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Faculty of Economics, Commerce and Management Sciences

Commerce Department

Module: International Finance

Branch: International Trade
Level: Third year Bachelor

Unit; the Balance of Payments

Lecture 08: The Balance of Payments – Part2-

The **balance of payments** is an accounting statement that summarizes all the economic transactions between residents of the home country and residents of all other countries. Balance-of-payments statistics are published quarterly in the United States by the Commerce Department and include transactions such as trade in goods and services, transfer payments, loans, and short- and long-term investments. The statistics are followed closely by bankers and businesspeople, economists, and foreign exchange traders; the publication affects the value of the home currency if these figures are more, or less, favorable than anticipated. The balance of payments is a summary of transactions between domestic and foreign residents for a specific country over a specified period of time. It represents an accounting of a country's international transactions for a period, usually a quarter or a year. It accounts for transactions by businesses, individuals, and the government. A balance-of-payments statement is composed of the current account, the capital account, and the financial account.

1-Balance -Of-Payments Categories

Currency inflows are recorded as *credits*, and outflows are recorded as *debits*. Credits show up with a plus sign, and debits have a minus sign. There are three principal balance-of-payments categories:

A. Current account, which records imports and exports of goods, services, income, and current unilateral transfers.

B. Capital account, which includes mainly debt forgiveness and transfers of goods and financial assets by migrants as they enter or leave the United States.

C. Financial account, which shows public and private investment and lending activities. The naming of this account is somewhat misleading as it, rather than the capital account, records inflows and outflows of capital.

For most countries, only the current and financial accounts are significant.

Exports of goods and services are credits; imports of goods and services are debits.

Financial inflows appear as credits because the nation is selling (exporting) to foreigners valuable assets—buildings, land, stock, bonds, and other financial claims—and receiving cash in return. Financial outflows show up as debits because they represent purchases (imports) of foreign assets. The increase in a nation's official reserves also shows up as a debit item because the purchase of gold and other reserve assets is equivalent to importing these assets

2-Double-entry bookkeeping

The balance-of-payments statement is based on double-entry bookkeeping; every economic transaction recorded as a credit brings about an equal and offsetting debit entry, and vice versa. According to accounting convention, a source of funds (either a decrease in assets or an increase in liabilities) is a credit, and a use of funds (either an increase in assets or a decrease in liabilities or net worth) is a debit.

Examples

Suppose a U.S. company exports machine tools to Switzerland at a price of 2,000,000 Swiss francs (SFr). At the current exchange rate of SFr 1 = $0.75, this order is worth $1,500,000. The Swiss importer pays for the order with a check drawn on its Swiss bank account. A credit is recorded for the increase in U.S. exports (a reduction in U.S. goods—a source of funds), and because the exporter has acquired a Swiss franc deposit (an increase in a foreign asset—a use of funds), a debit is recorded to reflect a private capital outflow:

////////////////////////////////	**Debit**	Credit
U.S. exports	//////////////////////////	$1,500,000
Private foreign assets	$1,500,000	///////////////////////

Suppose the U.S. company decides to sell the Swiss francs it received to the Federal Reserve for dollars. In this case, a private asset would have been converted into an official (government) liability. This transaction would show up as a credit to the private asset account (as it is a source of funds) and a debit to the official assets account (as it is a use of funds):

////////////////////////////////	**Debit**	Credit
Private assets	//////////////////////////	$1,500,000
Official assets	$1,500,000	///////////////////////

Credits: Sources of Foreign Exchange (+) Debits: Uses of Foreign Exchange (-)
a: Exports of goods 1,288.7 b: Imports of civilian goods 1,934.6
Trade balance = Deficit of $645.9
c: Exports of services (Fees earned,
transportation receipts, foreign
tourism in United States, etc.)
548.9 d: Imports of services (Fees paid
out, transportation charges, U.S.
tourism abroad, etc.)
403.0
Services balance = Surplus of $145.8
e: Income receipts 663.2 f: Income payments 498.0
Income balance = Surplus of $165.2

g: Net unilateral transfers (gifts) 136.1
Current-account balance = $a + c + e - (b + d + f + g)$
= Deficit of $470.9
h: Capital account transactions, net (0.2)
Capital-account balance = Deficit of $0.2
i: Foreign official investment in the
United States
349.8 j: U.S. government lending overseas (7.5)
k: Other foreign investment in the
United States
896.0 I: U.S. private investment overseas 1,010.9
m: Financial derivatives, net 13.7 n: Net increase in U.S. official
reserves
1.8
Financial-account balance = $i + k + m - (j + I + n)$
= Surplus of $254.3
n: Statistical discrepancy 216.8

3- Relationship between the Accounts

If a country has a negative current account balance, then it should have a positive financial and capital account balance (and vice versa). This implies that if it sends more money out of the country than it receives from other countries due to international trade and income payments, it receives more money from other countries than it spends on foreign investments. For example, if a country's DFI in other countries exceeds the amount of DFI by other countries into that country, this will result in a negative number (debit) for that country's financial account, because more funds are leaving that country than are coming into it. However, DFI in other countries generates primary income receipts for the country engaging in the investment. Therefore, the higher level of DFI by that country will cause it to receive more primary income from other countries, which results in a positive number (credit) for its current account balance because more primary income is coming into that country than is leaving it. **Errors and Omissions and Reserves** The balance-of-payments account also includes a category of errors and omissions, because measurement errors commonly occur when attempting to measure the value of funds transferred between two countries.