Topic 6.1

Balance of Payments Accounts

You Will Learn To:

- Explain how countries use the balance of payment to record their international transactions.
- Calculate and explain how changes in the current account and the capital and financial account affect the balance of payments.

Balance of Payments

The balance of payments is an accounting system used to record the payments for transactions from individuals in one country to another country. The BOP is divided into two accounts: the current account (CA) and the capital and financial account (CFA).

Any transaction that causes money to flow into a country is a credit to the BOP. Any transaction that causes money to flow out of a country is a debit to the BOP. The total credits to a country's accounts must equal the total debits, ensuring the current and capital and financial accounts zero each other out.

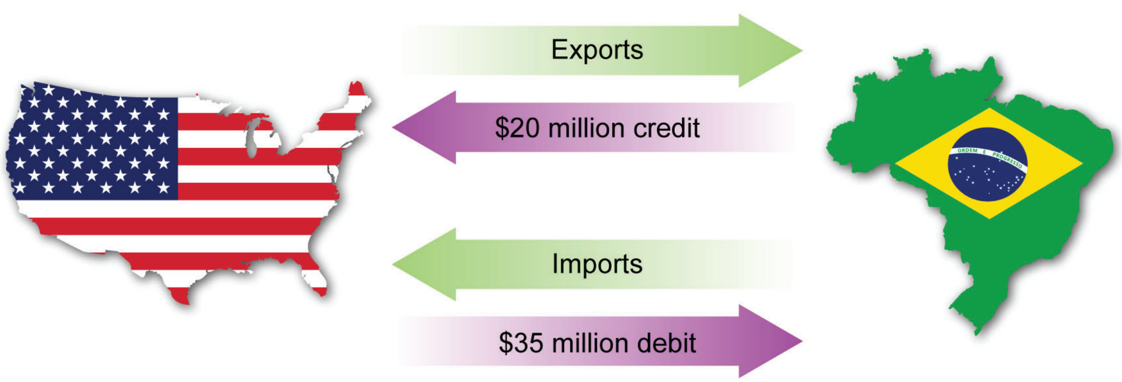
Current Account

The CA records the payments for net exports, net income from abroad, and net unilateral transfers. This account can have a surplus or a deficit, depending on the transactions of the country.

Net Exports

When two countries trade, the payments for exports are a credit to the CA because money is flowing into a country. Payments for imports are a debit to the CA because money is flowing out of the country.

When the value of imports is greater than the value of exports, there is a trade deficit. When the value of exports is greater than the value of imports, there is a trade surplus.



The United States exports $20 million worth of goods to Brazil creating a credit to the US current account. The United States imports $35 million worth of goods from Brazil creating a debit from the US current account.

US net exports = $20 million − $35 million = −$15 million

In this example, the US exports $20 million worth of goods to Brazil, causing $20 million to flow into the US—a credit. However, the US also imports $35 million worth of goods, causing $35 million to flow out of the US—a debit. Therefore, the US will have a trade deficit of $15 million, while Brazil will have a trade surplus of $15 million.

Net Income

Income payments include any money earned for employment or investments in another country. Inflows are credits, while outflows are debits. For example, when people who live in the US own bonds for a company in Brazil, an interest payment of $6 million counts as an inflow, or a credit to the CA of the US. Note that the principal of the bonds is not included as income, and only the interest earned on the investments is part of the CA.

An example of an outflow would be individuals in Brazil working remotely for a company in the US. If these workers earn a total of $1 million, the wages paid would be counted as a $1 million debit to the CA of the US.

Net Unilateral Transfers

Unilateral transfers are one-way transfers of money from one country to another. For example, say that people living in the US send a total of $1 million to family members in Brazil. These transactions are reflected as a $1 million debit from the CA of the US and a $1 million credit to Brazil's CA.

Capital and Financial Account

The CFA is a record of a country's international sales and purchases of financial assets, such as stocks and bonds. These transactions are the initial purchase of financial assets, not the income earned. Foreign direct investment is also included in the CFA.

Purchase of Financial Assets

The initial purchase of a foreign financial asset, such as a stock or bond, is a debit from a country's balance of payments. It was noted earlier that while interest earned on bonds is included in a country's CA, the principal investment is not. Rather, when individuals in the US purchase bonds for $8 million from companies in Brazil, the money leaves the US and flows into Brazil, creating a debit from the CFA of the US. When Brazilians purchase bonds for $13 million from US companies, money flows into the US, creating a credit to the CFA of the US.

Foreign Direct Investment

Foreign direct investment includes investment in a country's economy by a foreign company or individual, such as paying to construct a factory or building. For example, if a Brazilian company builds a factory in the US for $9 million, this creates a $9 million credit to the CFA of the US. When a US company builds a shopping mall in Brazil for $3 million, it creates a $3 million debit from the CFA of the US.

How Payments Balance Between Countries

The CA and the CFA balance each other out. When there is a surplus in the CA, there is an equal deficit in the CFA, and vice versa. This balance of accounts is a result of the exchange of goods and money as it flows between countries.

For example, if someone in the US buys a TV made in China, this will be a debit from the CA of the US, as money is flowing out of the US to China. The recipient of this money can do two things with these US dollars:

- Buy a US export, which will be a credit to the CA, offsetting the CA debit.
- Buy a US financial asset or increase foreign direct investment in the US, leading to a CFA credit, offsetting the CA debit.

Either way, once again, the accounts will balance each other out.

United States Balance of Payments			
Current Account		**Capital and Financial Account**	
Net exports	−$15 million	Net financial asset purchases	$5 million
Net income from abroad	$5 million	Net foreign direct investment	$6 million
Net unilateral transfers	−$1 million		
Total	−$11 million	Total	$11 million

When added together, the CA transactions in the table total −$11 million, meaning there is a deficit in the CA of the US. However, the CFA has a surplus of $11 million, resulting in the two accounts zeroing each other out.

Things to Remember

- The balance of payments records the payments for transactions between two countries.
- The current account includes net exports, net income from abroad, and net unilateral transfers.
- The capital and financial account includes net financial asset purchases and net foreign direct investment.
- The current account and the capital and financial accounts zero each other out.

6.1 Vocabulary

Balance of payments	The accounting of a country's payments to and from other countries. The balance of payments includes a country's current account and its capital and financial account.
Current account	A record of a country's payment to and from other countries for goods and services, its income from abroad, and any unilateral transfers.
Trade surplus	The value by which a country's exports exceed its imports.
Trade deficit	The value by which a country's imports exceed its exports.
Capital and financial account	A record of a country's international sales and purchases of financial assets, such as bonds and stocks, and foreign direct investment.
Unilateral transfers	A one-way transfer of money from one country to another. These transfers are recorded as part of a country's current account in the balance of payments.
Foreign direct investment	Investment in a country's economy by a foreign company.

6.1 Check for Understanding

1. **Which of the following are included in the current account of a country's balance of payments?**

   I. Net income
   II. Net unilateral transfers
   III. Net capital flows
   IV. Net exports

   A. I and II

   B. I, II, and IV

   C. I, III, and IV

   D. I, II, III, and IV

2. **Which of the following are included in the capital and financial account of a country's balance of payments?**

   I. Net unilateral transfers
   II. Purchase of financial assets
   III. Net income
   IV. Foreign direct investment

   A. I and III

   B. I, II, and III

   C. II and III

   D. II and IV

3. **The current account is always balanced.**

   A. True

   B. False

4. **If the current account has a deficit, what must be true of the capital and financial account (CFA)?**

   A. The CFA must also have a deficit

   B. The CFA must have a surplus

   C. The CFA will be zero

   D. The CFA is indeterminate

5. **Which of the following transactions would count as a credit to the current account of the United States?**

   A. A person in Brazil imports a United States good

   B. A person in the United States imports a Brazilian good

   C. A person in Brazil buys stock in a United States company

   D. A person in the United States builds an apartment complex in Brazil

6. **Which of the following would count as a debit from the capital and financial account of Brazil?**

   A. A person in Brazil imports a United States good

   B. A person in the United States imports a Brazilian good

   C. A person in Brazil buys stock in a United States company

   D. A person in the United States builds an apartment complex in Brazil