present this balance is not reported. Under freely floating exchange rates there are no meaningful balance-of-payments concepts, because in this case international transactions have no impact on the money supply. In this case the money account is always in balance, and therefore of no significance.

ever, with floating exchange rates the U.S. Government is no longer *obligated* to intervene in the market for foreign currencies and changes in the demand for the dollar are accommodated by movements in the dollar exchange rate. In other words, with floating exchange rates the U.S. Government no longer *guarantees* the convertibility of the dollar into its reserve assets.

[14]The official settlements balance was originally supposed to reflect the effects of past measures taken in support of the fixed dollar exchange rate, while the net liquidity balance was supposed to reflect the potential need for such measures in the future. This is because the net liquidity balance includes liquid *private* capital, a potential source of future pressure on fixed exchange rates, below the line. On the other hand, in the official settlements balance the only transactions carried below the line are those which reflect past *official* measures.

Thus, there is little, if any, reason why the publication of balance-of-payments data in the currently employed format should be continued. Not only is this format virtually without economic meaning, but it is often quite misleading. While there are many theoretical and empirical problems associated with any kind of aggregation of data pertaining to international transactions, the problems are unnecessarily exacerbated by the present practice of drawing balances on the various subaccounts (that is, the merchandise trade balance, the goods and services balance, the current account balance, etc.). These problems could be significantly reduced if the data were just presented and no balances were drawn.

In a world of freely floating exchange rates, changing pressures on the dollar are captured by movements in the exchange rate and not by some theoretically and empirically meaningless balances. For this reason, it would be helpful if international trade data were to include changes in the effective exchange rate.[15] However, we recognize that the current exchange rate arrangement cannot be realistically considered as an experiment with freely floating exchange rates. It is rather an experiment with a "managed float."[16] Whether recent official intervention activities have had any effect on the exchange rate or not, the fact is that they, as will any official exchange rate intervention activities, have had an impact on the U.S. monetary base. Thus, as it turns out, given the current "managed float," both the money account balance and changes in the effective exchange rate each convey some useful information.

Thus, any proposals for reform of the methods of presenting balance-of-payments data should include, at a minimum, a recommendation that the currently employed balances not be drawn and that the words "deficit" and "surplus" be dropped from any reference to international data. This would not prevent individuals from computing balances if they wished; it would only remove the implied government sanction of these concepts as economically meaningful.

In addition, any proposed reforms should address themselves to the obviously arbitrary classification of certain transactions as relating to liquid, illiquid, short-term, or long-term capital flows. They should also recognize that under a managed float changing pressures on the dollar are captured by movements in the exchange rate and the money account balance. With these goals in mind, a classification scheme similar to that presented in Exhibit II is suggested.

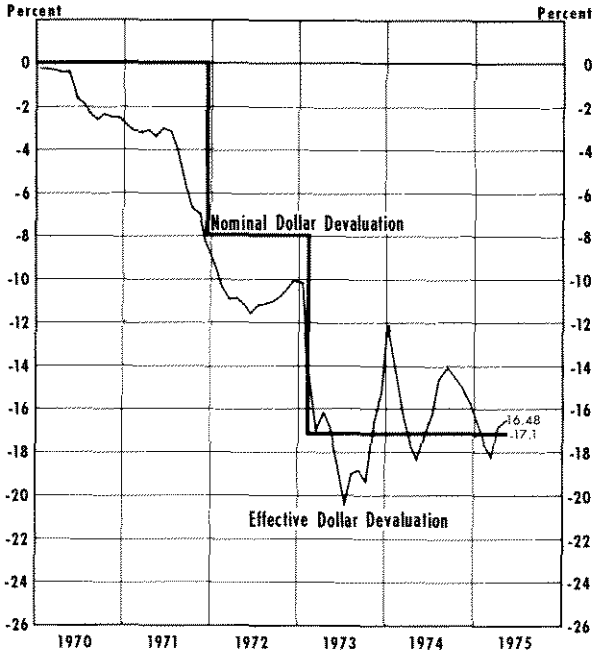
Exhibit II

INTERNATIONAL TRANSACTIONS, 1974p

	Millions of Dollars
Merchandise Exports	$100,047
Merchandise Imports	108,027
Service Exports	42,600
Service Imports	31,431
Unilateral Transfers (Net)	9,005
Direct Investment Abroad	6,801
Direct Investment in U.S.	2,308
Portfolio Investment Abroad	1,951
Portfolio Investment in U.S.	1,199
Deposits Abroad (Demand, Time, at Central Bank)	1,129
Deposits in U.S. (Demand, Time, at Central Bank)	20,746
Money Account Balance	46

Sources: *Survey of Current Business*, Board of Governors of the Federal Reserve System *Bulletin*, *Treasury Bulletin*.

Nominal and Effective Dollar Devaluation



Sources: IMF and the Federal Reserve Bank of New York

Note: Nominal devaluation is measured by the change in the dollar price of gold. Effective devaluation is measured by the appreciation of eleven major currencies relative to the par values which prevailed as of May 1970. The appreciation is then weighted by separate export and import shares with the United States based on 1972 trade data.

Latest data plotted: May

[15]The change in the effective exchange rate is a trade weighted average of changes in the exchange rate between the dollar and the currencies of the United States' trading partners.

[16]In other words, exchange rates are currently neither fixed at an officially specified level nor are they allowed to move completely free of official foreign exchange market intervention.

The advantages of this type of approach to the classification of international data are as follows:

1) No balances are computed or reported.

2) It allows individuals to make their own judgments regarding whether or not a particular transaction is related to liquid, illiquid, short-term, or long-term capital flows and to draw their own conclusions regarding the significance of changes in these flows.

3) It recognizes that pressures on the dollar are reflected in changes in exchange rates and in the money account balance and not by changes in the volume of a particular subset of transactions.

CONCLUSION

The current method of presenting data relating to international commerce attempts to group transactions so that the net of the transactions included in any category (the balance in that account) is significant for some reason in sign and amount. The transactions grouped together in any particular category are *supposed* to be similar in that, given the existing institutional framework within which they occur, the forces giving rise to, and the impact of, them is *supposed* to be similar. The idea is that the balance in that account should serve as a guide to policymakers as they attempt to gauge the impact of international transactions on domestic economic activity.

A particular balance is an appropriate guide to policy or is informationally useful only to the extent that it is based upon a correct perception of the forces which give rise to, and the impact of, the transactions included therein. The thrust of this article is that the balances highlighted in current balance-of-payments statistics are based on an incorrect perception of such forces and impacts. As such, these balances have very little economic meaning and are, therefore, often a misleading guide to policymakers. As an alternative, it is suggested that international trade and capital transactions be viewed within the framework presented in the first sections of this article.

Therefore, the conclusion of this article is that the present methods of presenting data concerning international transactions should be reformed so that it more closely reflects the underlying economic realities of international commerce. At a minimum, any such reform should include a discontinuation of the practice of calculating the balances which are currently presented. While this would not prevent individuals who wish to do so from calculating such balances, it would remove the implied governmental sanction of these balances as having some special economic or policy implications.

In addition, the above reform would also result in a discontinuation of the constant references to "deficits" and "surpluses" in the balance of payments. The words "deficits" and "surpluses" in this regard convey meanings that are not at all appropriate to the realities of the impact of international commerce on domestic economic activity. For example, every month we hear that the merchandise trade account was either in "deficit" or "surplus." A deficit in this account merely means that the United States imported more merchandise than it exported during that month. In other words, the United States received more goods during that month than it was forced to give up, and it was able to do so by borrowing from foreigners. Despite the stigma associated with the word "deficit", this information tells us virtually nothing about the overall impact of international commerce on domestic economic activity.