

## 19.4: Balance of Payments Accounts- Definitions

### Learning objectives

1. Learn the variety of ways exports and imports are classified in the balance of payments accounts.
2. Understand the distinction between GDP and GNP.

The balance of payments accounts is a record of all international transactions that are undertaken between residents of one country and residents of other countries during the year. The accounts are divided into several subaccounts, the most important being the **current account** and the **financial account**. The current account is often further subdivided into the merchandise trade account and the service account. These are each briefly defined in Table 2.3.

<b>Current Account</b>	Record of all international transactions for <b>goods and services, income payments and receipts, and unilateral transfers</b> . The current account is used in the national income identity for GNP.
<b>Merchandise Trade Account</b>	Record of all international transactions for <b>goods only</b> . Goods include physical items like autos, steel, food, clothes, appliances, furniture, etc.
<b>Services Account</b>	Record of all international transactions for <b>services only</b> . Services include transportation, insurance, hotel, restaurant, legal, consulting, etc.
<b>Goods and Services Account</b>	Record of all international transactions for <b>goods and services only</b> . The goods and services account is used in the national income identity for GDP.
<b>Financial Account</b>	Record of all international transactions for <b>assets</b> . Assets include bonds, Treasury bills, bank deposits, stocks, currency, real estate, etc.

Figure 19.4.1: Table 2.3 Balance of Payments Accounts Summary

The balance on each of these accounts is found by taking the difference between exports and imports.

### Current Account

The current account (CA) balance is defined as  $CA = EX^{G,S,IPR,UT} - IM^{G,S,IPR,UT}$  where the  $G, S, IPR, UT$  superscript is meant to include exports and imports of goods (G), services (S), income payments and receipts (IPR), and unilateral transfers (UT). If  $CA > 0$ , then exports of goods and services exceed imports and the country has a current account surplus. If  $CA < 0$ , then imports exceed exports and the country has a current account deficit.

Income payments represent the money earned (i.e., income) by foreign residents on their investments in the United States. For example, if a British company owns an office building in the United States and brings back to the United Kingdom a share of the profit earned there as a part of its income, then this is classified as an income payment on the current account of the balance of payments.

Income receipts represent the money earned by domestic residents on their investments abroad. For example, if a U.S. company owns an assembly plant in Costa Rica and brings back to the United States a share of the profit earned there as a part of its income, then this is classified as an income receipt on the current account of the balance of payments.

It may be helpful to think of income payments and receipts as payments for entrepreneurial services. For example, a British company running an office building is providing the management services and taking the risks associated with operating the property. In exchange for these services, the company is entitled to a stream of the profit that is earned. Thus income payments are classified as an import, the import of a service. Similarly, the U.S. company operating the assembly plant in Costa Rica is also providing entrepreneurial services for which it receives income. Since in this case the United States is exporting a service, income receipts are classified as a U.S. export.

Unilateral transfers represent payments that are made or received that do not have an offsetting product flow in the opposite direction. Normally, when a good is exported, for example, the good is exchanged for currency such that the value of the good and the value of the currency are equal. Thus there is an outflow and an inflow of equal value. An accountant would record both sides of this transaction, as will be seen in the next section. However, with a unilateral transfer, money flows out, but nothing comes back in exchange or vice versa. The primary examples of unilateral transfers are remittances and foreign aid. Remittances occur when a person in one country transfers money to a relative in another country and receives nothing in return. Foreign aid also involves a transfer, expecting nothing in return.

## Merchandise Trade Balance

The merchandise trade balance (or goods balance) can be defined as  $GB = EX^G - IM^G$ , where we record only the export and import of merchandise goods. If  $GB > 0$ , the country would have a (merchandise) trade surplus. If  $GB < 0$ , the country has a trade deficit.

## Services Balance

The service balance can be defined as  $SB = EX^S - IM^S$ , where we record only the export and import of services. If  $SB > 0$ , the country has a service surplus. If  $SB < 0$ , the country has a service deficit.

## Goods and Services Balance

The goods and services balance (or goods balance) can be defined as  $GSB = EX^{G\&S} - IM^{G\&S}$ , where we record the export and import of both merchandise goods and services. If  $GSB > 0$ , the country would have a goods and services (G&S) surplus. If  $GB < 0$  the country has a G&S deficit. Note that sometimes people will refer to the difference  $EX^{G\&S} - IM^{G\&S}$  as net exports. Often when this term is used the person is referencing the goods and services balance.

Here it is important to point out that when you hear a reference to a country's trade balance, it could mean the merchandise trade balance, or it could mean the goods and services balance, or it could even mean the current account balance.

Occasionally, one will hear trade deficit figures reported in the U.S. press followed by a comment that the deficit figures refer to the "broad" measure of trade between countries. In this case, the numbers reported refer to the current account deficit rather than the merchandise trade deficit. This usage is developing for a couple of reasons. First of all, at one time, around thirty years ago or more, there was very little international trade in services. At that time, it was common to report the merchandise trade balance since that accounted for most of the international trade. In the past decade or so, service trade has been growing much more rapidly than goods trade and it is now becoming a significant component of international trade. In the United States, service trade exceeds 30 percent of total trade. Thus a more complete record of a country's international trade is found in its current account balance rather than its merchandise trade account.

But there is a problem with reporting and calling it the current account deficit because most people don't know what the current account is. There is a greater chance that people will recognize the trade deficit (although most could probably not define it either) than will recognize the current account deficit. Thus the alternative of choice among commentators is to call the current account deficit a trade deficit and then define it briefly as a "broad" measure of trade.

A simple solution would be to call the current account balance the "trade balance" since it is a record of all trade in goods and services and to call the merchandise trade balance the "merchandise goods balance," or the "goods balance" for short. I will ascribe to this convention throughout this text in the hope that it might catch on.

## GDP versus GNP

There are two well-known measures of the national income of a country: GDP and GNP. Both represent the total value of output in a country during a year, only measured in slightly different ways. It is worthwhile to understand the distinction between the two and what adjustments must be made to measure one or the other.

Conceptually, the gross domestic product (GDP) represents the value of all goods and services produced within the borders of the country. The gross national product (GNP) represents the value of all goods and services produced by domestic factors of production.

Thus production in the United States by a foreign-owned company is counted as a part of U.S. GDP since the productive activity took place within the U.S. borders, even though the income earned from that activity does not go to a U.S. citizen. Similarly,

production by a U.S. company abroad will generate income for U.S. citizens, but that production does not count as a part of GDP since the productive activity generating that income occurred abroad. This production will count as a part of GNP though since the income goes to a U.S. citizen.

The way GDP versus GNP is measured is by including different items in the export and import terms. As noted above, GDP includes only exports and imports of goods and services, implying also that GDP excludes income payments and receipts and unilateral transfers. When these latter items are included in the national income identity and the current account balance is used for  $EX - IM$ , the national income variable becomes the GNP. Thus the GNP measure includes income payments and receipts and unilateral transfers. In so doing, GNP counts as additions to national income the profit made by U.S. citizens on its foreign operations (income receipts are added to GNP) and subtracts the profit made by foreign companies earning money on operations in the U.S. (income payments are subtracted).

To clarify, the national income identities for GDP and GNP are as follows:

$$GDP = C + I + G + E^{G\&S} - IM^{G\&S}$$

and

$$GNP = C + I + G + EX^{G,S,IPR,UT} - IM^{G,S,IPR,UT}$$

## Financial Account Balance

Finally, the financial account balance can be defined as  $KA = EX^A - IM^A$ , where  $EX^A$  and  $IM^A$  refer to the export and import of assets, respectively. If  $KA > 0$ , then the country is exporting more assets than it is importing and it has a financial account surplus. If  $KA < 0$ , then the country has a financial account deficit.

The financial account records all international trade in assets. Assets represent all forms of ownership claims in things that have value. They include bonds, Treasury bills, stocks, mutual funds, bank deposits, real estate, currency, and other types of financial instruments. Perhaps a clearer way to describe exports of assets is to say that *domestic assets are sold to foreigners*, whereas *imports of assets mean foreign assets that are purchased by domestic residents*.

It is useful to differentiate between two different types of assets. First, some assets represent IOUs (i.e., I owe you). In the case of bonds, savings accounts, Treasury bills, and so on, the purchaser of the asset agrees to give money to the seller of the asset in return for an interest payment plus the return of the principal at some time in the future. These asset purchases represent borrowing and lending. When the U.S. government sells a Treasury bill (T-bill), for example, it is borrowing money from the purchaser of the T-bill and agrees to pay back the principal and interest in the future. The Treasury bill certificate, held by the purchaser of the asset, is an IOU, a promissory note to repay principal plus interest at a predetermined time in the future.

The second type of asset represents ownership shares in a business or property, which is held in the expectation that it will realize a positive rate of return in the future. Assets, such as common stock, give the purchaser an ownership share in a corporation and entitle the owner to a stream of dividend payments in the future if the company is profitable. The future sale of the stock may also generate a capital gain if the future sales price is higher than the purchase price. Similarly, real estate purchases—say, of an office building—entitle the owner to the future stream of rental payments by the tenants in the building. Owner-occupied real estate, although it does not generate a stream of rental payments, does generate a stream of housing services for the occupant-owners. In either case, if real estate is sold later at a higher price, a capital gain on the investment will accrue.

An important distinction exists between assets classified as IOUs and assets consisting of ownership shares in a business or property. First of all, IOUs involve a contractual obligation to repay principal plus interest according to the terms of the contract or agreement. Failure to do so is referred to as a default on the part of the borrower and is likely to result in legal action to force repayment. Thus international asset purchases categorized as IOUs represent international borrowing and lending.

Ownership shares, on the other hand, carry no such obligation for repayment of the original investment and no guarantee that the asset will generate a positive rate of return. The risk is borne entirely by the purchaser of the asset. If the business is profitable, if numerous tenants can be found, or if real estate values rise over time, then the purchaser of the asset will make money. If the business is unprofitable, office space cannot be leased, or real estate values fall, then the purchaser will lose money. In the case of international transactions for ownership shares, there is no resulting international obligation for repayment.

### Key takeaways

- The *trade balance* may describe a variety of different ways to account for the difference between exports and imports.
- The current account is the broadest measure of trade flows between countries encompassing goods, services, income payments and receipts, and unilateral transfers.
- The merchandise trade balance is a more narrow measure of trade between countries encompassing only traded goods.
- Net exports often refer to the balance on goods and services alone.
- GDP is a measure of national income that includes all production that occurs within the borders of a country. It is measured by using the goods and services balance for exports and imports.
- GNP is a measure of national income that includes all production by U.S. citizens that occurs anywhere in the world. It is measured by using the current account balance for exports and imports.
- The financial account balance measures all exports and imports of assets, which means foreign purchases of domestic assets and domestic purchases of foreign assets.

### Exercises

1. **Jeopardy Questions.** As in the popular television game show, you are given an answer to a question and you must respond with the question. For example, if the answer is “a tax on imports,” then the correct question is “What is a tariff?”
  - A record of all international transactions for goods and services.
  - A record of all international transactions for assets.
  - The name of the balance of payments account that records transactions for goods.
  - The term used to describe the profit earned by domestic residents on their foreign business operations.
  - The term used to describe the profit earned by foreign residents on their domestic business operations.
  - The term used to describe remittances because they do not have a corresponding product flow to offset the money export or import.
  - Of *net importer* or *net exporter* of services, this describes a country that has more income payments than income receipts.
  - This measure of national output includes only the imports and exports of goods and services in its trade balance.
  - This measure of national output includes income payments and receipts in its trade balance.

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