Balance of Payments made simple

by

Fedrica Robinson

Bank of Jamaica
Pamphlet No. 8

Nethersole Place
Kingston
Jamaica

Telephone: 876 922 0750-9
Email: library@boj.org.jm
Internet: www.boj.org.jm

ISBN: 976 8044 21 7

FOREWORD

The Bank of Jamaica has undertaken to publish a series of pamphlets on topics that are integral to the policies and operations of the Bank.

The pamphlets are designed to enhance the public's understanding of key central banking issues. In this regard the pamphlets will present important economic and financial information in a manner that will benefit a wide cross-section of users. In particular, it is anticipated that the material presented will assist journalists, investors, students and other members of the public who frequently request relevant documentation and/or explanations from officers of the Bank.

The Bank and its staff in continuing to serve the Jamaican public are pleased to add these pamphlets to existing publications as we strive to inform and educate.

We take this opportunity to extend our gratitude to all who have supported the process and would like to invite suggestions and comments from all our readers.

Myrtle Halsall
Division Chief & Head of the Editing Committee
Research & Economic Programming Division

Bank of Jamaica
January 2004

CONTENTS

PREFACE

During a given year, Jamaicans like nationals of other countries, engage in a vast number and variety of transactions with residents of other countries. They import, export, engage in service transactions, receive or send gifts abroad, obtain net income from overseas, receive loans or make payments on loans received and undertake or receive foreign investment. All these transactions together comprise the international trade and payments of Jamaica. However, to analyze and evaluate these transactions they must be classified and aggregated to make a balance of payments (b.o.p.) statement.

The balance of payments is a summary of all economic transactions between domestic and foreign residents. In Jamaica the BOP is compiled using the latest (fifth) edition of the BOP manual. The manual provides standards for concepts, definitions, classification and convention and facilitates systematic national and international collection, organization and comparability of BOP statistics.

Part one of this pamphlet covers the theoretical framework of the balance of payments according to the fifth edition of the BOP Manual. Part two deals with the structure and classification of accounts and part three covers the main sources of data used to compile Jamaica's BOP statistics. Explanations are provided for the technical terms frequently used in the text.

Part I

CONCEPTUAL FRAMEWORK OF THE BALANCE OF PAYMENTS

Definition:

The balance of payments (BOP) is a summary of economic activities between the residents of a country and the rest of the world during a given period, usually one year. The main purpose of keeping these records is to inform government authorities of the overall international economic position of the country in order to assist them in arriving at decisions on monetary and fiscal policy, on the one hand, and trade and payments policy on the other. Balance of payments statistics are therefore helpful to government authorities charged with maintaining macroeconomic stability.

PRINCIPLES AND CONCEPTS

Balance of payments accounting is governed by a set of principles and conventions that ensures the systematic and coherent recording of transactions, which are consistent across countries and over time. These principles and concepts will be discussed and where necessary practical examples will be used to elucidate the concepts.

1. Double Entry System

The balance of payments is constructed according to the principles of double-entry bookkeeping. Under this system a transaction is represented in the balance of payment by two entries with equal values. One of these entries is designated a credit and the other a debit.

There are some basic rules governing how entries are recorded in the balance of payments. A credit entry is recorded when the transaction gives rise to a receipt by a domestic resident from a foreign resident. The receipt itself may take the form of an increase in the resident's foreign assets or balances of foreign currencies. Whatever its form, the receipt is recorded as a debit entry. Conversely, any transaction that gives rise to a payment by a resident to a foreign resident is recorded as a debit entry. The payment that results from this transaction is recorded as a credit entry.

The double entry approach can be demonstrated with some hypothetical examples.

Example 1
Let us assume Alcoa, a mining company in Jamaica exports US$2.0m worth of bauxite to Jimpex a company in the USA and Jimpex pays for the bauxite by depositing US$2.0mn to Alcoa's bank account. Table 1 shows the entries that would be made in Jamaica's balance of payments:

Table 1

Jamaica: Balance of Payments US$M	**Credit**	**Debit**
Exports (Transaction that gives rise to a recipt)	2.0	
Financial account (Receipts from exports or increase in claims on foreigners)		2.0

Exports will appear as a credit entry because they give rise to receipts from abroad and the receipt, which represents a claim on non-residents, appears as a debit entry in the financial account.

Conversely, imports of foreign goods and services will appear as debits in the balance of payments as these transactions give rise to payments to the rest of the world. The corresponding payments, which resulted from the increase in liabilities to foreigners, are recorded as credit entries. To illustrate, let us assume Jamaica imports US$150 million worth of oil. In the balance of payments of Jamaica (see table 2) the oil import is recorded as a debit entry, as it gives rise to a payment by a resident to a non-resident. The corresponding payment, which resulted from the increase in Jamaica's liabilities to foreigners, is recorded as a credit entry.

Table 2

Jamaica: Balance of Payments US$M	**Credit**	**Debit**
Imports (Transaction that gives rise to a payment)		150
Financial account (The payment for the oil import)	150	

Example 2

Let us now assume that Jamaica borrows US$100 million dollars from the World Bank and the proceeds of the loans are deposited at the Bank of Jamaica (BOJ). Table 3 shows the entries that would be made in Jamaica's balance of payments:

Jamaica: Balance of Payments US$M		
	Credit	**Debit**
Financial Account	100	
Official Loan		
(Transaction that gives rise to a receipt)		
Reserves		100
(The loan receipts)		

The loan, which gives rise to a receipt is recorded in the balance of payments of Jamaica as a credit entry and the actual proceeds from the loans - the foreign currency receipt- is recorded as a debit entry.

If all the principles of the BOP manual are adhered to then the sum of all the credit entries should be identical to the sum of all the debit entries and the net balance of all entries in the BOP statement, including changes in the reserves of the Central Bank, should be zero. In practice, however, when all the actual entries are summed the resulting balance will invariably show a net credit or a net debit. That balance is the result of incomplete coverage of transactions, use of non-uniform prices and inconsistent times of recording and conversion practices.

The custom in BOP accounting is to show the net balance of all the actual transactions as "net errors and omissions". This entry is equal to the difference in the credit and debit entries, but with the sign reversed. Thus if the balance of the recorded components is a credit, the item for net errors and omissions would be shown as a debit of equal value and vice versa.

The custom in BOP accounting is to show the net balance of all the actual transactions as "net errors and omissions". This entry is equal to the difference in the credit and debit entries, but with the sign reversed. Thus if the balance of the recorded components is a credit, the item for net errors and omissions would be shown as a debit of equal value and vice versa.

Relatively large and persistent net errors and omissions are cause for concern as they are indicative of statistical error, major discrepancies or improperly recorded information.

2. Concept of Economic territory and Residence

The identification of transactions between residents and non-residents underpins the balance of payment compilation process. For balance of payments purposes, the concept of residence is not based on nationality or legal criteria but rather on the transactor's centre of economic interest. Of importance too is the necessity to identify the economic territory of the country to which the concept of residence is to be applied. This is so as the boundaries recognized for political purposes may not necessarily coincide with those for economic purposes.

A country's **economic territory** consists of a geographic area, administered by a government. In addition to including the air space, and territorial waters over which the country has jurisdiction, the economic territory of a country also includes territorial enclaves in the rest of the world. These enclaves are clearly identified areas located in other countries that are owned or rented by governments for diplomatic, military, scientific or other purposes, with the agreement of the country where the land area is located. So for example, the Jamaican embassy in Washington DC is regarded as a part of the economic territory of Jamaica. Similarly Guantanomo Bay in Cuba is a part of the economic territory of the USA as is the US Embassy in Jamaica.

The concept of **residence** is defined broadly to include two main types of institutional units: (1) households and individuals that comprise a household and (2) the legal and social entities of that economy such as the government, and enterprises (profit and non-profit) operating in the economy, whether foreign owned or not.

As far as individuals are concerned, the concept of residence is based mainly on the principle of "centre of interest". It is generally accepted that if a person resides for more than a year in a given economy, he or she is considered to be a resident of that economy. So if a Jamaican resident leaves Jamaica and returns to his/her household within a year, the individual continues to be a resident even if he or she makes frequent trips outside Jamaica. The individual's centre of economic interest remains in the economy in which the household is resident. In the same vein tourists are residents of the country from which they come rather than the country they are visiting.

However, there are exceptional circumstances whereby individuals are regarded as residents, for BOP purposes even though they reside outside of their country for more than a year.

a. ***Students*** should be treated as residents of their countries of origin however long they study abroad, as long as they remain members of households in their home countries.

b. ***Military personnel and civil servants, including diplomats*** employed abroad in government enclaves are all regarded as residents of the country from which they originate as those enclaves form part of the economy of the employing government. The government employees working in these enclaves continue to have centres of economic interest in their countries of origin for however long they work in the enclaves. Therefore if a Jamaican diplomat/civil servant is posted to the Jamaican Embassy in Washington for three years that employee continues to be a Jamaican resident while he works in the enclave.

3. Valuations and Time of Recording

Valuation

A consistent method of valuing transactions is required for the compilation of the balance of payments statement. All transactions are valued at market prices. This is the price that willing buyers pay to acquire a good or service from willing sellers and the exchanges are made between independent parties and on the basis of commercial considerations only. Inconsistent valuations lead to different debit and credit entries being made for the same transaction thus resulting in "net errors and omissions" in the BOP.

Time of Recording

In the double entry system of the balance of payment it is important that both entries relating to a transaction are recorded at the same time. However, while this is the ideal data recording methodology, it is not always possible, thus resulting in " errors and omissions" in the BOP. An entry is recorded in the balance of payments when a transaction involves a change of ownership or where a change of ownership is not obvious the transaction is recorded when the parties enter it in their accounts.

4. Concept of Economic Transactions

The primary concern of the BOP is not confined to payments, as the name would suggest, but rather with transactions. A transaction involves the change of ownership of goods and/or financial assets, the provision of services, labour and capital.

The most numerous and important transactions in the balance of payments are classified as exchanges. This refers to transactions in which economic values are provided or received in exchange for other economic values. These values consist of real resources (goods, services and income) and financial items.

Transactions classified as exchanges

This form of transaction requires a transactor to provide an economic value to another transactor and receives in return an equal value. Listed below are some examples of this type of transaction:

- Purchases and sales of goods and services against financial items - e.g. the sale of bauxite for foreign exchange.
- Barter - e.g. the exchange of bauxite for motor vehicles.
- The interchange of financial items for other financial items - e.g. the sale of securities for money.

Transactions classified as transfers

There are also transactions in which a transactor provide an economic value to another transactor and does not require an economic value in return. The required offsetting entries, in the BOP, for these transactions are recorded as transfers. Listed below are some examples of this type of transaction:

- The provision or acquisition of goods and services without a *quid pro quo* - e.g. donation of medical supplies by USA government to government of Jamaica.
- The provision or acquisition of financial items without a *quid pro quo* - e.g. debt forgiveness.

Part II

MAJOR CATEGORIES IN THE BALANCE OF PAYMENTS

The BOP is divided into two main categories according to the broad nature of the transactions. These categories are:

1. *The Current Account, and*
2. *The Capital and Financial Account*

1. Current Account

The current account includes all transactions (excluding those recorded in the capital & financial account) between resident and non-resident entities that that involve economic value. This account is sub-divided into:

a. *Goods and Services*
b. *Income, and*
c. *Current transfers*

a. *The Goods and Services account covers merchandise trade, travel, transportation and other services.*

i. ***Merchandise trade*** records the value of exports and imports, of tangible goods, including those of the freezones and goods procured in ports by international carriers. The difference between exports and imports of tangible goods is the ***trade balance***.

ii. *__Travel__* covers goods and services acquired from an economy by non-resident travelers for business and personal purposes during their visits (of less than one year). Expenditures made by seasonal workers (e.g. Jamaican farm workers) and those for educational and health-related purposes made by students and medical patients are recorded n this sub-account.

iii. *__Transportation__* covers all transportation services (sea, air and land), bought and sold, that involve the carriage of passengers, movement of goods (freight), charter of carriers with crew and other supporting services.

iv. *__Other Services__* are accorded great prominence in the balance of payments and reflect the growing importance of international services in world trade.

Other Services consist of the purchase and sale of:

- Communication services
- Construction services
- Insurance services
- Financial services
- Computer and information services
- Royalties and licences fees
- Personal, cultural and recreational services, and
- Government services

b. *__Income__* encompasses the compensation of employees, i.e. salaries, wages and benefits of seasonal and other non-resident workers. In addition, it includes investment income that consists of dividends, profits, reinvested earnings, interest on debt and income on portfolio investment.

c. **Current transfers** cover transactions such as taxes on income, workers' remittances, and premiums and claims on non-life insurance.

2. Capital and Financial Account

The Capital and Financial Account records transactions that directly affect the wealth and debt of the country. The account is sub-divided into two main categories:

a. The Capital Account, and
b. The Financial Account

a. The Capital Account covers (i) capital transfers and (ii) the acquisition/disposal of non-produced, non-financial assets.

(i) Capital transfers include the transfer of ownership of fixed assets, the transfer of funds linked to disposal/acquisition of fixed assets and the cancellation of debt by creditors. Acquisition/disposal of non-produced, non-financial assets mainly involves intangibles such as patents and leases. It also includes purchases and sales of land by foreign embassies.

b. The Financial Account covers (i) direct investment, (ii) portfolio investment, (iii) other investments (trade credits, loans, currencies and deposits) and (iv) changes in reserves.

(i) ***Direct investment*** is the category of international investment in which a resident entity in one economy acquires or disposes of 10 per cent or more of the ordinary shares or voting power of an enterprise located in another economy and has an effective voice in management. The resident entity is referred to as the direct investor and the enterprise is the direct investment enterprise. The components of direct investment are: equity capital, reinvested earnings and inter company debt transactions.

(ii) ***Portfolio Investment*** covers transactions in equity securities and debt securities. With respect to equity a portfolio investment would imply less than 10 per cent ownership of the voting power of an enterprise located in another country. Debt securities include bonds and notes, money market instruments and financial derivatives. The essential characteristic of these instruments is that they are tradable. This means these instruments offer investors the flexibility to shift invested capital from one instrument to another.

(iii) ***Other investment*** is a residual category that includes all financial transactions not covered in direct investment, portfolio investment or reserve assets. It includes trade credits, (the direct extension of credit by suppliers to buyers of goods and services), loans to finance trade, other loans and advances and financial leases.

(iv) ***The Reserves*** represent the foreign exchange which the country has available for financing an imbalance of payments with the rest of the world. An increase in the reserves of a country (a debit) indicates that there was a surplus from the remanding non-reserve transactions, indicating an overall surplus for the balance of payments and vice versa.

A distinction is made between gross foreign reserves and net foreign reserves. In the case of Jamaica, gross foreign reserves represent the official holdings of foreign assets, by the Central Bank and the Central Government, while gross foreign liabilities are principally liabilities of the Central Bank to the International Monetary Fund (IMF). The difference between the gross foreign assets and liabilities gives the net international reserve position of the country. This can be disaggregated into the net international reserves of the Central Bank and the external assets of the Central Government.

A country's monetary authority normally should not permit reserve holdings to decrease below the level considered minimally appropriate or adequate for the country. A ***common measure of the adequacy of reserve holdings is the ratio of reserve assets to import of goods and services***. This ratio is sometimes expressed as the number of weeks worth of imports of goods and services that could be paid for from the of gross reserve assets. The international benchmark for reserve adequacy is 12 weeks of imports of goods and services.

Main Sources of Data

There are three main sources of data for compiling the balance of payments of Jamaica.

1. Surveys
2. Foreign exchange records
3. Administrative and other documentary sources

1. ***Balance of payments surveys*** of business enterprises and other organizations are conducted at least once per year. Information is requested regarding a company's transactions with the rest of the world. Like all statistical surveys, there are problems such as non-response and incomplete coverage for which estimates have to be done. Since the repeal of the Exchange Control Act, the annual survey has been one of the main sources of data.

2. ***Foreign exchange records*** are also a useful source of balance of payments statistics. However, such records do require adjustments with regard to classification and timing before they satisfy the needs of the balance of payments compiler. Many of the items in the services and financial accounts are prepared from consolidated foreign exchange reports received from the authorized foreign exchange dealers.

3. ***Administrative records***, particularly those kept by government institutions provide data on items such as merchandise trade, foreign loans and official transfers. External trade data is compiled by The Statistical Institute of Jamaica (STATIN) from records maintained by Customs. Estimates of receipts from foreign travel are derived from the number of visitors in various categories compiled by the Jamaica Tourist Board together with the average expenditure of each category. The Bank of Jamaica generates information on the country's foreign exchange reserves in keeping with the Bank's role as custodian of such reserves.

Balance of Payments Standards Presentation (In millions of US dollars)			
	Cr	**Dr**	**Net**
Current Account	**4401.2**	**4617.5**	**-216.3**
A. Goods & Ser vices	**3477.5**	**4008.6**	**-531.1**
Goods	1499.1	2685.6	-1186.5
Transportation	300.3	533.9	-233.6
Travel	1279.6	227.2	1052.4
Other Services	398.5	561.9	163.4
B. Income	**165.8**	**498.3**	**-332.5**
Compensation of employees	94.0	23.7	70.3
Investment Income	71.8	474.6	-402.8
C. Current Transfers	**757.9**	**110.6**	**647.3**
Official	53.5	7.7	45.8
Private	704.4	102.9	601.5
D. Capital Account	**19.1**	**30.0**	**-10.9**
Government capital transfers	4.1	0.0	4.1
Other sectors transfers	15.0	30.0	-15.0
E. Financial Account	**1644.2**	**1415.8**	**228.4**
Direct Investment	523.7	94.9	428.8
Other Investment	965.1	1299.1	-334.0
Reserves	155.4	21.8	133.6
F. Net errors & omissions	**0.0**	**1.2**	**-1.2**

GLOSSARY OF FREQUENTLY USED TERMS

Balance of Payments Manual: This is the standard issued by the International Monetary Fund (IMF), which provides guidance to member countries in the compilation of balance of payments statistics.

Transaction: A transaction is an economic flow between residents and non-residents. Transactions involve changes in ownership of goods and financial assets/liabilities, the provision of services, labour and capital and transfers in cash and kind.

Compensation of Employees: This is income received as remuneration for work. It includes wages and salaries paid to employees, commissions, bonuses, payments in kind and incentive payments in a given time period.

Direct Investor: The direct investor may be an individual; an incorporated or unincorporated private or public enterprise or any other organization that owns direct investment enterprises in an economy other than the one in which the direct investor resides.

Direct Investment Enterprise: A Direct Investment Enterprise is an incorporated or unincorporated company in which a direct investor acquires 10 per cent or more of its ordinary shares or voting power. Most Direct investment enterprises are either branches or subsidiaries.

Foreign Assets: Foreign assets refer to a country's claim on foreigners.

Foreign Liabilities: Foreign liabilities refer to a country's indebtedness to foreigners.

Trade Credits: This is credit that one non-financial firm extends to another for goods and services transactions.

Equity: The value of the ordinary shares issued by a company.

Monetary Policy: Monetary policy describes the use of variations in the quantity of money which may raise or lower interest rates, and hence either directly orindirectly lower or raise aggregate demand.

Fiscal Policy: Fiscal policy describes the use of taxation and expenditure by the government to influence the level of business activity.

PAMPHLETS IN THE SERIES

No.	*Title*	*Author*
1	Monetary Policy Management in Jamaica	Claney Lattie
2	Your Guide to the Jamaican Consumer Price Index	Robert Stennett
3	The Measurement of Money Supply	Michelle Hylton
4	Essential Facts about Inflation	Kevin Harriott
5	How the Foreign Exchange Market Works	Helen McIntosh
6	The Central Bank's Role as Regulator	Noel Shippey Courtney Christie-Veitch
7	Role And Functions Of The Bank of Jamaica	Michelle Hylton
8	Balance Of Payments Made Simple	Fedrica Robinson