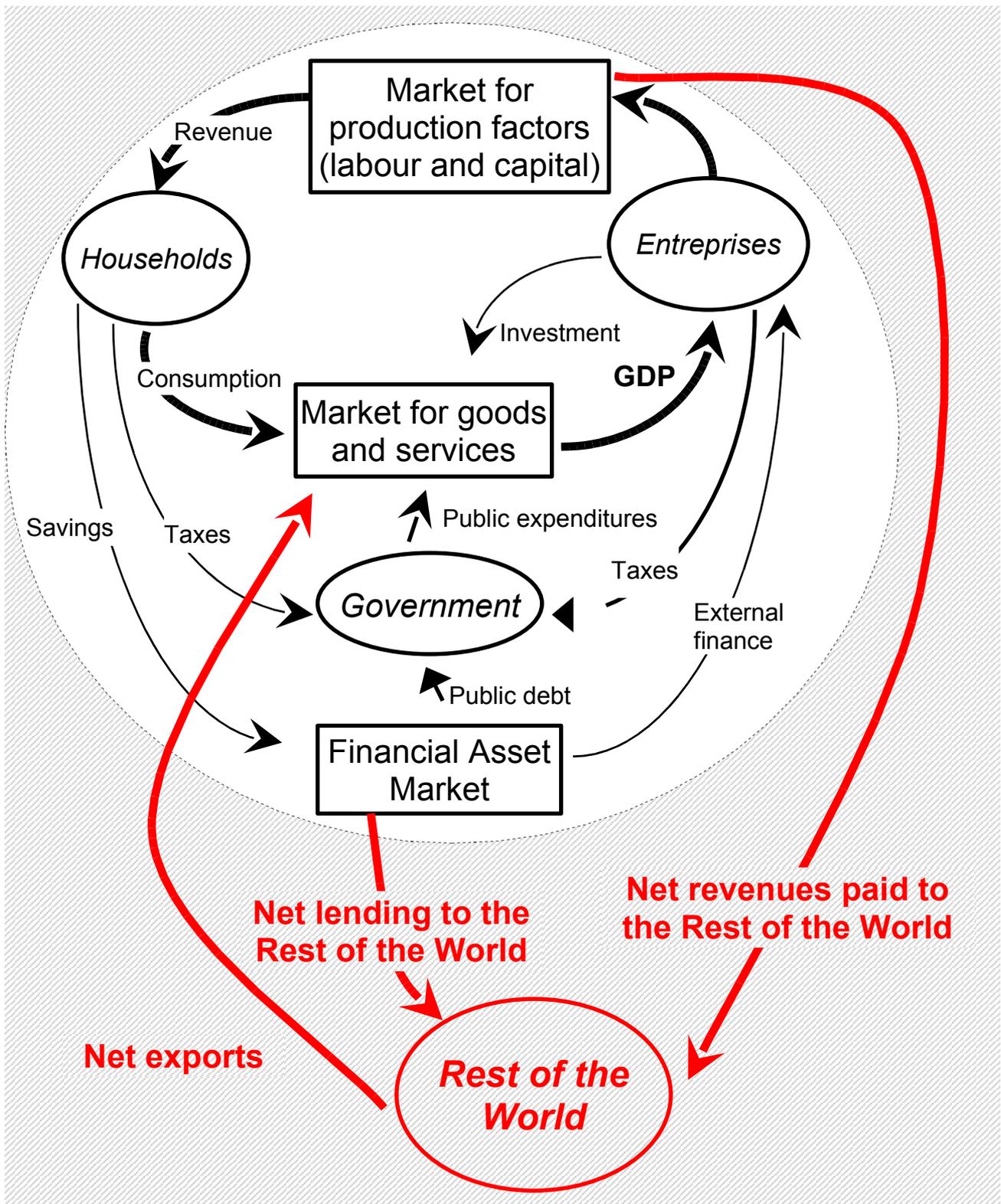


1- The balance of payments as an account of the relationship with the rest of the world

1- A diagram of some essential macroeconomic flows in an open economy



## 2- Definitions

### a- balance of payments

The methodological basis of the balance of payments is set out in the Balance of Payments Manual of the IMF (5th edition) published in 1993 (BPM5).

<http://www.imf.org/external/np/sta/bop/bopman.pdf>

BPM5 is currently under revision and a new version of the manual will be released in 2008. Previous editions were issued in 1948, 1950, 1961, and 1977.

*“The **balance of payments** is a statistical statement that systematically summarizes, for a specific time period, the economic transactions of an economy with the rest of the world.”* (BPM5)

#### Keywords:

##### 1- “Transactions”

- (i) Exchanges of goods, services, income, financial claims and liabilities
- (ii) Transfers of consumption goods, services, income or capital goods (“gifts” involving no payment)

*“Despite the connotation, the balance of payments is not concerned with payments, as that term is generally understood, but with transactions.”* (BPM5)

##### 2- “An economy with the rest of the world” → residents and non-residents

3- “For a specific time period” (as for any economic flow: a transaction itself is defined as an economic flow ≠ stock)

4- “Systematically summarizes” → not all-encompassing, but still consistent

The balance of payments is broken down into three broad sub-balances according to the type of operations involved in transactions

(a) the current account;    b) the capital account;    c) the financial account

### b- international investment position

*“Closely related to the flow-oriented balance of payments framework is the stock-oriented **international investment position**. Compiled at a specified date such as year end, this investment position is a statistical statement of*

- (i) *the value and composition of the stock of an economy’s financial assets, or the economy’s claims on the rest of the world, and*
- (ii) *the value and composition of the stock of an economy’s liabilities to the rest of the world.”* (BPM5)

## Balance of Payments

|                                   |
|-----------------------------------|
| <b>CURRENT ACCOUNT</b>            |
| <b>Goods</b>                      |
| Credits                           |
| Debits                            |
| <b>Services</b>                   |
| Credits                           |
| Debits                            |
| <b>Income</b>                     |
| Credits                           |
| Debits                            |
| <b>Current transfers</b>          |
| Credits                           |
| Debits                            |
| <b>Balance on Current Account</b> |

|  |
|--|
| <b>CAPITAL ACCOUNT</b>                                       |
| Capital transfers  |
| Acquisition / disposal of non-produced, non-financial assets |
| <b>Balance on Capital Account</b>                            |

International Income from  
International Investment

|   |   |  |  |                       |   |   |
|---|---|--|--|-----------------------|---|---|
| <b>International Investment Position</b>                      | <b>Position at Beginning of Period</b>  | <b>FINANCIAL ACCOUNT</b>                           | <b>Other Changes in Position Reflecting...</b> |                       |   | <b>Position at End of Period</b>  |
|   | <b>Australian investment Abroad</b>   | <b>Transaction Changes</b>                         | Price Changes                                  | Exchange Rate Changes | Other Adjustments   | <b>Australian investment Abroad</b>   |
|   | Direct investment<br>Portfolio investment<br>Other investment<br>Reserve assets               | <b>Direct Investment</b><br>Abroad<br>In Australia |  |                       |   | Direct investment<br>Portfolio investment<br>Other investment<br>Reserve assets |
| <b>Foreign Investment in Australia</b>                        | <b>Portfolio Investment</b>   |  |  |                       | <b>Foreign Investment in Australia</b>                        |   |
| Direct investment<br>Portfolio investment<br>Other investment | Assets<br>Liabilities   |  |  |                       | Direct investment<br>Portfolio investment<br>Other investment |   |
| <b>Net International Investment Position</b>                  | <b>Other Investment</b>   |  |  |                       | <b>Net International Investment Position</b>                  |   |
|   | Assets<br>Liabilities   |  |  |                       |   |   |
|   | <b>Reserve Assets</b>   |  |  |                       |   |   |
|   | <b>Balance on Financial Account</b>   |  |  |                       |   |   |
|   | <b>Net errors and omissions</b>   |  |  |                       |   |   |
|   | (the sum, with sign reversed, of the balances on the current, capital and financial accounts) |  |  |                       |   |   |

Australian Bureau of Statistics (<http://www.abs.gov.au/>)

### 3- The accounts of the balance of payments

[http://europa.eu.int/estatref/info/sdds/fr/bop/bop\\_base.htm](http://europa.eu.int/estatref/info/sdds/fr/bop/bop_base.htm)

#### a) CURRENT ACCOUNT

The *Current account* is divided into four basic components: goods, services, income and current transfers.

##### a.1 - Goods

BoP item *Goods* covers *general merchandise, non-monetary gold* and, since the implementation of the BPM5, *goods for processing, repairs on goods and goods procured in ports by carriers*.

The most important component, *General merchandise*, includes all movable goods whose ownership is transferred from a resident to a non-resident and vice versa.

When calculating the balance of payments, both exports and imports of *Goods* should be valued free-on-board (f.o.b.). When a cost-insurance-freight (c.i.f.) valuation is provided, freight and insurance components have to be estimated separately and eliminated from the trade figures to arrive at a f.o.b. valuation. These components are then recorded in the services account.

##### a.2 - Services

*Services* are the second major category of the current account.

The main breakdown of services includes three sub-items: transportation, travel, and other services.

*Transportation* covers services provided by all modes of transportation - sea, air, and other, which includes space, rail, road, inland waterway and pipeline - that are performed by residents of one economy for those of another. The different types of services offered include transport of passengers, transport of freight and other supporting and auxiliary services (e.g., storage and warehousing).

The debit side of the item *Travel* consists of goods and services which are acquired by residents who stay abroad for less than one year. The credit side includes purchases of the same type made by foreign travellers on the national territory. This item contains two main categories of travel: business travel and personal travel (leisure, study, health-related purposes, etc.).

*Other services* comprise those international services transactions not covered under transportation and travel (communication services, construction services, insurance services, financial services, computer and information services, royalties and license fees, other business services, personal, cultural and recreational services, and government services n.i.e.).

##### a.3 - Income

*Income* covers two types of transactions between residents and non-residents.

*Compensation of employees* records wages, salaries and other benefits, in cash or in kind, earned by individuals for work performed for economic units whose place of residence is different from their own (border workers, seasonal workers, employees of international organisations, etc.). It records money paid to non-resident workers or received from non-resident employers.

*Investment income* is income derived from ownership of external financial assets and liabilities and payable by residents of one economy to residents of another economy. It includes interest, dividends, remittances of branch profits, and direct investor's shares of the retained earnings of direct investment enterprises. In line with the related financial account, *Investment income* is classified in *Direct investment*, *Portfolio investment*, and *Other investment income*.

#### **a.4 - Current transfers**

*Current transfers* cover international transactions in which goods, services, or financial items are transferred between the residents of one economy and the residents of foreign economies without something of economic value being received in return (*quid pro quo*). These resources are immediately consumed or shortly consumed after the transfer is made. Current transfers are all transfers that are not capital. Current transfers are broken down, according to the sector of the compiling economy, into two subcomponents: general government and other sectors.

*General government* covers cash transfers and gifts to/from other governments etc. (in the European Union: contributions to the budget of the European Union institutions, flows from the European Union institutions).

*Other sectors* include workers' remittances, residents' contributions to foreign social security schemes, etc.

#### **b) CAPITAL ACCOUNT**

This item covers all transactions that involve (a) the receipt or payment of capital transfers (debt forgiveness, migrant's transfers, etc.) and (b) the acquisition/disposal of non-produced, non-financial assets, which includes transactions associated with tangible assets (e.g., land and subsoil assets) and transactions associated with intangible assets (e.g., patents, copyrights, trademarks, franchises, etc.).

#### **c) FINANCIAL ACCOUNT**

The *Financial account* covers all transactions associated with changes of ownership in the foreign financial assets and liabilities of an economy. The financial account is broken down into four basic components: *Direct investment*, *Portfolio investment*, *Financial derivatives*, *Other investment* and *Official reserve assets*.

##### **c1. Direct investment**

Direct investment implies that a resident investor in one economy has a lasting interest in, and a degree of influence over the management of, a business enterprise resident in another economy. The lasting interest implies the existence of a long-term relationship between the direct investor (resident entity) and the enterprise (direct investment enterprise) and a significant degree of influence by the investor on the management of the enterprise. Direct investment comprises the initial transaction between the two entities - that is, the transaction that establishes the direct investment relationship - and all subsequent transactions between the entities and among affiliated enterprises, both incorporated and unincorporated. Direct investment is classified primarily on a directional basis: resident *direct investment abroad* and non-resident *direct investment in the*

*reporting economy*. Within this classification the BPM5 distinguishes three main components: *equity capital*, *reinvested earnings* and *other capital*.

## **c2. Portfolio investment**

Portfolio investment records the transactions in negotiable securities with the exception of the transactions which fall within the definition of direct investment or reserve assets. The BPM5 first classifies portfolio investment by *assets* and *liabilities*. Within this classification it distinguishes four main components: *equity securities*, *bonds and notes*, *money market instruments*, and *financial derivatives*.

## **c3. Other investment**

This is a residual category. *Other investment* is the investment which is not recorded under the other headings of the financial account (direct investment, portfolio investment, financial derivatives or reserve assets). It also encompasses the offsetting entries for accrued income on instruments classified under other investment. Like portfolio investment, other investment is first classified into *assets* and *liabilities*. Within the directional classification four types of instruments are identified: *trade credits*, *loans*, *currency and deposits*, *other assets* and *other liabilities*.

## **c4. Official reserve assets**

These are foreign financial assets available to, and controlled by, the monetary authorities for financing or regulating payments imbalances or for other purposes. *Reserve assets* consist of monetary gold, Special Drawing Rights, reserve position in the International Monetary Fund, foreign exchange, and other claims. Changes in the holdings of reserves may reflect payments imbalances or responses to them, official exchange market intervention to influence the exchange rate, and/or other actions or influences.

## 4- Double-entry System

*“The basic convention applied in constructing a balance of payments statement is that every recorded transaction is represented by two entries with equal values. One of these entries is designated a credit with a positive arithmetic sign; the other is designated a debit with a negative sign. In principle, the sum of all credit entries is identical to the sum of all debit entries, and the net balance of all entries in the statement is zero.” (BPM5)*

For example, when an exporter sells (provides) goods to a non-resident, the exporter may receive cash (a financial asset) or another type of financial asset (e.g. a trade credit claim) in return. The export is represented by a credit entry and the financial asset acquired is represented by an offset debit entry.

Credit entries are required for exports of goods and services, income receivable, and increases in liabilities or reductions in assets. Likewise, debit entries are required for imports of goods and services, income payable, and increases in assets or reductions in liabilities.

Where something of economic value is provided without something of economic value in exchange (i.e. without a quid pro quo) the double entry system requires an offset to be imputed (a transfer entry) of equivalent value.

For example, food exported as aid requires a credit entry for the goods provided and a debit transfer as the aid offset.

### RULES FOR THE DOUBLE ENTRY SYSTEM

| <b>Credit entries</b> , all economic resources provided by the compiling economy, including:   | <b>Debit entries</b> , all economic resources received by the compiling economy, including:  |
|--|--|
| <ul style="list-style-type: none"> <li>• Exports of goods and services.</li> <li>• Income accruing to residents from non-residents.</li> <li>• Claims on residents provided to non-residents; and resident claims on the rest of the world returned to the rest of the world.</li> <li>• Transfers, which are offsets to debit entries.</li> </ul> | <ul style="list-style-type: none"> <li>• Imports of goods and services.</li> <li>• Income accruing to non-residents from residents.</li> <li>• Claims on residents returned from the rest of the world; and claims on the rest of the world provided to residents.</li> <li>• Transfers, which are offsets to credit entries.</li> </ul> |

## EXAMPLES OF DOUBLE ENTRY RECORDING

1- Sale of goods (value 100) to non-residents for foreign exchange (i.e. goods provided and bank payment (a bank deposit) received)

|  | Credit | Debit |
|--|--------|-------|
| Goods                                  | 100    |       |
| Bank deposits, foreign currency assets |        | 100   |

2- Purchase of goods (value 120) from a non-resident using trade credit (i.e. goods received and a claim by a non-resident on a resident (trade credit liability) provided)

|                          | Credit | Debit |
|--------------------------|--------|-------|
| Goods                    |        | 120   |
| Trade credit liabilities | 120    |       |

3- Food aid (value 5) provided to non-residents (i.e. goods provided and transfer imputed)

|                   | Credit | Debit |
|-------------------|--------|-------|
| Goods             | 5      |       |
| Current transfers |        | 5     |

4- Repayment of a loan (value 25) by a resident company to a non-resident (i.e. liability to a non-resident returned reduced and a reduction in bank deposits)

|  | Credit | Debit |
|--|--------|-------|
| Loan repayment                         |        | 25    |
| Bank deposits, foreign currency assets | 25     |       |

Australian Bureau of Statistics (<http://www.abs.gov.au/>)

## Residual item (non-recorded transactions and statistical errors, net)

In principle, given complete and accurate recording, the overall balance of payments (i.e. the combined current and capital account and the financial account) should sum to zero.

In practice, however, the accounts frequently do not balance. Data for BoP items are often derived from different data sources. Timing, valuation and other factors cause imbalances in the information recorded. The item “**Net errors and omissions**” is used to balance the Current and Capital account with the *Financial account*.

## RECAP:

In principle:  $CA + KA + FA = 0$

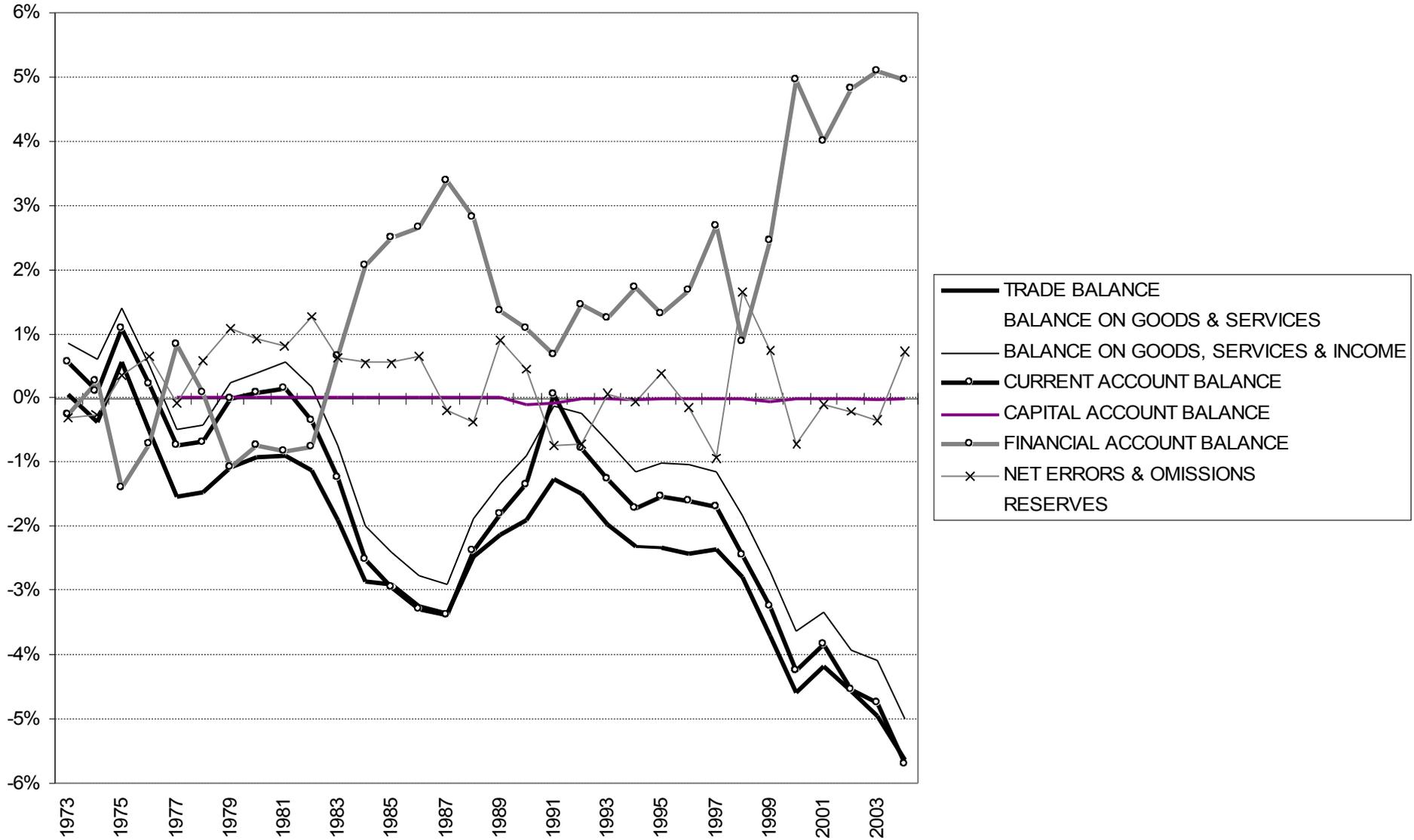
In practice:  $CA + KA + FA + \text{Net errors and omissions} = 0$

**Another presentation:** Transactions in official reserve assets are excluded from the financial account

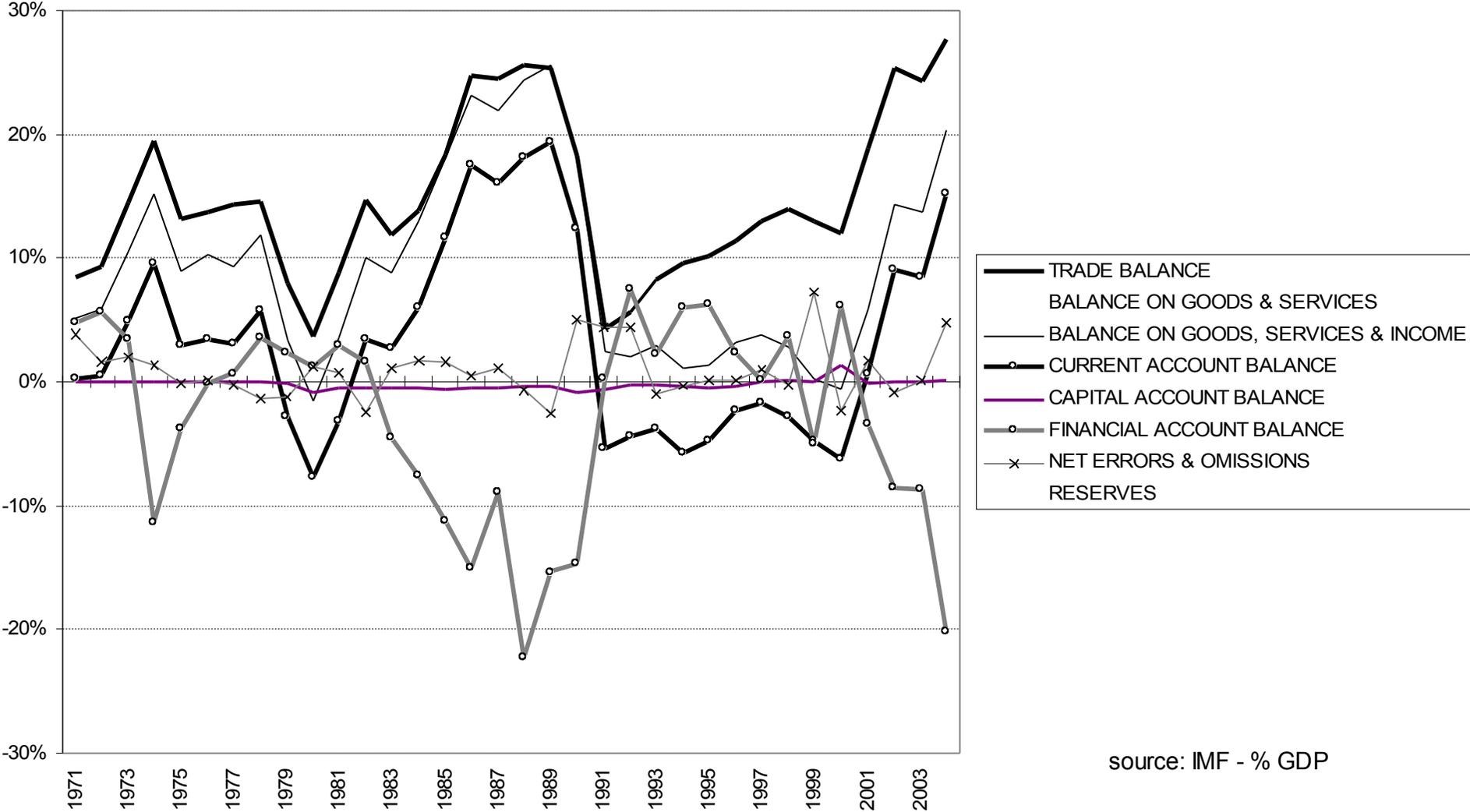
In principle:  $CA + KA + \text{“Financial Account”} = \text{Transactions in official reserve assets}$

In practice:  $CA + KA + \text{“Financial Account”} + \text{Net errors and omissions} = \text{Transactions in official reserve assets}$

# US balance of payments



### German balance of payments



source: IMF - % GDP

## Japanese balance of payments

