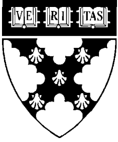

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Balance of Payments

Accounting and Presentation

Introduction

Few countries in the world run their economies in autarky. Most nations export and import goods and services, borrow and lend capital, and engage in government-to-government transactions. To record this activity, countries compile a balance of payments statement. When countries are heavily engaged in international commerce, an informed reading of a nation's balance of payments can be critical for evaluating a nation's ability to realize its objectives and for forecasting political, social and economic developments.

The balance of payments statement of a country is simply a listing of the transactions taking place between the domestic economy and the rest of the world. The construction of a balance of payments statement is governed by a double entry system, similar to corporate accounting with its own rules, conventions and chart of accounts. Balance of payments statements are presented in a variety of formats which reflect the differing patterns of individual countries' international economic relationships and emphasize the aspects which are of particular interest to the user of the statement. This introductory note will briefly describe the accounting system behind a balance of payments statement and the most widely used format for presenting balance of payments data.

Balance of Payments Accounting

A balance of payments can be broadly described as the record of an economy's international economic transactions, that is, of the goods and services that an economy has received from and provided to the rest of the world and of the changes in the economy's claims on and liabilities to the rest of the world.[1]

For balance of payments purposes a nation's economy consists of its government, the enterprises which operate within its territory and its individual residents. The government includes not only the departments located in its territory but also those located abroad, such as embassies and

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[1] IMF, *Balance of Payments Manual,* 4th edition, Washington, D.C., 1976.

This note was prepared by Jane Kenney Austin, Research Associate, under the supervision of Assistant Professor David B. Yoffie, as a basis for class discussion.

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military establishments. Embassy personnel, armed forces and dependents are considered residents of their home country. Regardless of the legal status of a company's foreign branches and subsidiaries, they are considered part of the economy of the country in which they operate.

Most international transactions consist of an *exchange* of goods, services or financial items which are reflected in pairs of equal credit and debit entries. Credit entries are positive and made for the export of goods, services or financial items, while debit entries are negative and made for the import of goods, services, or financial items. The balance of payments statement can be thought of as analogous to a source and use statement for a firm, with funds in this case defined as external purchasing power or foreign exchange. Credits are considered sources of funds and debits are considered uses of funds. The balance of payments statement is not analogous to either the income statement or balance sheet of a firm. Unlike the income statement, the balance of payments does not provide any information regarding the profitability of the underlying transactions. Unlike a balance sheet which shows stocks of assets and liabilities at a specific point in time, the balance of payments measures flows of goods, services and capital occurring over a period of time.

The standard accounts which make up a balance of payments statement fall into two major groups: the current account which includes goods, services and transfers, and the capital account which consists of financial items and reserves. The major components of the two groups are listed below in *Table 1.*

Application of the debit and credit rules and the analogy to the sources and uses statement is fairly straightforward when dealing with the goods and services accounts. An export of merchandise or the provision of services (such as transportation) to foreigners is a source of foreign exchange and a credit (+) entry. An import of goods or the use of foreign services (such as hotel accommodations) is a use of foreign exchange and treated as a debit (–).

The investment income account is somewhat different from the other goods and services accounts. Although financial in nature, income from foreign investments is treated as payment for the services of capital. This income includes dividends, interest, and earnings of foreign subsidiaries. Those received from foreigners are a source of foreign exchange and treated as credits (+). Those paid to foreigners represent a use of foreign exchange and are treated as debits (–). Reinvested earnings in foreign subsidiaries are credited to the investment income account and a matching debit made to the capital accounts under direct investment.

While most transactions involve an exchange and automatically give rise to both a credit and a debit entry, some goods, services and financial resources, such as gifts from individuals or grants from governments, are exported or imported without a quid pro quo. In such cases, offsetting debits or credits are made to one of the transfer accounts insuring that debits and credits are equal for the statement as a whole.

Table 1 Standard Components of a Balance of Payments Statement

I. Current Account	II. Capital Account
A. *Goods, Services & Income*	A. *Capital, excluding reserves*
Merchandise	Direct investment
Shipment	Portfolio investment
Other transportation	Other long-term capital
Travel	Short-term capital
Investment income	
Other	B. *Reserves*
	Monetary gold
B. *Transfers*	Special Drawing Rights (SDR)
Private	Reserve position in IMF
Official	Foreign exchange assets
	Other, including use of IMF credit

The capital accounts tend to be confusing from both an accounting and a conceptual standpoint. The accounting difficulties arise because the financial transactions are divided along several dimensions. Distinctions are made between assets and liabilities; the term of the securities based on original contractual maturity; and the type of capital (direct investment, portfolio investment, and other capital). Short-term capital consists of currency and financial obligations with original maturity of less than one year. Portfolio investment and direct investments are long term by definition but direct investments include only those equities and debt instruments which give the holder significant managerial control over the foreign firm. Some detailed statements provide additional information specifying whether the domestic debtor or creditor is a government body or banking (monetary) institution and identifying those liabilities which appear as reserves on the balance of payments statements of other countries. The components of the capital accounts are usually presented on a net basis, which may result in either a debit or a credit entry.

The conceptual problem arises because discussions about the capital accounts are conducted in terms of the underlying flows of *capital,* which may be opposite in direction to the movement of the financial *item* involved. For example, when a resident purchases a bond from a foreigner, he imports a financial item, giving rise to a debit (–) entry in the balance of payments accounts; however, his action is likely to be called an export of capital.

The assets which make up a country's foreign reserves are singled out within the capital account because these assets are available to the government to finance payments imbalances directly or to intervene in the foreign exchange markets. The accounting conventions are the same for reserve assets as for other financial items, but the results tend to be counterintuitive. The import of foreign exchange or gold by the government gives rise to a debit (–) just like any other import of a good, service, or financial item. In fact, the decision to import foreign exchange or gold can be considered a use of foreign purchasing power if only in the sense that the government could have acquired alternative assets.

Reserves are held in a variety of forms including gold, foreign currencies, interest-bearing deposits and foreign government securities. A significant subset of the reserve assets are related to the IMF and the workings of the international monetary system. SDRs are money created by the IMF whose value is based on a weighted basket of currencies and are used only in transactions among governments or between governments and the IMF. A country's reserve position in the Fund, which is based on its contributions to the IMF, and Fund Credit are available under various conditions to countries facing balance of payments difficulties.

The series of examples which follow illustrate how to interpret various transactions in U.S. balance of payments accounts in 1950.[1] In these examples we look at the international money flows generated to finance these transactions. When thinking about these examples, it may be helpful to keep the following identities in mind.

Export = credit = source = (+)
Import = debit = use = (–)

<u>1950</u>

Example 1 Merchandise, fob exports: $10,117m (line lb)[2]

The United States exports $10.117 billion in goods. F.o.b. stands for "free on board," and means that costs of insurance and freight (c.i.f.) are excluded.

[1] The terminology used in these examples are derived from OECD statements, which can be found in the Kennedy and The Balance of Payments case, no. 4-383-073, Rev. 6/83, *Exhibit 3.*

[2] Kennedy and The Balance of Payments case, no. 4-383-073, Rev. 6/83, *Exhibit 3.*

Example 2	Foreign travel, debit: American citizens spent $754 million in tourism and travel expenses.	$754m (line 3a)
Example 3	Unilateral transfers, official credit: The U.S. government received $153m in gifts from foreign sources.	$153m (line 8b)
Example 4	Nonmonetary sector, private direct investment, assets: Private U.S. firms invested a net of $1.096 billion in overseas companies. These investments were long term and entailed substantial control of the overseas company.	$-1,096m (line 9b)
Example 5	Monetary sector, central institutions, other short-term liabilities: Monetary sector means that a bank is involved; central institutions refer to the U.S. Treasury and the Federal Reserve; and short-term liabilities are usually T-bills. In other words, this line means that foreign holders of U.S. dollars purchased a net of $1.5 billion in U.S. Treasury Bills in 1950.	$1,500m (line 15c)

In theory, every transaction in the balance of payments statement should be recorded separately, and, like all double-entry bookkeeping systems, there should always be a debit entry for every credit entry. In practice, however, this is impossible. Each side of a transaction is often obtained from different data sources, such as customs declarations and bank records, and in some cases entries have to be estimated. Furthermore, debits and the credits do not always balance. For this reason an errors and omissions account is included to balance the statement. Errors and omissions, which can fluctuate widely from year to year, are believed to contain significant unrecorded short-term capital movements. The errors and omissions account and the variety of methods used to collect balance of payments data point to a need for caution in interpreting the data. A number of other issues also complicate the compilation of balance of payments data including the recording of transactions at market value, timing differences and the selection of a stable unit of account. Hence, accuracy and consistency in collecting data cannot always be assumed for a given country, and care must be taken when comparing the statements of two countries.

Presentation of Balance of Payments Data

The reader may well ask at this point how these mechanical records of international transactions are transformed into weighty "balance" of payments statements full of deficits that worry presidents and finance ministers, and surpluses that aggravate trading partners. The "balances" rise from different analytical presentations of the data in which component accounts are grouped together and subtotals or partial balances struck.

Total debits and credits on a balance of payments statement are equal as a result of the double entry system (with the aid of the errors and omissions account) and automatically net to zero. While true for the statement as a whole, debits and credits are not necessarily equal within individual accounts or for groups of accounts. A country's merchandise imports (debits) do not necessarily equal its merchandise exports (credits) during a given period, nor do its total imports of goods and services necessarily equal total exports. The net sum of the debits and credits of any particular account or group of accounts is called a *balance* and it may be a net credit or a net debit balance. A net credit balance is called a *surplus.* A net debit balance is called a *deficit.*

A surplus in any particular balance is not necessarily good for a country, nor a deficit necessarily bad, despite the connotation. Judgments about the appropriate sign or level for any

balance depend upon many factors, including the country's level of development and its national goals and strategy. For example, a developing country which must import capital goods to build an infrastructure is likely to show a net deficit in its merchandise accounts as well as rely heavily upon foreign sources for capital to finance its development. On the other hand, a developed country may depend on a large and positive balance in its merchandise accounts to sustain the desired levels of foreign investment and aid. The balances used most frequently to evaluate a nation's balance of payments position can be obtained by a simple rearranging of the accounts presented earlier. Each of the balances highlights different aspects of a country's performance, policies and international competitiveness. The groupings and their overlapping relationships can be seen in *Table 2.*

Table 2 Standard Payments Balances: A Hypothetical Example

Merchandise	
Exports	+ 6,000
Imports	– 4,500
Balance of Trade	+ 1,500
Services	+ 100
Balance on Goods & Services	+ 1,600
Transfers	– 150
Current Account Balance	+ 1,450
Long-term Capital	– 2,300
Basic Balance	– 850
Short-term Capital	+ 200
Errors & Omissions	– 300
Overall Balance	– 950
Official Settlements Balance	+ 950
Reserves	+ 950

The balances range from the narrow balance of trade to the comprehensive overall balance. The *trade* balance focuses on exports and imports of goods, which tend to be the largest components in the balance of payments statement, and provides a measure of the country's international competitiveness. Examining the makeup of exports and imports, noting for example whether imports consist of consumer goods or capital goods, reveals information about a country's economic strategy and the key determinants of its trade performance. A country heavily reliant upon the export of a single raw material may be vulnerable to changes in world demand and commodity prices, while the fortunes of a country competing in world markets for manufactured goods may rest on domestic wage levels, productivity, and the value of its currency.

The *balance on goods and services* is the point at which the balance of payments ties in with the national income accounts. The balance on goods and services is roughly equivalent to the export minus imports term of the GNP equation: $GNP = C + I + G + (X - M)$. The balance on goods and services measures the extent to which a country is supplying resources to the rest of the world or drawing in resources to satisfy its consumption and investment needs.

The *current account balance* is obtained by adding transfers to the balance on goods and services. The current account balance excludes all capital items and is made up of largely stable components. Therefore, it is often used when measuring the effects of economic policies or setting economic goals.

The *basic balance* is designed to give a clearer picture of long-term trends in a country's competitive position. It incorporates long-term capital flows which usually respond to higher anticipated returns over the long run. Since short-term capital is highly sensitive to relative interest rates, this measure attempts to reduce distortions caused by volatile or speculative capital movements.

The *overall balance* is the one most frequently referred to as "the" balance of payments. The overall balance includes goods, services, transfers, errors and omissions and the capital accounts except for reserves.[3] In fact, the same total can be obtained simply by totaling the official reserve accounts (obtaining what is called the Official Settlements Balance) and changing the sign. Because information about reserve changes is more precise and readily available, the balance is often calculated this way. The overall balance measures the imbalance between sources and uses of foreign exchange which is financed through the loss or accumulation of reserves. Because the overall balance focuses on the use of reserves, it tends to be more relevant under a fixed exchange rate system in which reserve changes play a critical role. Under a system of freely floating exchange rates, a nation's foreign exchange rate (the value of its currency in terms of foreign purchasing power) theoretically changes to bring sources and uses into balance and in theory there is no need for reserves. In practice, however, floating rate regimes are rarely pure. Some monetary authorities use reserves to intervene in foreign exchange markets as a way to alter the relative value of their currencies. Moreover, a developing country may not allow its currency to float in a floating rate system, but will instead tie its currency to that of a major trading partner. As a consequence, most developing countries are in need of reserves in both fixed and floating rate regimes.

Reflecting the fact that no particular balance, positive or negative, tells the whole story of a country's balance of payments situation, the trend has been to deemphasize the standard balances. The intent is to force the user to examine the individual accounts, to identify the factors affecting each account, and to look at the patterns as well as the levels of international flows of real resources and capital. With practice and with attention to a country's context, goals, and domestic economic performance, a careful reading of the balance of payments is an important element of country analysis.

[3] The overall balance is not always calculated on a consistent basis. In some cases, particular foreign assets may be included in reserves, while in other cases, these assets are placed in the capital account. The OECD, for example, includes short-term foreign assets and liabilities of the private monetary sector in its definition of reserves, and excludes them from the overall balance.

A Balance of Payments Glossary

Current Account The net effect of exports, imports, services and transfers. It shows the extent to which a country is sending its real resources to the rest of the world, or is drawing on real resources abroad, to supply its own current consumption and investment demands.

Transfers Goods, services or financial items provided without any quid pro quo are transferred. Because a transfer is a one-sided transaction and does not automatically give rise to a pair of debit and credit entries, offsetting entries are created and made to the transfer accounts.

Capital Account Capital movements are conventionally divided into long-term and short-term transactions. Long-term flows are transactions in claims with an original maturity of more than 12 months; other financial transactions are considered short term.

Direct Investment A type of long-term investment where the investor controls a substantial portion of the management of the foreign operation. (Substantial management control is often defined as 10% or more of the ownership of a company.)

Portfolio Investments Long-term investments in which the investor does not hold substantial management control, as defined above. (Portfolio investments include both bonds and stocks.)

Short-Term Capital There are two major types of short-term capital flows:

1. Those made in connection with other entries in the balance of payments, such as a bank deposit received in payment for merchandise exported, and
2. Those made in search of the maximum rate of return. This latter type of short-term capital flow may be reversed several times during any given year.

Allocation of SDRs SDRs (Special Drawing Rights) are a form of currency issued by the International Monetary Fund, used only by governments in place of gold as a monetary reserve. The periodic allocation of SDRs by the International Monetary Fund is treated as an inflow of capital.

Reserves Reserves consist of gold, foreign exchange, SDRs and a country's reserve position in the IMF. Reserves are available to a government to finance payments imbalances directly and to intervene in foreign exchange markets to alter the relative value of its currency.

Foreign Exchange Foreign exchange consists of foreign currencies. Currencies held as reserves are limited to "hard" currencies or those which the market accepts as having high liquidity and readily established market value.