

An Introduction to Balance of Payments

Balance of Payments statement is a summary of a country's cross-border transactions. It is a systematic record of all the transactions between the residents of a country and the rest of the world. Like GDP, Balance of Payments statement is a flow statement and summarizes flows within a certain period. In other words it registers the changes in the country's financial claims and obligations vis a vis the rest of the world during a specified period (month, quarter or year).

Balance of Payments statement reports sources and uses of foreign exchange over a period of time. In this sense it resembles more to a fund sources and uses statement, than a balance sheet which reports stock of values. Exports for instance, constitute source of funds because exports lead to payments made in foreign currencies¹. In contrast, imports require payments in foreign currencies; therefore they constitute use of funds. Similarly, borrowing abroad represents a source of foreign exchange, lending to foreign residents represents use of funds.

The accounting methods used to compile Balance of Payments statements have also parallels to financial accounting. In accounting, an increase in assets or a decrease in liabilities is recognized through a debit entry. In contrast, an increase in liabilities or a decrease in assets leads to a credit entry. The double entry principle used in accounting requires that a debit entry is always accompanied by a credit entry. Consequently, book value of the total assets of a firm is always equal to the value of total liabilities (including the claims of stockholders). These accounting principles are also applied to recording of transactions in the balance of payments. For example, when a U.S. resident exports goods to a foreign country with payment to be made in the future, a debit entry is made to record the increase in U.S. financial claims on foreigners and a credit entry is made to record the decrease in goods. In summary, any transaction that brings foreign exchange into the country is recorded as a credit, and any transaction that requires transfer of currencies to other countries is recorded as a debit.

In its most basic form BOP is divided into four sections:

- Current Account
- Financial/Capital Account
- Official Reserves Account
- Net Errors or Omissions (or Net Statistical Discrepancy) Account

The current account reflects country's all interactions with the rest of the world in real (non-financial) sectors. It summarizes exports and imports of goods and services, earnings on investments and unilateral transfers.

¹ Regardless if we are paid in our own local currency or in a foreign currency, and export transaction increases our claims over foreigners. In that sense, it creates a source for the country.

Financial/Capital account on the other hand reports country's interactions with the rest of the world in financial sectors. It shows sources and uses of a financial nature such as lending, borrowing, portfolio investments and foreign direct investments.

The official reserves account reports changes in the official reserves of the country as a result of interactions in the real and financial sectors. Official Reserves account is composed of foreign exchange deposits, foreign security holdings, gold, Special Drawing Rights, IMF credits and loans and net borrowing rights from foreign central banks.

Finally, "Errors or Omissions Account" or "Net Statistical Discrepancy Account" is used to balance the individual accounts in all three categories. All cumulative imbalances are aggregated in this account.

Current Account:

Goods (or merchandise) trade consists of all raw materials and manufactured goods bought, sold, or given away.

Services include tourism, transportation, engineering, and business services, such as management consulting, and accounting. Fees from patents and copyrights on new technology, software, books, and movies also are recorded in the service category.

Income receipts include income derived from ownership of assets, such as dividends on holdings of stock and interest on securities.

Unilateral transfers represent one-way transfer of assets, such as worker remittances from abroad and direct foreign aid.

Financial/Capital Account

Until relatively recently, most countries recorded all international financial transactions under "capital account". Beginning in 1993, IMF substituted the term "financial account" for "capital account" and assigned a new and narrower definition to the term "capital account." According to this new definition, the capital account covers "all transactions that involve the receipt or payment of capital transfers and acquisition or disposal of non-produced, non-financial assets"². Under this new definition, the capital account includes only unilateral transfers of capital, such as the forgiveness of one country's debts by the government of another country and land and real estate acquisitions. In most cases, the newly defined capital account is a very small (almost negligible) item on the balance of payment

² IMF Balance of Payments Manual, pp 77, IMF Publications 1993 Washington D.C.

The new “financial account” is far more important, since it includes all other financial transactions, such as cross-border trades of stocks and bonds. Although the term “capital account” is widely used with its old, inclusive meaning in mind, most governments now use the IMF’s new definitions of the capital and financial accounts in preparing their balance of payments statements. The Financial Account of the balance of payments measures all international economic transactions of financial assets.

The IMF definition of Financial/Capital Account classifies transactions under foreign direct investment (or simply “direct investment”), portfolio investments, financial derivatives, other investments and capital account. Portfolio investments and foreign direct investment constitute a large percentage of transactions under Financial/Capital Account.

While US International transactions are organized in compliance with IMF definitions, Financial/Capital Account transactions are reported slightly differently. US Financial/Capital Account items are the following:

“US Owned Assets Abroad” represent capital outflows from the US and they are divided into government assets (or investments made by the US government), and private assets (investments made by private entities). Private assets include U.S. credits and other long-term assets, direct foreign investment, and the U.S. claims reported by the U.S. banks.

“Foreign Owned Assets in the US” represent capital inflows into the U.S. Foreign-owned assets in the United States are divided into foreign official assets and other foreign assets in the United States. Foreign Official assets in the US primarily include investments made by foreign governments into the U.S. government and agency securities. Other foreign assets refer to investments made by foreign private entities into US Government and agency securities, corporate bonds, equities, direct investment and U.S. currency. This category also includes U.S. liabilities reported by U.S. banks and trade credits extended by non-financial counterparties.

Official Reserve Account

The Official Reserves Account is the total reserves held by official monetary authorities within the country. These reserves are normally composed of the major currencies used in international trade and financial transactions (hard currencies). The significance of official reserves depends generally on whether the country is operating under a fixed exchange rate regime or a floating exchange rate system. Countries with a freely floating exchange rate regime can function with moderate levels of reserves. Case in point is the US. The US official reserves were to be \$148bn as of September 12, 2011. Despite much

larger size of its economy, the official reserves in the US are far smaller than official reserves held by smaller economies with currency pegs or managed floating systems.

Net Statistical Discrepancy (NSD)

This account is basically used to balance the BOP statement. This results from unaccounted/untracked transactions. A surplus in NSD implies a capital inflow that could not be documented and a deficit implies a capital outflow with same characteristics. In either case we lack the information about the source and the destination.

Balance of Payments Deficit and Surplus

In theory, the current account should balance with the financial/capital account. The sum of the balance of payments statements accounts (ie sum of current account balance, financial and capital account balance and change in reserves) should be zero. For example, when the United States generates current account deficits, it must finance this deficit by borrowing, or by selling more capital assets than it buys. This means that US has to generate capital account surplus in order to be able to sustain its current account deficit. A country with a persistent current account deficit is, therefore, effectively exchanging capital assets for goods and services. Large current account deficits mean that the country is borrowing from abroad. In the balance of payments, this appears as a net inflow of foreign capital. Sustained current account deficits lead to accumulation of foreign debt and increase the risk of financing shortfalls in future periods. Countries with large outstanding foreign liabilities may find it difficult to raise capital in private capital markets. This may lead to concerns among creditors and may trigger massive capital outflows. These outflows increase demand for foreign currency eventually put pressure on country's currency. Such episodes often end with currency crises. If they cannot be contained, they morph into systemic financial crises.

Balance of Payment Dynamics, External and Domestic Sector Linkages

The BOP statement allows us to keep track of external transactions of a country. We pay a particular attention to Current Account Balance (CAB), since current account transactions have important linkages to the domestic sectors of an economy.

An open economy can be modeled as:

$$Y=C+I+G + (X-M) \text{ where}$$

Y=Domestic Production

C=Domestic Consumption

I=Private Investments

G=Government Expenditures

X=Exports

M=Imports

$C+I+G$ =Domestic Absorption

If $Y > (C+I+G) \rightarrow$ i.e. if domestic production exceeds domestic absorption, then country has a trade surplus or $(X-M)>0$

If $Y < (C+I+G) \rightarrow$ i.e. if domestic absorption exceeds domestic production, then country has a trade deficit or $(X-M)<0$

This simple model can be improved by separating private and public sectors through few simple manipulations. As a result of these manipulations we can derive a more useful relationship:

Current Account Balance= $(S-I)+(T-G)$ where

S=Private Savings [$(Y+R-T)$ =Disposable Income, $S = (Y+R-T)-C$]

I=Private Investments

G=Government Expenditures

T=Government Revenues

R=Net Income Transfers (Net of income receipts and payments)

The model above can be used to explain the drivers of current account surpluses and deficits. Let's use this model to explain drivers of US Current Account deficit:

In general, persistence of US Current Account deficits since early 1990s indicates that domestic absorption (Consumption, Investment and Government Expenditures) in the US exceeds its domestic production. While this diagnosis is straightforward, identification of drivers is more involving:

During the 1998-2000 period, the US government produced budget surpluses under the balanced budget initiative of President Clinton. Therefore in this period $(T-G)$ part of the equation was in surplus. Essentially $(S-I)$ part of the equation was the driving force behind the CA deficit. What did this mean? This meant that US private savings were not sufficient to finance the US private investments. Since the surplus in $(T-G)$ was relatively small it was not sufficient to cover the deficit in private sectors because of insufficient savings and high levels of private investment. Indeed in the climax of US growth cycle in 2000, The Economist

reported that US savings gap, i.e. (S-I), was a whopping 5% of the GDP. Since we had government surplus of (T-G) of only 1% of GDP, we had a CA deficit that reached to almost 4.5% of the GDP. This was quite large by industrialized country standards.

Fast forward to 2006, the year before the financial crisis, US current account deficit hit 6% of GDP, which was a historical peak. During this period we had deficits both in government sector and private sector. US government budget deficit (T-G) was at upwards of \$400bn, another \$400bn or so were contributed by private sector deficits (S-I).

In 2011 US Current Account deficit was about \$466bn. The fiscal deficit at the end of 2011 was about \$1.3tr. These figures imply that private sector balance produced a surplus of roughly \$900bn. This surplus was attributed to both increasing private savings and declining private investments.