VII

Balance of Payments

Concept of Balance of Payments

The balance of payments of a country is an accounting statement that can be tentatively defined as a systematic record of economic transactions, during a given period, between its residents and the residents of the rest of the world, which are usually referred to as foreigners or nonresidents.[14]

The balance of payments is not a record of the country's receipts and payments of money or foreign exchange. Rather, the balance of payments covers (a) all real flows of goods and services into and out of the country, regardless of whether they involve use of money or foreign exchange; (b) all transfers that are the counterpart of real resources or financial claims provided to, or received from, the rest of the world without a *quid pro quo* (donations, grants); and (c) all changes in the residents' claims on, and liabilities to, nonresidents that arise from economic transactions.

The coverage of the compiling country may be defined as the totality of individuals, enterprises, and private and governmental institutions that are permanently associated with that country. All these individuals, enterprises, and institutions are called residents, regardless of their nationality. Resident individuals are citizens of the compiling country living there permanently. In addition, they include diplomatic personnel and members of the armed forces stationed abroad, and citizens studying or undergoing medical treatment abroad.

Citizens living abroad may be treated as residents (travelers) or nonresidents (emigrants), depending on a number of factors including the permanence of their stay abroad, their source of earnings, and their investment. The "center of interest" concept will assist in defining a resident from the balance of payments point of view. The same principle of "center of interest" will be used to decide whether noncitizens staying in the compiling country are to be treated as residents or nonresidents. Branches and subsidiaries of local and/or foreign companies are treated as residents of the country in which they operate, because they are considered an integral part of that country's economy.

The balance of payments also includes transactions among residents that are related to change of ownership of claims on, and liabilities to, nonresidents. Thus, if a resident bank sells foreign exchange to the resident private sector, this transaction is reported as a decline in foreign assets of the banking system and an increase in foreign assets of the private sector.

[14]For more details on the description and definition of the balance of payments, see International Monetary Fund, *Balance of Payments Manual*, Fifth edition (Washington: IMF, 1993).

©International Monetary Fund. Not for Redistribution

Similarly, if the central government takes over external obligations of the private sector, this transaction could be reported in the balance of payments.[15] Also, if imports are reported on a c.i.f. basis, the balance of payments will show a credit entry for freight and merchandise insurance paid to residents.

Differences Between Balance of Payments and Exchange Records

Since the balance of payments covers all transactions between residents and nonresidents of a country that take place during a given period, it also covers transactions that do not require payments (for example, donations); transfers of financial resources (for example, reinvestment of profits); and foreign exchange (such as operations in local currency, swaps of goods, and trade loans). In contrast, exchange records report only transactions in foreign exchange that take place during a given period.

Exchange records are derived from complete, comprehensive, and reliable sources and should reconcile with foreign-asset holdings of the central bank or of the banking system at the beginning and at the end of the period under observation. Because of their nature, exchange records are on a cash basis. In contrast, balance of payments statistics are derived from a variety of sources that are neither complete nor consistent (such as customs data, travel surveys, external debt records, balance sheets, etc.). Also, balance of payments data are on an accrual basis; therefore, they also include unpaid bills (arrears). While exchange transactions should add up to zero (once the initial and final foreign-exchange balances are taken into account), balance of payments data usually show a residual unexplained amount (net errors and omissions).

All transactions that are included in the exchange records are also included in the balance of payments, whereas balance of payments transactions are not necessarily included in the exchange records. In fact, certain balance of payments transactions would never be included in the exchange records. Thus, the two documents, balance of payments and exchange records, are quite different in coverage, classification of transactions, and timing of the reporting of a transaction.

To illustrate the difference between the two sets of statistics, assume that, during a given year, a country imported $100 of merchandise on credit with payment to be made in the following year and received a prepayment of $100 against exports of merchandise also to be made in the following year. The balance of payments and the exchange records of that country would be as shown in Table 6:

[15]An alternative would be to record this change of liability as a memorandum item in order not to inflate data of any given year. The servicing of the debt, however, would be attributed to the new legal debtor (the central government in this specific example).

©International Monetary Fund. Not for Redistribution

Table 6. Comparison of Balance of Payments and Exchange Records

	Balance of Payments		Exchange Records	
	Year one	Year two	Year one	Year two
Exports	—	100	100	—
Imports	–100	—	—	–100
Export credits	100	–100	—	—
Import credits	100	–100	—	—
Foreign assets[1]	–100	100	–100	100

[1]A minus sign indicates an increase.

The changes in foreign assets are the same in both cases, but their offsetting entries are different in the two documents (changes in trade credits in the case of the balance of payments; and exports and imports in the case of exchange records). Also, the balance of payments would show a deficit in the current account in year one and a surplus in year two, while the exchange record would show a current account surplus in year one and a deficit in year two.

In most developing countries, exports and imports are derived from customs statistics, but as data on trade credits are not available, a reconciliation with exchange records is usually lacking.[16] The balance of payments is, therefore, likely to be as shown in Table 7 below:

Table 7. Exports/Imports Entries in Balance of Payments

	Year One	Year Two
Exports	—	100
Imports	–100	—
Net errors and omissions	200	–200
Foreign assets[1]	–100	100

[1]A minus sign indicates an increase.

It is evident from this example that both sources of data are required, if we are to present a complete balance of payments that allows for a better analysis of external developments. In the above example, the authorities of the country in question could erroneously conclude that foreign assets will increase by $100 in year two because the country is expected to export $100 and to make no imports. In reality, foreign assets will decline by $100.

Sources and Deficiencies of Balance of Payments Data

To analyze external developments, it is important to be familiar with the sources—and weaknesses—of balance of payments statistics. As mentioned before, there is no single source of information for balance of payments transactions; these must, therefore, be derived from a

[16]Appendix V describes ways to estimate import credits.

©International Monetary Fund. Not for Redistribution

number of sources that are at times inconsistent. Because of problems related to sources of data, errors and duplications may occur.

In a typical country, the main sources of balance of payments information are:

A. *Customs data*, which record external merchandise transactions as declared by exporters and importers. A main problem with customs data is the valuation of the transactions, as traders may overinvoice or underinvoice their operations, depending on the circumstances. Also, coverage may be incomplete or deficient, because illicit traffic (contraband) is not covered, and certain important transactions, such as border trade and family or charitable remittances in kind, may be excluded. Also, merchandise may be shipped abroad or received on consignment, or it may be declared at customs at a certain unit or reference price that may differ substantially from the final price.

B. *Monetary accounts*, which provide data on foreign assets and liabilities of the banking system. These data are expected to be accurate, although some problems may arise because of valuation adjustments. Also, information on nonresident claims on, and liabilities to, resident banks that are denominated in the currency of the compiling country is not always available. Similarly, in countries that allow deposits denominated in foreign currency, a breakdown between accounts of residents and of nonresidents may not be available.

C. *External debt statistics*, which provide data on stock and changes (drawings, amortization, and interest payments) of the debt due to nonresidents by the public sector and/or the private sector. External debt records may sometimes be based on information provided by creditors and, therefore, may not reconcile fully with other balance of payments data (for example, imports, estimated services, and estimated sales of foreign exchange). Problems may also arise in countries that have domestic debt denominated in foreign currency, because a breakdown between debt held by residents and nonresidents may not be available.

D. *Surveys* to estimate certain service transactions. For example, travel receipts and payments are based on periodic surveys distributed to travelers, supplemented by estimates received from hotels and travel offices and by immigration statistics. These surveys, however, can have a high margin of error.

E. *Other sources used to estimate transfers and other services*. The reliability of these estimates, particularly in the case of countries with large migrant remittances, is very limited.

F. *Information provided by individual enterprises* to estimate direct investment, investment income, credit to the private sector, supplier credits, etc. The coverage of this information is limited and incomplete. For example, in the case of private sector borrowing, in some countries the private sector needs authorization to borrow abroad, but it is usually difficult to ascertain if and when the borrowing actually took place.

G. *Exchange records*. As mentioned above, exchange records only cover transactions effected in foreign exchange; nevertheless, they are an invaluable source of information to compile a balance of payments. Their usefulness depends on their coverage, that is whether they cover all transactions using legally obtained foreign exchange or only certain operations handled by the central bank, as well as the amount of details provided on individual transactions. In evaluating their usefulness, it should be noted that certain important transactions using foreign exchange may not be recorded in the exchange records. For example, certain export proceeds may not be surrendered to a bank in the exporting country but used

©International Monetary Fund. Not for Redistribution

by the exporter to build up private foreign exchange balances or to purchase goods abroad. The use of exchange records to derive balance of payments statistics is reviewed in more detail in Appendix V.

The Complete and the Actual Balance of Payments

A complete balance of payments could be prepared if every piece of information were available. All transactions would be classified properly, and, by definition, there would be no residual unexplained items. But in practice, the compiler of the balance of payments does not have at his disposal such complete and flawless information. As noted above, balance of payments statistics are derived from a variety of sources, some of which are rough estimates, and often inconsistent in timing and/or coverage. As a result, the credit and debit entries of the balance of payments are not necessarily equal. An entry called "net errors and omissions" must, therefore, be included in order to balance the statement.

Even if the balance of payments is derived from exchange records which, if properly prepared should have no unexplained items, and these have been adjusted with proper contra-entries for transactions not effected in foreign exchange, there is still no certainty that all balance of payments transactions are included. In this instance, the *net* omissions would add to zero, but *gross* credit and debit omissions could be substantial.

Appendix V attempts to compare complete balance of payments (one where every piece of information is available) with an actual balance of payments (one where the compiler had at his disposal only a certain amount of information and estimates) and with an exchange record (transactions involving use of foreign exchange).

Both current and capital accounts—and individual entries thereunder—differ considerably in the three documents. Certain items, however, would be identical, for instance, changes in net international reserves, because they are derived from the same source.

Net Errors and Omissions

The residual or balancing item (net errors and omissions) is, in many instances, one of the most important items of the balance of payments.[17] It reflects all transactions that were not recorded in the balance of payments (omissions), as well as all errors made in estimating other balance of payments entries (errors). The magnitude of this item is relevant only to a certain point, as it is on a net basis. If, for example, exports were greatly underinvoiced and the receipts of these unrecorded exports were retained abroad, the *net* omission in the balance of payments would be zero.

Moreover, the item net errors and omissions does not reflect *all* errors and omissions of the balance of payments. Thus, if imports were overinvoiced at customs, the error would be reflected under imports and not under errors and omissions. As already mentioned, if exports

[17]For possible sources of net errors and omissions, see Appendix V.

©International Monetary Fund. Not for Redistribution

were underinvoiced at customs, both sides of the unrecorded transaction (exports and increase in private sector foreign assets) would be left out of the balance of payments.

In general, net errors and omissions in the balance of payments arise for the following reasons:

A. Only one side of a balance of payments transaction has been recorded, and no contra-entry has been made, or the contra-entry is for a larger or smaller amount. For instance, the balance of payments includes estimates for private transfers received in kind, but imports are derived from customs data that do not include—and have not been adjusted for—these donations in kind. Similarly, the balance of payment presents no estimates for trade credits, but exports and imports related to those credits are recorded in the customs data. While trade and customs data have been adjusted for smuggling and border trade, no contra-entries have been made elsewhere in the balance of payments.

Trade on consignment, particularly in the case of mineral ore, is a source of errors and omissions in the balance of payments, as customs declarations are based on reference prices and are not usually adjusted once the final selling price has been determined. Also, exporters may receive an advance payment against their exports, which may differ from the value declared at customs. Table 8 presents the likely entries in a balance of payments in the case of exports on consignment:

Year One. Shipment on consignment of 1,000 tons, declared at customs at a reference price of $2 per ton. Exporter receives advance payment of $300, which is sold to the local central bank.

Year Two. Final settlement of exports at a price of $3.5 per ton. Exporter sells $2,000 to local central bank and retains $1,200 abroad.

Actual balance of payments: trade data are based on unadjusted customs declarations. No data are available on trade credits and on private sector deposits abroad.

Table 8. Trade Data in Balance of Payments

	Complete BOP		Actual BOP	
	Year one	Year two	Year one	Year two
Exports	3,500	—	2,000	—
Trade credits	–3,200	3,200	—	—
Private foreign assets[1]	—	–1,200	—	—
Net errors and omissions	—	—	–1,700	2,000
Net international reserves[1]	–300	–2,000	–300	–2,000

[1]A minus sign indicates an increase.

B. One side of a balance of payments transaction (for instance, tourism receipts) has been incorrectly estimated.

C. The two sides of a balance of payments transaction have been derived from sources that differ in coverage and/or timing. For instance, drawings of foreign loans are derived from

©International Monetary Fund. Not for Redistribution

creditor sources, but their use, in terms of goods, services, and cash, is based on debtor records and/or estimates.

Other sources of errors and omissions that may be classified into one of the above categories include (a) the sale of foreign currency-denominated domestic bonds (the foreign exchange receipt will be included in the changes in net international reserves, but the amount of bonds sold to nonresidents may be based on rough estimates, or may have been left out of the balance of payments on the grounds that it is considered a domestic debt); (b) contra-entries to loans in kind or for services; (c) errors in estimating trade credits; and (d) timing discrepancies between use of foreign loans for imports and arrival of merchandise.

In general, external debt records pose serious problems, because they may be based on information provided by creditors and, therefore, may not fully reconcile with data (such as imports, estimated services, and estimated sales of foreign exchange) derived from other balance of payments sources. Also, under certain trade loan agreements, import payments are reimbursed upon presentation to, and revision by, the creditor of proper import documentation. In its balance of payments, the debtor country may present as use of a foreign loan the import bills accumulated but not yet submitted for revision. For purchases of specific equipment, the creditor may make periodic payments directly to the supplier (upon placing the order, upon completion of a certain percentage of the work, etc.). These payments could be reported as use of foreign loans in the external debt and in the balance of payments, but their counterpart may be either missing or overestimated, depending on the circumstances (see references to use of a foreign loan for purchase of a turbine in Appendix V).

Capital Flight

In describing balance of payments developments in a country, reference is often made to capital flight, and, in particular, to its negative repercussions on the economy and the need to reverse such movements. In this context, three questions should be asked: What is capital flight? In which form can capital flight take place? Can capital flight be measured?

In general, the term capital flight has a certain connotation of transactions that are either illegal or morally wrong, despite the fact that in many countries capital flight, broadly defined, is legal. Indeed, capital flight is a matter of perception, and it differs from other balance of payments transactions because of its motivation. More broadly, one could define capital flight as any diversion of resources from the economy of a country for specific reasons. These reasons, or motivations, can be classified into four broad categories:

- Perception that the rate of return abroad is higher than domestically
- Concern over the political situation in a country
- Concern over domestic financial policies in a country
- Concern over present and/or future exchange rate developments in a country.

Capital flight is no different from other balance of payments transactions, except for its motivation, and in effect, there is a fine distinction between a "legitimate" transaction and capital flight. For instance, direct investment abroad may be considered a legitimate operation,

©International Monetary Fund. Not for Redistribution

but if it is undertaken for one of the reasons mentioned above, it would be considered capital flight.

Capital flight usually takes one of the following forms:

- Investment in foreign financial instruments (foreign currency, gold, deposits abroad, foreign bills, bonds, stocks, etc.)
- Investment in foreign real assets (purchases of real estate)
- Investment abroad (establishment of companies and similar activities in foreign countries)
- Purchases of foreign goods (speculative imports in expectation of devaluation)
- Other external operations (prepayment of foreign loans)
- Certain domestic transactions (shift from local currency-denominated deposits to foreign currency-denominated deposits).

In some instances, the initial impact of capital flight could be an inflow of foreign capital. For example, an enterprise may borrow abroad because it expects that, in the event of a large devaluation, it would obtain an exchange rate guarantee for the amortization of the loan and could, therefore, realize a substantial profit.

As can be seen from the above list, notwithstanding the reference to "capital," capital flight is not necessarily recorded in the capital account (for example, speculative imports would be entered in the current account) and capital does not necessarily leave the country (for example, hoarding of foreign banknotes constitutes capital flight).

The sources of capital flight also vary. In a country with no exchange restrictions, any individual or enterprise may legally and freely purchase foreign currency or make investments abroad. In countries with exchange controls, resources for capital flight are mostly provided by underinvoicing of exports, overinvoicing of imports, or other legal operations (such as advance repayment of loans, stockpiling of imported goods, and investment abroad). Shifts of deposits from local currency denomination to foreign currency denomination may involve simple bookkeeping transactions, with no actual local or foreign currency movement.

Reporting of capital flight (broadly defined) in the balance of payments would depend on the source and means. In general, one of the following four alternatives may occur:

A. The transaction is currently reported in the balance of payments; for example, capital movements effected legally, either because there are no exchange restrictions or because the operation has been authorized; and stockpiling of imports, in which case the capital flight will be recorded as an import.

B. The transaction and its counterpart entry are omitted from the balance of payments (for example, underinvoicing of exports).

C. The transaction is erroneously reported in the balance of payments (for example, overinvoicing of imports).

D. The transaction is omitted from the balance of payments because it represents a transaction between two residents (for example, shift of deposits).

©International Monetary Fund. Not for Redistribution