

An hourglass-shaped graphic with a globe in the top bulb and another globe in the bottom bulb. The hourglass is light blue and has a dark blue cap at the top. The globe in the top bulb is dark blue, while the globe in the bottom bulb is light blue. The text is centered within the hourglass.

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The Balance of Payments: Meaning and Significance

Gary J. Wells, Visiting Fellow, Foreign Affairs, Defense, and Trade Division

April 30, 2003

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The Balance of Payments: Meaning and Significance

Summary

This report provides a basic discussion of the U.S. balance of payments (BOP). The BOP is a systematic accounting of the U.S.'s international transactions for a specified period of time. It is an economic indicator that is followed closely by Members and Committees concerned with international trade and financial flows. The BOP measures flows between U.S. and non-U.S. residents. Transactions involving items capable of directly satisfying economic needs and wants are recorded in the BOP's current account. These are further distinguished as goods and services trade, receipt or payment of income from investments, and one-way (unilateral) transfers. The capital and financial accounts capture transactions involving asset transfers (e.g., ownership transfer of equities between residents and non-residents).

The BOP is organized as a double-entry bookkeeping system. As a result, credits (i.e., inflows of funds) are, in principle, offset by debits (i.e., outflows of funds). However, difficulty in gathering accurate information creates a statistical discrepancy. To ensure credits and debits sum to zero the statistical discrepancy is calculated as the sum of all BOP transactions with the opposite sign.

A key element of the BOP is the balance of trade (BOT). The BOT equals exports minus imports of goods and services. The BOT is used to quantify the trade deficit (i.e., imports exceeding exports). From the early 1990s until the third quarter of 2002 the U.S. trade deficit grew from less than 1% of U.S. gross domestic product (GDP) to more than 4%. Because of the BOP's dual entry bookkeeping organization, the trade deficit must be offset by other transactions. Typically, a net investment inflow into the United States provides the bulk of the required offset. That is, in order to purchase U.S.-based assets foreign investors acquire the net outflow of dollars generated by the trade deficit.

Many analysts believe the trade deficit is not sustainable and that the attractiveness of foreign investments will gain ground relative to U.S. investments. This will encourage domestic investors to send more investment funds out of the country while also encouraging foreign investors to send less to the United States. Both would make it more difficult to fund U.S. imports at current levels. Two possible scenarios have been formulated to explain how the trade deficit might fall—soft and hard landings. With a soft landing the trade deficit gradually falls allowing exchange rates and other economic measures to adjust; the adverse impact on the economy is thought to be minimal. A hard landing, on the other hand, would entail a dramatic fall in the value of the dollar and insufficient time for the economy to adjust. A recession may ensue.

The terrorists events of September 11 and the weakening economy had the potential to trigger a hard landing, but the data do not indicate that this is happening. The exchange value of the dollar relative to widely-traded currencies has steadily weakened since the beginning of 2002, but at the same time its value has strengthened relative to less widely-traded currencies.

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For questions regarding this report, contact James Jackson, CRS Foreign Affairs, Defense, and Trade Division, at 707-7751.

The Balance of Payments: Meaning and Significance

Some Members of Congress have voiced concerns regarding the persistent and growing trade deficit the United States has experienced since the 1990s. A significant manifestation of this concern was the formation of the U.S. Trade Deficit Review Commission in 1998 (19 U.S.C. 2213 as amended). This commission was charged with exploring:

- The causes and consequences of the merchandise trade and current account deficits and specific bilateral trade deficits.
- The impact that United States monetary and fiscal policies may have on U.S. merchandise trade and current account balances.
- The relationship of the merchandise trade and current account balances to the overall well-being of the United States economy, and to wages and employment in various sectors of the U.S. economy.
- The extent to which the coordination, allocation, and accountability of trade responsibilities among federal agencies may contribute to the trade and current account deficits.¹

To get a sense of the trade deficit's importance, this report will place the trade deficit into the larger context of the balance of payments (BOP). Specifically, the report will define the balance of payments, illustrate it via a diagram, provide examples of BOP transactions, and discuss the trade deficit generally and in light of recent events.

The Balance of Payments Defined

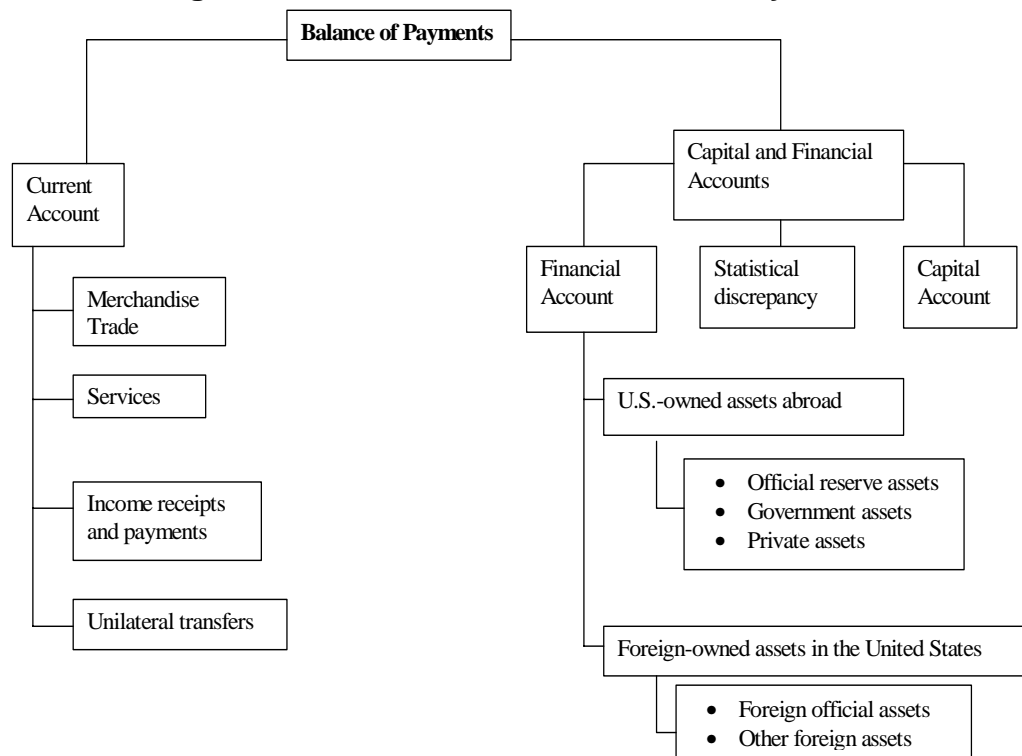
The U. S. balance of payments (BOP) is a systematic accounting of the U.S.'s international transactions for a specified period of time, typically a quarter or a year.² Transactions take place between U.S. residents and residents of other countries. Residents include individuals, businesses and governmental units (federal, state and

¹ See the *Report of the U.S. Trade Deficit Review Commission*. November 14, 2000. For more information on this report see *Trade Deficit Review Commission* by Dick K. Nanto (CRS Trade Briefing Book. April 12, 2001.)

² For BOP purposes the U.S. economy consists of the 50 states, the District of Columbia, the Commonwealth of Puerto Rico, American Samoa, Guam, Midway Island, the Virgin Islands, Wake Island, and all other U.S. territories and possessions. For more information see *The Balance of Payments of the United States: Concepts, Data Sources, and Estimating Procedures*. U.S. Department of Commerce. May 1990.

local). A place of residency is the country where a resident ordinarily lives.³ A transaction is defined as “the transfer of ownership of something that has an economic value measurable in monetary terms from residents of one country to residents of another.”⁴ The balance of payments measures transactions between domestic and foreign residents, but only if the transactions occur during the specified measurement period. That is, the BOP captures flows of transactions. It is organized as a double-entry bookkeeping system with each transaction, in principle, having an offsetting entry. As a consequence the BOP should always balance—that is sum to zero. However, individual components (i.e., accounts and sub accounts) may not balance. The Department of Commerce’s Bureau of Economic Analysis (BEA) maintains the balance of payments for the United States. BEA reports the BOP quarterly.

Figure 1. Flowchart of the Balance of Payments.



BOP transactions are grouped by type. Figure 1 illustrates BOP transaction categories in a flowchart. The two primary headings are the current account and the capital/financial accounts. Merchandise (goods) trade, services trade, income from ownership of assets (e.g., income from stocks, securities, and businesses), and unilateral transfers are recorded in the current account, and asset flows are recorded in the capital/financial accounts. The general distinction between current account and capital/financial account transactions is that the items involved in the former are available to satisfy economic needs or wants in and by themselves, whereas the latter transactions involve assets that would first need to be exchanged for resources

³ For details see *ibid.* p. 3.

⁴ *Ibid.* p. xiii

capable of satisfying these needs or wants. For example, stock certificates would first need to be sold to satisfy economic needs or wants. As a matter of convention the statistical discrepancy, which arises because of the complexity in gathering the required data, is placed on the capital/financial account side of the BOP.

The Current Account⁵

Merchandise or goods trade includes all raw materials and manufactured goods bought, sold, or given away. **Services trade** includes tourism, transportation, engineering services, and business services (e.g. banking, insurance, law, management consulting and accounting services). Patent and copyright fees that cross international borders are also included in the services category. As a matter of practicality, the distinction between goods and services sometimes becomes blurred (e.g., gifts purchased by travelers are classified as services).

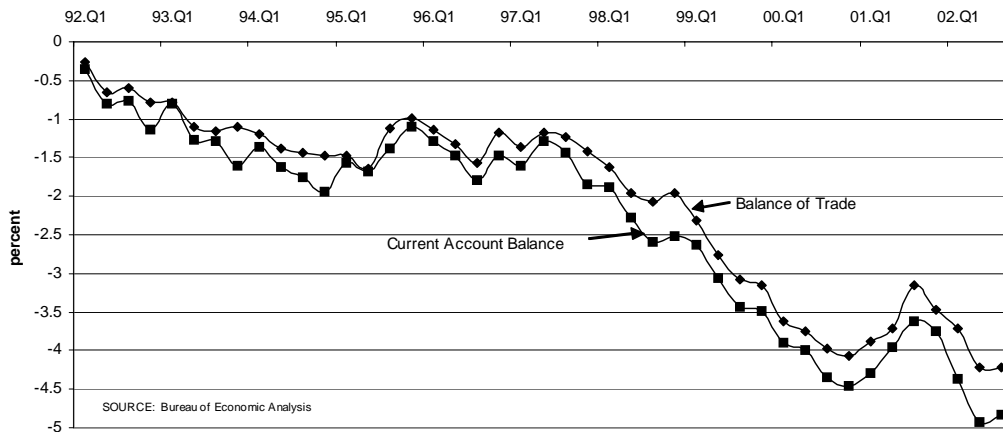
A good or service transaction is classified by the direction of the flow of funds. For example, an exported good or service generates an inflow of funds and is recorded as a credit with a positive sign in the BOP. An import is accompanied by a funds outflow and is recorded as a debit with a negative sign. Typically, the United States imports more goods than are exported, while just the opposite is the case for services.

If imports exceed exports, a **trade deficit** occurs; and when exports exceed imports, a **trade surplus** occurs. The **balance of trade (BOT)** is used to quantify a trade deficit or surplus. To reflect the growing importance of services in the U.S. economy the balance of trade measure in this publication includes goods and services. However, as a result the trade deficit as measured by the BOT is lower than had merchandise trade been used exclusively.⁶ As stated above, this is the case because the United States typically exports more services than are imported. To show the balance of trade in the context of the size of the U.S. economy, Figure 2 presents the BOT as a percent of U.S. gross domestic product (a measure of national income). As Figure 2 illustrates the United States has had a trade deficit over the period since 1992, and this deficit has generally grown.

⁵ For further information on items included in the current account see *America's Growing Current Account Deficit: Its Cause and What it Means for the Economy* by Gail E. Makinen and Marc Labonte (CRS Report RL30534, Updated April 19, 2001) and *U.S. International Trade: Data and Forecasts* by Dick K. Nanto and Vivian C. Jones (CRS Issue Brief IB96038, July 25, 2001.) In addition to discussing trade generally, IB96038 discusses bilateral trade flows and the alternative methods used to calculate current account items. The data in this current report utilizes the balance of payments method.

⁶ Even though a balance of trade deficit is a negative number, it is discussed as if it were positive. That is, a growing deficit is moving from a negative number closer to zero to one further away.

Figure 2. Measures of the U.S. Trade Deficit as a Percent of Gross Domestic Product—1992:Q1-2002Q3.



A measure closely related to the balance of trade is the **current account balance**. As can be seen in Figure 2, the BOT and current account balance track similar paths. This is the case because the BOT is a significant component of the current account balance. However, in addition to goods and services trade, the current account balance also includes income payments and receipts and unilateral transfers. In this regard, the current account balance is more complete because it encompasses all international transactions of items available to satisfy economic needs or wants.

International income receipts and payments derive from ownership of assets. Stock dividends are an example. An outflow results from income earned in the United States being repatriated by foreign asset holders, and an inflow results as American residents repatriate foreign generated income. **Unilateral transfers** are one-way transfers of funds. Worker remittances from abroad (e.g., a foreign worker sending money back home), direct foreign aid, and pension payments involving residents and non-residents are examples. The Bureau of Economic Analysis does not individually report inflows and outflows of unilateral transfers, but, instead, reports only the net flow.

The Capital/Financial Accounts

The capital/financial accounts actually include three accounts—the capital account, the financial account, and the statistical discrepancy.⁷ Each will be discussed in turn.

The Capital Account. In order to comply with International Monetary Fund suggested guidelines the Bureau of Economic Analysis reorganized the balance of

⁷ The capital and financial accounts are distinct asset accounts. They are grouped together in this report for ease of exposition.

payments in June 1999. Several transaction categories were moved from the unilateral transfer account into a newly formed capital account. “The newly defined capital account consists of capital transfers and the acquisition and disposal of non-produced, non-financial assets. The major types of capital transfers are debt forgiveness and migrants’ transfers (goods and financial assets accompanying migrants as they leave or enter the country).”⁸ Non-produced, non-financial asset transactions include transfers of the rights to natural resources, patents, copyrights, trademarks, franchises, and leases. Other transactions recorded in the new capital account include the transfer of title to fixed assets, gift and inheritance taxes, death duties, uninsured damage to fixed assets, and legacies.

For the United States, these transactions typically comprise a relatively small portion of the balance of payments (see the appendix), but a significant debt forgiveness program could increase the importance of this account. Prior to the introduction of this new account, the fundamental division of the balance of payments was between the current account and what was then called the capital account. With the introduction of this new capital account the capital account that existed prior to the change was renamed the financial account.

The Financial Account. International transactions involving assets that are not recorded in the capital account are reported in the **financial account**.⁹ Financial account transactions may involve financial assets such as loans, bank deposits, drafts, government and private debt and equities. Assets may also encompass physical or real assets held for the production of income such as manufacturing facilities and controlling interest in a business enterprise.

The financial account is further divided into U.S. assets abroad (claims) and foreign assets in the United States (liabilities). U.S. assets abroad are classified either as U.S. official reserve assets, other U.S. government assets, or U.S. private assets. Only the net of each of these transactions is reported in the balance of payments. Official reserves, as opposed to other government assets, are used for currency support and to ensure smooth operation of the international transactions system.¹⁰

The Statistical Discrepancy. Collection of BOP data is very complex and involves numerous government agencies, international organizations, and industry and trade associations. As a result, there is significant potential for data collection error. For example, merchandise trade valuation is dependent on the paperwork

⁸ See “Upcoming Changes in the Classification of Current and Capital Transactions in the U.S. International Accounts.” *Survey of Current Business*. February, 1999. pp. 10-11.

⁹ A few transactions that should be included in the capital account are inadvertently classified as current account transactions because of the difficulty in disentangling these transactions from other current account transactions.

¹⁰ Reserve assets include foreign currencies, gold, and special drawing rights (SDRs). SDRs were created as part of the International Monetary Fund to help stabilize international transactions. For more information see *The Balance of Payments of the United States: Concepts, Data Sources, and Estimating Procedures*. U.S. Department of Commerce. May 1990. (Because this publication pre-dates the revision of the U.S. BOP, the discussion of the financial account is conducted in the capital account section.)

accompanying a transaction. If this paperwork is inaccurate, then a statistical discrepancy might arise. The only transactions that are thought to generate few discrepancies are those involving U.S. official reserve assets. In contrast, private financial transactions are difficult to track, and therefore may substantially contribute to the discrepancy. It should be noted, if both the credit and debit entries of a transaction are omitted, then no statistical discrepancy is recorded in spite of the fact that the individual components of the BOP that are affected would be inaccurate. Also, many errors and omissions may offset each other. In short, the statistical discrepancy underestimates the magnitude of errors and omissions. The statistical discrepancy is calculated as the sum of all other BOP transactions but with the opposite sign.

The Nature of Balance of Payments Transactions

The nature of balance of payments transactions becomes clearest when more than one currency is involved. For example, consider a U.S. importer purchasing goods manufactured in Japan. In this case, it is likely that the U.S. importer desires to make payment in dollars and the Japanese manufacturer desires to receive payment in yen. To complete the transaction a third party willing to exchange yen for dollars at the current exchange rate needs to be located.¹¹ The third party can be a bank, a business enterprise, a government or an individual, and the third party does not have to be from Japan or the United States. The critical aspects are that the third party is willing to exchange yen for dollars for a reason and this reason is not likely to have anything to do with the transaction between the U.S. importer and Japanese manufacturer. For example, the yen supplier may want to purchase U.S. goods for shipment to Japan, or he or she may want to purchase U.S. stocks, bonds or other assets. Regardless, all of the possible transactions are captured in the U.S. balance of payments. The transaction between the U.S. importer and the Japanese manufacturer is captured as a U.S. import, and the third party transaction is captured as either a U.S. export or as a transfer of U.S. assets to foreign-ownership.

It should be noted that the dollar-yen exchange rate plays a critical role in both transactions. In the first transaction the U.S. importer judges the wisdom of the transaction based on the dollar value, and the Japanese exporter passes judgment based on the yen value. These two valuations are linked by the exchange rate. Likewise, the exchange rate influences the third party's willingness to make yen available to complete the exchange.

Thus far, the third party has been portrayed as reacting to the initial transaction between the U.S. importer and the Japanese exporter. However, the third party is not likely to be aware of the other transaction. One or more banks are probably acting as intermediaries to complete the two transactions. In reality, both transactions are

¹¹ Of course, it is possible that the U.S. importer has yen from a previous transaction or the Japanese manufacturer desires dollars for an upcoming transaction. In either of these cases, the U.S. importer or the Japanese manufacturer is playing the role of the third party described in this example.

occurring in a somewhat independent manner. The connecting links are the exchange rate and financial intermediaries.

If the exchange rate is allowed to find its own value, then the number of dollars flowing into the foreign exchange market in search of yen and yen flowing into the market in search of dollars determine the rate. If U.S. importers are attempting to purchase a growing amount of Japanese products, yen holders may have to be enticed into exchanging their yen for dollars by a more favorable yen-dollar exchange rate (i.e., they may require more dollars for a yen than was previously the case). If, on the other hand, yen holders are bringing increasing numbers of yen for exchange into dollars, the dollar-yen exchange rate may begin to swing the other way. Hence, the question that needs to be answered is, “Are dollar holders’ desire for yen driving changes in the exchange rate or is the driving force yen holders’ desire to have dollars?” This question will be explored in the next section.

Another key aspect of balance of payments transactions is that they likely interact with every part of the domestic economy. Hence, every domestic market, be it for final goods or services, inputs or financial instruments, is impacted to some degree by BOP transactions, and, in turn, the BOP is influenced heavily by these domestic markets. Any strength or weakness in the domestic economy is, in part, shaped by international transactions.

The Trade Deficit

As shown in Figure 2, the U.S. trade deficit steadily grew during the latter part of the 1990s and during 2000. During the first half of 2001 the trade deficit began to shrink, but resumed growing again in the second half of the year. In 2002 the deficit grew to more than 4 percent of gross domestic product. This section of the report will consider the possible causes of the persistent and growing trade deficit, explore its characteristics and possible consequences, and its likely sustainability.

Possible Causes of the Trade Deficit

The U.S. Trade Deficit Review Commission identified several potential causes of the U.S. “large and growing” trade deficit. They are:

1. “...(T)he more rapid expansion of the U.S. economy compared to the economies of our trading partners...” (According to the Commission report this is the most widely held reason for the trade deficit.)
2. “...(T)he American economy’s strength has encouraged foreigners to invest in and lend to Americans and that has led to a real appreciation of the U.S. dollar, which has lowered import prices and raised prices abroad of our exports.”
3. “...(T)he belief that foreign trade barriers that hinder U.S. exports can contribute to trade deficits (specialists in international economics tend to discount this last point).”

4. “...(T)he huge imbalance between domestic savings and domestic investment as the fundamental cause of the major inflows of foreign funds that, as they are respent, are the basic source of the excess of imports over exports.”¹²

These causes reflect the fact that balance of payments transactions touch every aspect of the domestic economy. The first two relate to the strength of the U.S. economy relative to other economies. The second and fourth are related in that foreign investors are filling the gap between domestic savings and domestic investment. The third plays a role in shaping U.S. trade policy, and is indirectly a factor determining where firms locate their operations.

Characteristics and Consequences of the Trade Deficit

The growing trade deficit/financial surplus led the U.S. Trade Deficit Review Commission to conclude:

In our strongly held view, trade deficits are a part of the recent ‘virtuous circle’ of the U.S. economy, contributing to low interest rates (with the net inflow of funds from foreign investors increasing the overall supply of investment funds) and to low inflation (with imported products meeting domestic demand for goods and services that exceeds domestic production). The huge trade deficits have helped to make possible a period of high employment and rapid economic growth. By enabling U.S. investment to exceed U.S. saving and U.S. consumption to exceed U.S. production, trade deficits have contributed to higher American living standards.

Others see trade deficits as a measure of the problems that international trade causes our society, particularly the jobs and business lost to import competition. Most egregiously in this view, persistent trade deficits between the United States and several other nations represent the impact of unfair foreign trade barriers. U.S. businesses are seen as unable to sell their products in those nations because of their restrictions on U.S. imports while, at the same time, businesses from those nations have easy access to our markets. But, the positive feedback effects of some of our imports on jobs in U.S. export industries should not be forgotten. The competitiveness of U.S. producers is enhanced by their ability to source globally the lowest cost and highest quality parts and components.¹³

These paragraphs of the commission report capture the multifaceted nature of the trade deficit/financial surplus.

The double-entry bookkeeping nature of the balance of payments captures the fact that parties to all transactions enter them for a reason. The end result is that balance of payments outflows are offset by inflows of like amount. However, the trade deficit represents an imbalance with more dollars flowing out to purchase

¹² See page vi of the Commission Report.

¹³ This was in the “Searching for Common Ground and Areas of Basic Agreement” section of the U.S. Trade Deficit Review Commission report (page iv). The Republican members submitted this portion of the report, but the Democratic members assisted in its preparation and acknowledged that it represented common ground.

imports than flow in to pay for exports. To maintain overall balance a trade deficit necessitates a surplus in the remainder of the BOP, but because the U.S. trade deficit is not offset by the remainder of the current account it is necessary that the financial/capital accounts run a surplus to provide the offset. Table 1 illustrates this for the year 2001 and the first three quarters of 2002.

Table 1. The Balance Between the Current Account and Capital/Financial Accounts

Date	Current Account Balance (millions of dollars)	Capital, Financial and Statistical Discrepancy Account Balances (millions of dollars)
2001	-\$393,371	\$826 + \$381,844 + \$10,701 = \$393,371
2002:Q1	-\$112,454	\$208 + \$87,578 + \$24,668 = \$112,454
2002:Q2	-\$127,611	\$200 + \$73,228 + \$54,183 = \$127,611
2002:Q3	-\$127,041	\$223 + \$172,430 - \$45,612 = \$127,041

Source: Bureau of Economic Analysis. (See the appendix.)

Because trade in goods and services dominate the current account and financial account transactions dominate the asset side of the BOP, many analysts view a trade deficit as being accompanied by a financial account surplus. The data support this view.¹⁴

Some believe the trade deficit is an opportunity for domestic residents to have a wider variety of goods and services available without having to give up the same value of goods and services via exports as are received via imports. In this context, the growing trade deficit enriches consumers.

At the same time, many view the trade deficit as a sign of weakness for our economy that is due, in part, to the unfair trade practices of our trading partners. Proponents of this view point to the growing anxiety many workers have experienced even during recent prosperous times as an argument counterbalancing the consumer gain discussed in the proceeding paragraph.¹⁵

Additionally, some view the growing financial account surplus as the United States becoming more indebted to foreign investors. Technically, a growing financial account surplus simply means that foreigners hold a growing value of U.S. assets. These assets include the nation's loan portfolio (public and private) as well as other

¹⁴ Because of the double-entry nature of the BOP a current account deficit must be offset by a surplus in the capital/financial accounts (i.e., an identity is formed), but with subsets of the current account and the capital/financial accounts (in this case the balance of trade and the financial account) the necessity of an identity is broken.

¹⁵ See *Globalization and the Perceptions of American Workers* by Kenneth F. Scheve and Matthew J. Slaughter (Institute for International Economics, March 2001) for a discussion of the growing worker anxiety.

assets of every type (e.g., equities, real estate, and productive capacity). The use of the term “more indebted” or the United States increasingly becoming a “debtor” nation in this context refers to foreign residents owning a growing number of domestic assets, and reflects a growing loss of domestic control of the country’s productive base.

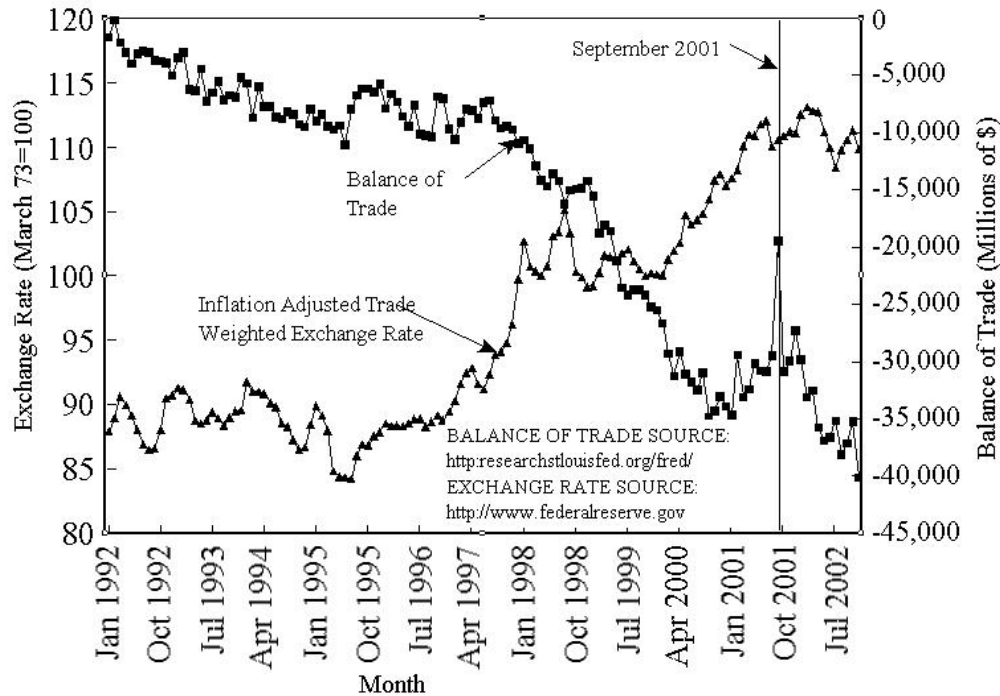
However, others view attracting foreign private investment into the United States as a vote of confidence for our economy and a sign of strength, and foreign direct investments are viewed as an even stronger statement of confidence because of their more permanent nature. Hence, as stated above, strong investor interest in U.S. opportunities may be viewed as a signal of the relative strength of the U.S. economy vis á vis other economies. This raises the question, is the trade deficit driving the financial account surplus or is the financial account surplus driving the trade deficit? The exchange value of the dollar holds some clues in making this determination.

If the growing U.S. trade deficit were the driving force, the increasing outflow of dollars required to pay for the imports not offset by exports should have put downward pressure on the dollar’s exchange value relative to the currencies of U.S. trading partners. That is, to entice a third party to accept the dollars offered to pay for the imports not offset by exports a more favorable exchange rate was likely needed. If this were the case, the dollar should have weakened against the currencies of our trading partners during the period of our growing trade deficit. If, on the other hand, foreign investors’ desire to invest in the United States was the driving force, the dollar should have strengthened. Figure 3 shows the balance of trade and the inflation adjusted trade-weighted exchange value of the dollar.¹⁶ In 1995, the dollar began to strengthen relative to U.S. trading partners currencies. During this same period the trade deficit was growing. This indicates that the financial account surplus was likely having more influence during this period than the trade deficit (i.e., driving the process). It should be noted that in the months following September 2001 the dollar’s strength has not been as robust. This will be investigated below.

¹⁶ “The broad index (used in Figure 3) is a weighted average of the foreign exchange values of the U.S. dollar against the currencies of a large group of major U.S. trading partners. The index weights, which change over time, are derived from U.S. export shares and from U.S. and foreign import shares.” (See the St. Louis Federal Reserve Web Site [<http://www.federalreserve.gov/releases/H10/Summary>])

Sustainability of the Trade Deficit/Financial Surplus

Figure 3. Balance of Trade and Inflation Adjusted Trade Weighted Exchange Rate (Monthly January 1992-November 2002)



Many analysts raise the possibility that the persistent trade deficit/financial surplus is not sustainable over the long run. If investors see the need to begin realigning their portfolios to include fewer U.S. investments, then the trade deficit would have to contract because the funding to pay for the excess imports would not be available. Additionally, if domestic savings did not fill the void, domestic investment would also have to be curtailed. This would impact the growth prospects of the United States. Analysts consider two scenarios for a pull back by investors—soft and hard landings. With a soft landing as investors gradually reduce their interest in the U.S. economy the dollar's exchange value relative to our major trading partners begins to weaken and imports become relatively more expensive on the domestic U.S. market and U.S. exports become more competitive on the world market. The end result is an expected reduced trade deficit and lower foreign investment in the United States.

With a hard landing, the above events are compressed in time. An event such as a sharp decline in the stock market is put forth as a possible spark to a hard landing. As foreign investment recedes and domestic investors seek safer investments outside the United States, interest rates could rise significantly to fund the trade deficit, or if viewed from the investment side, the rising interest rates could facilitate closing the gap between domestic savings and investments. The result could be a recession because the economy would not have adequate time to react to the rapid change. Relatively liquid portfolio investments would lead the stampede

of funds out of the United States in this scenario.¹⁷ The Mexican peso crisis of 1994-95 and the more recent financial crises in Asia, Latin America, and Russia show the extreme situation that can arise when there is a sudden drop in confidence in the prospects of an economy.

The Impact of Recent Events

As Figures 2 and 3 indicate the trade deficit's growth trend was only briefly interrupted after September 2001, but the dollar's strength position is currently more clouded. Figure 4 shows three indexes of the monthly trade-weighted exchange rate of the dollar. The first is a broad index of the dollar's value relative to major U.S. trading partners.¹⁸ This index began and ended the period at almost the same value, but after a strengthening of the dollar during the first half of the period the recent trend has been for the dollar to weaken. It remains to be seen if this weakening trend will continue.

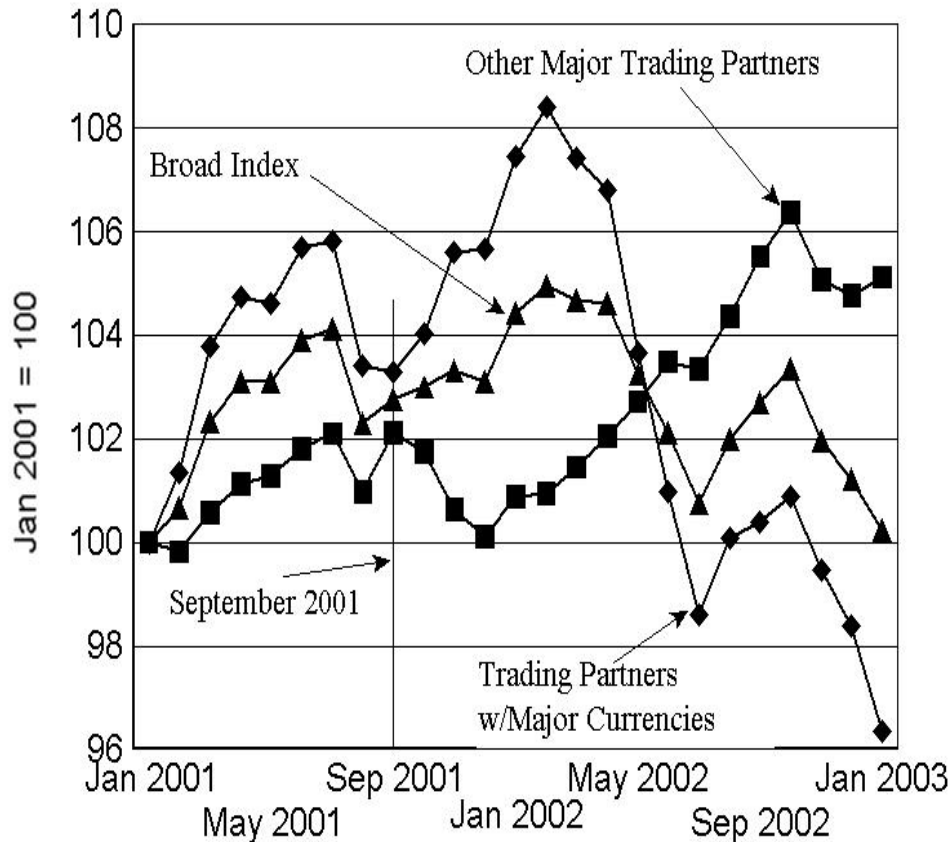
The next index is a subset of the broad index that measures the dollar's value relative to the United States' trading partners having widely traded currencies (e.g., the euro, Swiss franc, etc.). With this index the dollar peaked in value in February 2002, but it has fallen by more than 11 percent since that time and is almost 4 percent lower than the rate at the beginning of 2001. This weakening of the dollar encourages increased U.S. exports and dampens imports in the United States. Many analysts have claimed that the dollar has been overvalued for several years and this gradual downward trend is bringing the dollar back into line with the other major currencies. Other analysts point to the soft economies and geopolitical tensions as possible further causes.

The final index measures the dollar relative to major trading partners who do not have widely trading currencies. These include countries in Latin America, Asia, the Middle East, and Eastern Europe. While the dollar lost ground against these currencies in the months after September 2001, it has generally strengthened since the beginning of 2002 and ended the period up by just over 5 percent. A weakened investment climate in these countries relative to the United States may explain why these currencies have not increased in value relative to the dollar. Nonetheless, the strengthening trend encourages U.S. residents to increase imports from countries comprising this index and discourages U.S. export increases.

¹⁷ The most liquid funds are sometimes referred to as "hot" money. In its broadest usage, hot money is available for any speculative international transaction. Large hot money flows may destabilize a currency.

¹⁸ According to the Federal Reserve the broad index includes countries or regions "that had a share of U.S. non-oil imports or nonagricultural exports of at least ½ percent." (See "New Summary Measures of the Foreign Exchange Value of the Dollar." *Federal Reserve Bulletin*. October 1998. P 813.)

Figure 4. Monthly Inflation-Adjusted, Trade-Weighted Dollar Exchange Rate Indexes (January 2001-January 2003).



SOURCE: Federal Reserve Bank

Conclusion

As the record of all transactions between domestic and foreign residents, items in the balance of payments influence all segments of the U.S. economy. This breadth of activity ensures that the global economy influences all domestic economic outcomes. As a result, the international economy contributes to all the strengths and weaknesses observed in the domestic economy. Analysts who emphasize the BOP's contribution to the strengths point to items such as lower consumer prices and the advancements that result from heightened international competition. Analysts who emphasize the BOP's contribution to weaknesses point to items such as the widening income gap between low and high income earners and adverse employment impacts.

In large measure, the controversy international economic transactions create is centered around the U.S. trade deficit. During the period from the early 1990s until the third quarter of 2002 the trade deficit grew to more than 4% of U.S. domestic economic activity. Analysts are concerned that a trade deficit of this magnitude is not sustainable. With a trade deficit, the imports of goods and services not funded by exports is, in large measure, funded primarily by non-U.S. residents investing in

the United States. If the U.S. investment climate weakens relative to the rest of the world, the readily available funding to run a trade deficit could shrink dramatically. This adjustment is termed a soft landing if the change is gradual enough to allow markets to adjust. Many analysts believe the U.S. economy can weather a soft landing without significant adverse consequences. An abrupt adjustment is termed a hard landing. With a hard landing, the U.S. economy could experience significant recessionary pressures. Most analysts believe a soft landing is more likely than a hard landing, but the possibility of a hard landing cannot be eliminated.

The events since September 11 have created the type of pressures many analysts believe could trigger a hard landing. Fortunately, thus far the evidence does not suggest that the U.S. is experiencing a hard landing. Typically, with a hard landing the domestic currency's value falls significantly and quickly relative to the currencies of its trading partners. This occurs because the hard landing is being fueled by investors liquidating their investments and moving their funds to safer investment destinations. The outflow of funds puts downward pressure on the currency's value. In recent months the dollar has lost value relative to major economic powers with widely-traded currencies, but it appears this decline has been gradual enough not to cause severe problems. At the same time the dollar has weakened relative to major currencies, it has strengthened relative to less widely traded currencies. The end result is a clouded picture as to the impact the dollar's value is having on the economy and vice versa. Nonetheless, even in the face of the dollar weakening against some currencies the resiliency of the U.S. economy appears to be strong enough to withstand significant stress without eroding investor confidence enough to trigger a mass outflow of funds.

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Appendix

Table I.--U.S. International Transactions
[Millions of dollars, quarters seasonally adjusted]

(Credits +, debits -)	2001	2001				2002		
		I	II	III	IV	I	IIr	IIIp
Current account								
1 Exports of goods and services and income receipts	1,281,793	349,040	331,612	309,477	291,667	291,348	305,262	312,881
2 Exports of goods and services	998,022	266,004	256,766	242,325	232,930	233,252	244,540	249,409
3 Goods, balance of payments basis	718,762	193,284	184,846	173,274	167,358	164,649	172,426	175,727
4 Services	279,260	72,720	71,920	69,051	65,572	68,603	72,114	73,682
5 Transfers under US military agency sales contracts	12,220	2,806	3,227	3,079	3,108	2,990	3,087	2,922
6 Travel	73,119	20,735	19,803	17,845	14,736	17,038	17,200	17,586
7 Passenger fares	18,007	5,007	4,849	4,522	3,629	4,171	4,172	4,503
8 Other transportation	28,306	7,495	7,170	6,968	6,674	6,805	6,986	7,159
9 Royalties and license fees	38,668	9,717	9,743	9,537	9,672	9,931	11,085	11,020
10 Other private services	108,109	26,738	26,927	26,886	27,559	27,473	29,385	30,292
11 US Government miscellaneous services	831	222	201	214	194	195	199	200
12 Income receipts	283,771	83,036	74,846	67,152	58,737	58,096	60,722	63,472
13 Income receipts on US-owned assets abroad	281,389	82,444	74,253	66,555	58,137	57,485	60,108	62,854
14 Direct investment receipts	125,996	35,270	33,078	30,211	27,436	28,679	30,958	33,763
15 Other private receipts	151,832	46,281	40,398	35,494	29,659	27,994	28,486	28,231
16 US Government receipts	3,561	893	777	850	1,042	812	664	860
17 Compensation of employees	2,382	592	593	597	600	611	614	618
18 Imports of goods and services and income payments	-1,625,701	-445,154	-418,930	-388,448	-373,174	-387,786	-419,862	-426,701

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19	Imports of goods and services	-1,356,312	-363,164	-350,090	-322,103	-320,958	-328,744	-353,853	-360,270
20	Goods, balance of payments basis	-1,145,927	-306,316	-292,565	-279,025	-268,021	-271,073	-294,893	-298,903
21	Services	-210,385	-56,848	-57,525	-43,078	-52,937	-57,671	-58,960	-61,367
22	Direct defense expenditures	-15,198	-3,548	-3,512	-3,785	-4,353	-4,488	-4,766	-5,005
23	Travel	-60,117	-16,003	-16,698	-14,468	-12,948	-14,587	-14,454	-14,995
24	Passenger fares	-22,418	-5,810	-6,213	-5,944	-4,451	-5,113	-5,028	-5,352
25	Other transportation	-38,823	-10,521	-10,130	-9,178	-8,997	-8,858	-9,739	-9,709
26	Royalties and license fees	-16,359	-4,097	-4,038	-4,113	-4,110	-4,764	-4,951	-5,264
27	Other private services	-54,588	-16,146	-16,208	-4,864	-17,371	-19,120	-19,297	-20,317
28	US Government miscellaneous services	-2,882	-723	-726	-726	-707	-741	-725	-725
29	Income payments	-269,389	-81,990	-68,840	-66,345	-52,216	-59,042	-66,009	-66,431
30	Income payments on foreign-owned assets in the U. S.	-260,850	-79,881	-66,727	-64,210	-50,035	-56,803	-63,737	-64,229
31	Direct investment payments	-23,401	-13,021	-5,246	-6,303	1,166	-6,610	-12,163	-14,942
32	Other private payments	-156,784	-45,512	-40,886	-38,156	-32,230	-31,679	-32,943	-31,114
33	US Government payments	-80,665	-21,348	-20,595	-19,751	-18,971	-18,514	-18,631	-18,173
34	Compensation of employees	-8,539	-2,109	-2,113	-2,135	-2,181	-2,239	-2,272	-2,202
35	Unilateral current transfers, net	-49,463	-11,608	-11,916	-12,360	-13,579	-16,016	-13,011	-13,221
36	US Government grants	-11,628	-2,419	-2,522	-2,905	-3,782	-6,273	-3,312	-3,147
37	US Government pensions and other transfers	-5,798	-1,316	-1,291	-1,305	-1,886	-1,348	-1,356	-1,368
38	Private remittances and other transfers	-32,037	-7,873	-8,103	-8,150	-7,911	-8,395	-8,343	-8,706

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Table 1--US International Transactions (Continued)
 [Millions of dollars, quarters seasonally adjusted]

(Credits +, debits -)	2001	2001				2002		
		I	II	III	IV	I	IIr	IIIp
Capital and financial account								
Capital account								
39 Capital account transactions, net	826	208	207	206	205	208	200	223
Financial account								
40 US-owned assets abroad, net (increase/financial outflow (-))	-370,962	-215,815	-80,036	24,978	-100,088	-25,918	-131,079	23,920
41 US official reserve assets, net	-4,911	190	-1,343	-3,559	-199	390	-1,843	-1,416
42 Gold								
43 Special drawing rights	-630	-189	-156	-145	-140	-109	-107	-132
44 Reserve position in the International Monetary Fund	-3,600	574	-1,015	-3,242	83	652	-1,607	-1,136
45 Foreign currencies	-681	-195	-172	-172	-142	-153	-129	-148
46 US Government assets, other than official reserve assets, net	-486	77	-783	77	143	133	42	172
47 US credits and other long-term assets	-4,431	-1,094	-1,330	-1,011	-996	-853	-565	-897
48 Repayments on US credits and other long-term assets	3,873	1,071	573	1,118	1,111	994	566	1,190
49 US foreign currency holdings and US short-term assets, net	72	100	-26	-30	28	-8	41	-121
50 US private assets, net	-365,565	-216,082	-77,910	28,460	-100,032	-26,441	-129,278	25,164
51 Direct investment	-127,840	-23,514	-35,131	-41,724	-27,470	-29,280	-34,255	-27,463
52 Foreign securities	-94,662	-26,895	-51,764	10,087	-26,090	2,047	-9,675	18,295
53 US claims on unaffiliated foreigners reported by US nonbanking concerns	-14,358	-51,759	9,670	-9,479	37,210	65	-16,693	-12,087
54 US claims reported by US banks, not included elsewhere	-128,705	-113,914	-685	69,576	-83,682	727	-68,655	46,419
55 Foreign-owned assets in the U. S., net (increase/financial inflow (+))	752,806	302,510	181,610	17,889	250,797	113,496	204,307	148,510

http://www.fedres.org/wiki/CRS/RL31220

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56	Foreign official assets in the United States, net	5,224	4,087	-20,831	16,882	5,086	7,641	47,252	9,319
57	US Government securities	31,665	2,547	-10,866	15,594	24,390	6,714	21,741	12,309
58	US Treasury securities	10,745	-1,027	-20,798	15,810	16,760	-582	15,193	1,424
59	Other	20,920	3,574	9,932	-216	7,630	7,296	6,548	10,885
60	Other US Government liabilities	-1,882	-676	-791	89	-504	-790	54	999
61	US liabilities reported by US banks, not included elsewhere	-30,278	1,213	-10,202	-782	-20,507	991	24,531	-4,824
62	Other foreign official assets	5,719	1,003	1,028	1,981	1,707	726	926	835
63	Other foreign assets in the United States, net	747,582	298,423	202,441	1,007	245,711	105,855	157,055	139,191
64	Direct investment	130,796	43,589	51,102	14,208	21,897	16,223	-2,704	11,037
65	US Treasury securities	-7,670	-4,744	-14,685	-15,470	27,229	-7,282	-5,124	54,691
66	US securities other than US Treasury securities	407,653	129,990	113,556	64,787	99,320	71,095	104,404	46,647
67	US currency	23,783	2,311	2,772	8,203	10,497	4,525	7,183	2,556
68	US liabilities to unaffiliated foreigners reported by US nonbanking concerns	82,353	111,644	-5,307	-25,154	1,170	32,345	21,056	15,961
69	US liabilities reported by US banks, not included elsewhere	110,667	15,633	55,003	-45,567	85,598	-11,051	32,240	8,299
70	Statistical discrepancy (sum of above items with sign reversed)	10,701	20,819	-2,547	48,258	-55,828	24,668	54,183	-45,612
Memoranda:									
71	Balance on goods (lines 3 and 20)	-427,165	-113,032	-107,719	-105,751	-100,663	-106,424	-122,467	-123,176
72	Balance on services (lines 4 and 21)	68,875	15,872	14,395	25,973	12,635	10,932	13,154	12,315
73	Balance on goods and services (lines 2 and 19)	-358,290	-97,160	-93,324	-79,778	-88,028	-95,492	-109,313	-110,861
74	Balance on income (lines 12 and 29)	14,382	1,046	6,006	807	6,521	-946	-5,287	-2,959
75	Unilateral current transfers, net (line 35)	-49,463	-11,608	-11,916	-12,360	-13,579	-16,016	-13,011	-13,221
76	Balance on current account (lines 1, 18, and 35 or lines 73, 74, and 75)	-393,371	-107,722	-99,234	-91,331	-95,086	-112,454	-127,611	-127,041
	r Revised p Preliminary								
NOTE:--Details may not add to totals because of rounding Source: U S Bureau of Economic Analysis									