



Arrowhead Center

What is the Balance of Payments?

Increasingly, workers and consumers in New Mexico and elsewhere are affected by the process of globalization. Actions and events in far off places have local consequences and vice versa. Working or operating a business in an increasingly complex world economy demands a realistic understanding of global economic information. One often misunderstood and seemingly incomprehensible source of global economic information is the Balance-of-Payments (BOP). Our purpose in this article is to take some, perhaps most, of the mystery out of the BOP accounts.

The BOP accounts provide a more comprehensive view of international financial flows than other commonly reported data such as the trade balance. Indeed, the trade balance is a part of the BOP accounting system. The BOP has two major account categories: the current account, and the capital account which is also known as the financial account. Together, the two BOP accounts provide us with the details of *the international aspects of the sources and uses of our national income*.

The BOP is a double-entry bookkeeping system in which flows of international payments are recorded. Each nation has its own BOP system. For example, the BOP of the United States records international transactions between residents of the United States and residents of the rest of the world. The U.S. BOP data can be found on the website of the U.S. Department of Commerce, Bureau of Economic Analysis (BEA) at: <http://www.bea.gov/bea/di/home/bop.htm>

As with any double-entry bookkeeping system, BOP transactions are recorded in such a way that each transaction results in equal entries on both the debit and credit sides of the system. If all transactions have been properly accounted for, the sum of debit entries will equal the sum of credit entries and the balance-of-payments will be zero (debits = credits) at the end of the accounting cycle. If debits do not equal credits at the end of the accounting cycle an adjusting entry (statistical discrepancy) is required to account for errors and omissions. In this accounting sense, there is no such thing as a BOP deficit or surplus.

THE CURRENT ACCOUNT

The current account records transactions such as trade in goods and services (imports and exports), net unilateral transfers, and income from international investments. Table 1 displays a highly condensed version of the U.S. current account for 2005.

Table 1

U.S. Current Account for 2005 (Preliminary Data)		
		(billions of \$)
	Exports of Goods	892.6
	Imports of Goods	-1,674.2
Balance on Goods		-781.6
	Exports of Goods and Services	\$1,272.2
	Imports of Goods and Services	-1,995.8
Balance on Goods and Services		-723.6
Net Unilateral Transfers		-82.9
	Income Receipts from the Rest of the World	468.7
	Income Payments to the Rest of the World	-467.1
Balance on Income Receipts		1.6
Balance on Current Account		-804.9

Source: U.S. Department of Commerce, Bureau of Economic Analysis
<http://www.bea.gov/bea/di/home/bop.htm>

The most reported piece of current account (and BOP) information is the trade balance. Reports usually focus specifically on the merchandise trade balance which only includes imports and exports of goods, not services. In 2005, the U.S. had a merchandise trade deficit (balance on goods) of approximately \$781.6 billion because Americans imported more goods than they exported. Because the U.S. tends to export more services than it imports, the trade deficit (including goods and services) was only \$723.6 billion in 2005. These numbers are only one important piece of a bigger puzzle. The trade balance tells us something but it doesn't tell us everything.

Net Unilateral Transfers can be thought of as summarizing the flow of money as gifts across borders. In 2005, the U.S. sent \$82.9 billion more out of the country than it received in gifts from abroad. These transfers include private giving (a foreign worker sends part of his pay to his or her family in another country or I receive a check from my rich aunt in Brazil), public giving (the U.S. Government sends aid money to sub-Saharan Africa) and international transfers from private organizations such as the Red Cross. Only the balance or net amount (minus \$82.9 billion) is shown here but more detailed information is available from the BEA.

The balance on income receipts (or income balance) shows the difference between the amount of income U.S. residents received from their international investments and the amount that was sent out of the U.S. to compensate foreign owners of U.S. assets. For example, if a U.S. auto manufacturer has a plant in Germany that sells cars to Europeans, the profits returned to the U.S. is recorded in the "Income Receipts from the Rest of the World" category in Table 1. In 2005, U.S. residents received approximately \$16 billion more from foreign investments than foreign investors received from their investments in the U.S.

Because the current account is a sub account of the BOP it is possible to discuss the current account as having a deficit or surplus. A current account surplus means current

account transactions resulted in a net inflow of international payments into the U.S. A current account deficit means the opposite. As you can see in Table 1, the United States had a current account deficit of about \$805 billion in 2005. The U.S. current account has been in deficit since 1982 with the exception of 1991 (a recession year) when the U.S. ran a slight surplus. But again, the Current Account is still only part of the story as there are many other transactions recorded in the financial and capital account.

THE CAPITAL AND FINANCIAL ACCOUNT

The financial and capital account records various international flows of financial assets, or rather transfers of or payments for assets. For simplicity, the financial and capital account is often referred to as the capital account. The current account and the capital account are opposites. A nation running a current account deficit will automatically have a capital account surplus. Table 2 summarizes the U.S. capital account for 2005.

Table 2

U.S. Capital and Financial Account for 2005 (Preliminary Data)		
		(billions of \$)
Capital Account Transactions (net)		-5.6
Financial Account		
U.S.-Owned Assets Abroad, net (increase/financial outflow(-))		-491.7
Foreign-Owned Assets in the U.S., net (increase/financial inflow (+)).		1,292.7
Balance on Capital and Financial Accounts		795.4
Note: Statistical Discrepancy = \$9.6 billion		

Source: U.S. Department of Commerce, U.S. Bureau of Economic Analysis
<http://www.bea.gov/bea/di/home/bop.htm>

Capital account transactions include “non-typical” financial transactions such as debt forgiveness, transfers of assets by immigrants and other one-time financial transactions. In 2005, the U.S. experienced a net outflow of \$5.6 billion from these transactions. Other more “typical” financial transactions such as the sale of stocks, bonds, real estate, and businesses and changes in the official assets of the nation are also recorded in the capital account. These ‘typical’ transactions are much larger than the ones described as “non-typical.” Table 2 indicates that U.S. residents increased their holdings of foreign assets by \$491.7 billion (financial outflow from the U.S.) in 2005 while foreigners increased their holdings of U.S. assets by \$1,292.7 billion. For 2005 the U.S. experienced a net capital inflow or capital account surplus of \$795.4 billion. As with the current account, the financial accounts are sub accounts of the BOP and may end the accounting cycle in either a deficit or surplus position.

THE BALANCE OF PAYMENTS

While the terms current account surplus (deficit) or financial account surplus (deficit) are meaningful they should not be used when talking about the BOP as a whole. As discussed above, by definition the double-entry bookkeeping leads to balance in the sense of debits equaling credits. Overall, the balance of payments is always zero. This is easy to see in Figure 1 which displays the U.S. Current Account and the Capital Account including the statistical discrepancy from 1982 to 2005. Stated differently, in 2005, the U.S. current account deficit of \$804.9 billion is offset by the \$795.4 surplus in the financial accounts (after adjusting for the statistical discrepancy of \$9.6 billion).

We have focused here on understanding the mechanics and meaning of the Balance of Payments. If this exercise in accounting for international transactions sounds dry and technical, please remember that this is just the beginning of a larger story. In the end, debits do equal credits in the BOP but the way the debits and credits are distributed among the accounts can have relatively serious macroeconomic consequences including changing the prices you pay for goods and services, the wages you receive and determining whether or not your job will be out-sourced in the future. But, this is a topic for another day.

Figure 1.

