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[Balance of Payments]

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Balance of Payments

Balance of Payment

Introduction:

Hello friends, in this session I will discuss about the balance of payment, its meaning and the principles on which credits and debits are to be entered. Here I will discuss all the concepts by taking the example of US transactions.

1.1 Balance of Payments:

According to Bo Sodersten, "the Balance of Payment is merely a way of listing receipts and payments in international transactions for a country."

The Balance of Payment is an annual statement which shows all the transactions of residents of a nation with the residents of all other nations. The Balance of Payments helps in the formulation of monetary, fiscal and trade policies.

Clarification about Balance of Payment definitions-

- The Balance of Payment categorizes all merchandise trade into a few major categories. It gives a summary statement.
- Balance of Payment shows international transactions which means exchange of goods, service or assets between the countries. For these transactions payments are required. But Balance of Payment also includes those transfers for which no payments are required such as gifts.
- Another important clarification about Balance of Payment is who is a resident of a nation.

  Diplomats, military personnel, tourists and workers who temporarily migrate are residents of a nation in which they hold citizenship.

1.2 Principles of Balance of Payment Accounting:

1.2A Credits and Debits-

International transactions are classified as credits and debits.

Credit transactions are those transactions for which receipt of payments are received from foreigners.

Debit transactions are those transactions which involved payments to foreigners.

Credit transactions are entered with positive sign, and debit transactions are entered with a negative sign.

Transactions which are on the credit side are- exports of goods and services, unilateral transfers (gifts) received from foreigners and capital inflows because they involve the receipts payments from foreigners.

And transactions which are on the debit side are – the import of goods and services, unilateral transfers made to foreigners and capital outflows because they involve payments to foreigners.

1.2B Forms of Financial Inflows and Outflows:

An increase in foreign assets in the nation or a reduction in the nation's assets abroad is the two forms of capital inflows.

When a foreigner purchases a U.S. asset, there is increase in foreign assets in the U.S. because there are receipts of a payment from foreigners and hence it is a capital inflow.

In the same way, when U.S resident sells a foreign asset, there is a reduction in U.S assets abroad. This involves a payment from foreigners. And hence it too involves a capital inflow to the U.S.

On the other hand, financial outflow involves increase in the nation's assets abroad or a reduction in foreign assets in the nation because both of them involve payment to foreigners.

1.3C Double-Entry Book Keeping:

The Balance of Payment account of a country is constructed on the principle of double entry book keeping. Each transaction is entered on the credit and debit side of the balance sheet. This means that each international transaction is recorded twice, once as a credit and once as a debit of an equal amount, because in general every transaction has two sides. Let us understand this with the help of various examples-

First example:

Suppose that a U.S. firm exports goods of $500 to be paid for in four months. So, U.S first enters this on credit side because these exports will lead to the receipt of a payment from foreigners of $500.

Now this payment is again entered as a financial debit because U.S has to wait for four months to get the payments, they acquired a claim on the foreign importer.
The entire transaction is entered as follows in the U.S BOP.

	Credit (+)	Debit (—)
Goods exports	$500	
Financial outflow		$500

Second example:
Another example is suppose that a U.S resident visits London and spends $200 on hotels, meals and so on.
The U.S resident is purchasing travel services from foreigners requiring a payment. Thus, it is a debit for U.S for $200. It is a credit also because it shows an increase in foreign claims on the U.S.
The entire transaction is entered as follows in U.S BOP:

	Credit (+)	Debit (—)
Travel services purchased from foreigners		$200
Financial inflow	$200	

Third example:

Suppose that U.S government gives $100 to the government of a developing nation as a part of the US Aid programme. This is a unilateral transfer of $100 from U.S to foreigner. This payment is itself the U.S bank balance given to the government of the developing nation. It shows an increase in foreign claims on or foreign assets in the US and is recorded as a financial inflow in the U.S Balance of Payment.
The entire transaction is thus-

	Credit (+)	Debit (—)
Unilateral transfers made		$100
Financial inflow	$100	

Fourth example:

Suppose that a U.S. resident purchases a foreign stock of $400 billion. This purchase of the foreign stock increases U.S. assets abroad. It will be recorded in the debit side because there is financial outflow from the U.S. This will also be entered in the credit side as it is a financial inflow for the U.S. because of the increase in foreign bank balances in the U.S. is an increase in foreign assets in the U.S. This will be entered in Balance of Payment as-

	Credit (+)	Debit (–)
Financial outflow (the purchase of the foreign stock by the U.S. resident)		$400
Financial inflow (the increase in foreign bank balances in the U.S.)	$400	

Fifth example:

Suppose that a foreign investor purchases $300 billion of U.S. treasury bills and pays by drawing down his bank balance in the U.S. by an equal amount. The purchase of the US treasury bills increases foreign assets in the U.S.; this is a financial inflow to the U.S. and hence is recorded as a credit in the U.S. balance of payment.
And the drawing down of U.S. bank balances by the foreigner is a reduction in foreign assets in the U.S. This is financial outflow from the U.S. and the entire transaction is recorded as-

	Credit (+)	Debit (–)
Financial inflow (the purchase of U.S. treasury bills by a foreigner)	$300	
Financial outflow (the reduction in foreign bank balances in the U.S.)		$300

Now, if we suppose that all the above examples as international transactions of the U.S. of a year, then the U.S. Balance of Payment-

	Credit (+)	Debit (–)
Goods	$500	
Services		$200
Unilateral transfers		100
Financial flows, net		200
Total debits and credits	$500	$500

Total credits are equal to total debits because of double entry book keeping.

1.3 The International Transaction of the U.S:

The table 1 shows the summary of the international transaction of the U.S. for the year 2011.

Current account	**Credits**	**Debits**
Exports of goods, services and income	+2,848	
Imports of goods, services and income		-3,181
Unilateral transfers		-133
Capital account		
Capital account transaction		-1
U.S. owned assets abroad, excluding financial derivatives		-484
Foreign owned assets in the U.S. excluding financial derivatives	+1,001	
Financial derivatives	+39	
Statistical discrepancy		-89

Source: U.S. Department of Commerce

Table 2 shows the summary of the exports and imports of U.S. in the year 2011

Exports	Value	Imports	Value
Automobiles	$133.1	Petroleum	$462.3
Petroleum products	131.4	Automobiles	255.2
Chemicals	123.1	Household appliances	136.4
Agricultural food products	117.4	Apparel and household goods	125.7
Computers	48.4	Computers	119.7
Electrical generating machinery	48.3	Medical products	91.8
Semiconductors	45.0	Agricultural food products	84.6
Medical products	44.9	Chemicals	75.4
Scientific equipment	42.7	Electrical generating machinery	59.5
Telecommunications	35.9	Telecommunications	48.5
Household appliances	34.0	Semiconductors	40.4
Civilian aircraft	33.4	Scientific equipment	35.9
Oil drilling and construction equipment	32.9	Civilian aircraft	35.5

Source: U.S. Department of Commerce, *Survey of Current Business* (Washington, D.C.: U.S. Government Printing Office, July 2012), pp. 70–71.

The above two tables shows the U.S. exports of $2,848 billion of goods and services in 2011. It shows the goods exported of $1,497 billion, service exports of $606 billion included travel and transportation service given to foreigners, fees and royalties received from foreigners. $745 billion also earned by US as interest and dividends on their foreign investment.

Table also shows the imported goods and services for $3,181 billion in 2011. Goods imports a total of (-) $2,236 billion. The $427 billion imports of services included the travel and transportation services purchased by U.S. residents. $578 billion paid as interest and dividends on foreign investment in the U.S.

Unilateral transfers to foreigners made by the U.S. of (-) $133 billion during 2011. This include net U.S. government economic and military grants to foreign nations of (-) $47 billion, net U.S. government pensions and other transfers to foreign nations (-) $9 billion, and net private remittances and other transfers (-) $77 billion.

The official reserve assets of the U.S. include the gold holdings of US monetary authorities, SDRs, the U.S. reserve position in the IMF and the official foreign currency holding of U.S. monetary authorities.

If we want to know the total credits and debits of US, we sum the total credits of (+) $2,848 billion for U.S. exports of goods, services and income, (+) $1,001 billion net increase in foreign-owned assets in the U.S., and (+) $39 billion of net inflow of financial derivatives. Hence the overall credit is (+) $3,888 billion for the U.S. international transactions during 2011 and the overall debits are the sum of (-) $3,181 billion for the U.S. import of goods and services and income, (-) $133 billion for the net unilateral transfers, (-) $1 billion net capital account balance, and (-) $484 billion net increase in U.S. owned assets abroad, the overall debit total of (-) $3,798 billion. As we can see here that overall credit (+) $3,888 billion exceeds overall debits total of (-) $3,798 billion by (+) $90 billion, this shows that there is negative entry called statistical discrepancy (-) $89 billion with a (-) $1 billion of rounding errors.

This entry is required to make the total credits equal to the total debits because it is the requirement of the double entry book keeping.

<u>1.4 Accounting Balances and Balance Of Payments</u>:

As we know that horizontally Balance of Payment is divided into three categories namely- Current Account, Capital Account and Financial Account.

First we will discuss about the current account. In table 1, the first accounting memorandum is the balance on goods trade which shows that in 2011, U.S. exported $1,497 billion and imported $2,236 billion of goods, the net debit balance on goods trade of (-)$739 billion.

On the other hand, if we look at the services, U.S. had a net credit balance on services of $179 billion.

The third component of current account is investment income. If we look at the investment side, U.S. had a net surplus balance of (+) $227 billion on investment income.

Thus, U.S. had a net debit balance on goods, services and income of (-) $332 billion.

Adding the net debit balance of (-) $133 billion of unilateral transfers to the net debit balance of (-) $332 billion on goods, services and income, the total current account net debit balance is (-) $465 billion.

If there is surplus current account balance, it stimulates the domestic production and income, while when there is deficit in current account; it dampens domestic production and income.

Now the second part of the balance of payment is capital account. Table 1 shows the net debit balance of (-) $1 billion on capital account transaction for US in 2011.

The deficits in the current and capital account is financed by an equal net inflow of capital from abroad.

The third part of the balance of payment is the financial account; it shows the change in U.S. owned assets abroad and foreign owned

assets in the U.S. Table 1 shows that in 2011, U.S. owned assets abroad have increased by (-) $484 billion excluding financial derivatives, while foreign owned assets in the U.S. excluding financial derivatives increased by (+) $1,001 billion. This gives a net credit balance of (+) $517 billion. When we add the net credit balance of (+) $39billion of financial derivatives and the net capital account debit balance of (-) $1 billion gives the net credit financial account balance of (+) $555 billion. When we add this statistical discrepancy of (-) $89 billion, it gives the net credit balance of (+) $466 billion on financial account and statistical discrepancy for the U.S. in 2011.
This is how; the U.S. covered its current account deficit with an equal net financial account surplus.
Thus, a balance of payments deficit is given either by the net debit balance on all non-official or autonomous transactions or by the equal credit balance on official reserve or accommodating transactions.

Summary:

In this topic, we have learnt about the meaning of balance of payment, how it is accounted, what are the principles on which credits and debits are to be entered in the balance of payments by the help of U.S. transactions in 2011.