Department of Economics, Rice University
International Finance (Econ 421)
Yossi Yakhin

Handout #2: The Balance of Payments

1. Introduction

The **balance of payments** (**BOP**) is an accounting system for the external sector of the economy. The BOP keeps track of all transactions between home residents and the rest of the world.

The International Monetary Fund (IMF) sets the standards for compiling the balance of payments statistics. These standards are published by the IMF in the Balance of Payments Manual (BPM).[1] The standards in the BPM change from time to time, and there is typically a few years lag between the time they are set to the time countries actually follow them. The last (major) revision was made in 1993 and the US, for example, started reporting its BOP statistics according to the new manual only in 1999. Since this change is relatively recent[2], older textbooks describe a somewhat different BOP system than the one in this handout.

This handout describes the structure of the BOP and how it records different types of transaction.

2. The Structure of the BOP

The BOP has two main components: the **current account** (**CA**), and the **capital and financial accounts**. The capital and financial accounts are separated, obviously, into two main accounts; the **capital account** (**KA**), and the **financial account** (**FA**).

Generally speaking, the CA keeps track of the export and import of goods and services, and the international movement of income. The KA and FA keep track of changes in the stock of foreign financial assets. These accounts are the mirror image of the CA since any international movement in goods and services or income, recorded by

---

[1] The BPM is available online from the IMF website at: www.imf.org/external/np/sta/bop/bopman.pdf
[2] To this day, some countries have not fully adopted the new IMF guidelines.

the CA, must be accompanied by some form of payment which is typically recorded in the KA and FA. This leads to the basic BOP identity:

Current Account + Capital Account + Financial Account = 0

Each transaction is recorded in one of the accounts as either a debit or a credit. The rule is that inflows of real resources (i.e. imports of goods and services), increases in financial assets, and decreases in liabilities should all be recorded as debits in the BOP (i.e. entered with a minus sign). Similarly, outflows of real resources (i.e. exports of goods and services), decreases in financial assets, and increases in liabilities should all be recorded as credits in the BOP (i.e. entered with a plus sign). In short, any transaction that requires a payment to the rest of the world is recorded as a debit (imports for example), and any transaction in which the country receives a payment is recorded as a credit (selling financial assets for example).

Table 1: The Balance of Payments (BOP)

	Debit (-)	Credit (+)
Current Account (CA)		
Trade in Goods and Services	Import	Export
Income	Pay	Receive
Labor income		
Investment Income		
Dividends		
Profits		
Interest Payments		
Unilateral Current Transfers	Provide	Receive
Capital Account (KA)		
Capital Transfers	Provide	Receive
Non-Produced, Non-Financial Assets	Purchase assets	Sell assets
Financial Account (FA)		
Non-Reserve Financial Account		
Financial Assets	Purchase assets	Sell assets
Direct Investment	Home investment abroad	Foreign investment at home
Official Reserves Account	Increase in reserves (purchase assets)	Decrease in reserves (sell assets)

Table 1 summarizes the structure of the balance of payments including the main entries in each account, and shows how each type of transaction is recorded. In the following sections we discuss in some detail the components of each account.

3. The Current Account

The current account keeps track of the international movement of goods and services, income, and unilateral current transfers.

Movements in goods and services are simply the exports and imports of the country. When the country exports, the value of the exported goods and services is recorded as a credit (added to the CA), while imports are recorded as a debit (subtracted from the CA).

Income payments are labor and investment income. Labor income includes wages, salaries, and other benefits. Investment income includes dividends, profits, and interest payments. When residents of the home country receive income from foreigners, that income is recorded as a credit, while income payments to foreigners are recorded as debits.

Finally, unilateral *current* transfers are transfers that do not result in a change in the stock of assets; that is all transfers that are not transfers of capital. These may include gifts in food, clothing, and other consumer goods, military equipment, regular contributions to international organizations or other countries, cash transfers for the purpose of financing current expenditure, etc. Typically we classify a gift as a current transfer if it is aimed at increasing current consumption in the recipient country. Current transfers are recorded as credits when the country receives them and as debits when the country provides them.

4. The Capital Account

The capital account records capital transfers and acquisition/disposal of non-produced, non-financial assets.

Capital transfers are gifts that result in a change in the stock of assets. These may include transfers of ownership of fixed assets, transfers of funds, debt forgiveness, cash transfers for the purpose of financing investment projects, etc. Capital transfers are recorded as credits when the country receives them and as debits when the country provides them.

Non-produced and non-financial assets are, for example, patents, copyrights, trademarks, etc. When the country sells such assets the transaction is recorded as a credit (same as exports), while an acquisition is recorded as a debit (same as imports).

5. The Financial Account

The financial account records all transactions that involve a change of ownership in assets and liabilities. These include both financial assets (bonds, financial derivatives such as options and futures, loans, foreign currency, etc.) and direct investment (ownership of at least 10% of a foreign enterprise). Also, for the purpose of BOP accounting land and structures are considered to be financial assets.

The financial account is divided into a **non-reserve financial account** and an **official reserves account**. The only difference between the two components is that official reserves are the foreign assets held by the monetary authority, while the change in foreign assets held by other agents is recorded in the non-reserve financial account. We will discuss the official reserves in more detail in the next subsection.

Increases in assets and decreases in liabilities enter the financial account as debits, since these transactions are associated with payments to the rest of the world (capital outflows). Decreases in assets and increases liabilities are associated with receiving payments from foreigners (capital inflows), and therefore they are recorded as credits.

We should emphasize here the difference between income and ownership of assets. Assets generate income; thus the purchase of an asset is recorded in the FA while the income it generates is recorded in the CA. For example, suppose we buy (from a foreigner) an apartment in a foreign country. This is a purchase of an asset, and therefore this transaction is recorded as a debit in the FA. When we receive rent payments (again from foreigners) from renting the apartment this is classified as income and recorded as a credit in the CA (export of rental services).

Another example is getting a loan from a foreign bank. When we receive the loan (capital inflow) we increase our liabilities and therefore this is recorded as a credit in the FA. However, interest payments for the loan are recorded as debits in the CA (imports of financial services). Principle payments reduce our liabilities, and therefore are recorded as debits in the FA.

5.1. Official Reserves

Official reserves are foreign assets held by the central bank. The central bank is the monetary authority; this is the institution that manages the monetary policy of the country (in the US this is the Federal Reserve System). Official reserves include gold, reserves position in the IMF, foreign currencies, and other foreign assets (bonds and deposits, for example).

Official reserves are of special interest since they can be used as a policy instrument. For example, a country can use its reserves to control its exchange rate[3], or as a shock absorber to smooth economic fluctuations.

A decrease in official reserves is recorded as a credit in the FA since it indicates that the monetary authority sold financial assets. Similarly, an increase in official reserves is recorded as a debit.

Notice that by construction the change in official reserves matches the imbalance of CA + KA + the non-reserve portion of the FA. This imbalance is sometimes loosely called "the balance of payments". Of course, the balance of payments is always balanced, but often people use the term balance of payment deficit to indicate a fall in official reserves, and balance of payments surplus to indicate an increase in official reserves.

It should be noted that a BOP deficit in and of itself is neither good nor bad. It simply indicates a fall in official reserves. A deficit might be "good" if it is used, for example, to finance investment projects in the economy. It might be "bad" if a country constantly runs down its reserves in an attempt to protect the value of its currency.

6. The Double-Entry System

Every transaction has (at least) two sides; delivery of goods or assets and the corresponding payment. As a result each transaction is recorded with two entries, one as a

---

[3] The exchange rate is the price of one currency in terms of another. If the Fed buys yens using US dollars (this is an increase in official reserves) it increases the demand for yens and therefore the price of a yen in terms of dollars increases.

credit and the other, with the same value, as a debit. This double-entry accounting system guarantees that the balance of payments identity, discussed in section 2, always hold. Here are some examples for the American BOP.

Example 1: An American farmer exports $5 million worth of grain to Russia on a 90 day credit. The export is recorded as a credit in the CA. The payment was made by extending a loan to the Russian importer, which is an asset for the American farmer. Therefore, the non-reserve financial account is debited by $5 million.

Example 2: An American buys $10,000 worth of Sony stocks and pays by increasing a foreign brokerage company's balance in an American bank. The purchase of Sony stocks increases the stock of foreign assets that are held by Americans (capital outflow) and therefore the non-reserve financial account is debited by $10,000. The increase of bank deposits of foreigners in American banks is an increase in American liabilities (capital inflow) and is recorded as a credit in the non-reserves financial account.

Example 3: The same American receives $20 in dividends for holding his Sony stocks. The payment is made by a deposit to his account from the American bank account of the foreign brokerage company. The dividends are income that is generated by holding the stocks. Therefore, the investment income component in the CA is credited by $20. This transaction is offset by a $20 debit in the non-reserve financial account due to a decrease in liabilities to foreigners.

Example 4: An American buys $10,000 worth of Sony stocks and uses his Japanese bank account to pay a Japanese brokerage company. The purchase of Sony stocks increases the stock of foreign assets that are held by Americans (capital outflow) and therefore the non-reserve financial account is debited by $10,000. The decrease in balance in the Japanese bank account that is owned by Americans is a decrease in foreign (capital inflow) and is recorded as a credit in the non-reserves financial account. In this example the American simply exchanged one foreign asset for another.

6.1. Errors and Omissions

It should be noted, however, that in practice the BOP is never exactly balanced. That is, the sum of the KA and FA does not exactly match the CA imbalance. As a result the BOP includes one more account called **errors and omissions**. This account simply balances the BOP. One of the main reasons for this statistical discrepancy is that data for the BOP entries come from independent sources that may use different coverage, accuracy, and timing. As a result, implementation of the double-entry recording system is not perfect.