Balance of Payments Textbook

INTERNATIONAL MONETARY FUND

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Contents

Foreword

The *Balance of Payments Textbook* (the *Textbook*) is the second of two companion documents to the fifth edition of the *Balance of Payments Manual* (the *Manual*), which was published by the International Monetary Fund in 1993. The fifth edition of the *Manual* addresses the many important changes that have occurred in international transactions, harmonizes (as closely as possible) balance of payments concepts with the revised *System of National Accounts 1993* and other IMF statistical methodologies, and covers the important topic of international investment position statistics. The *Balance of Payments Compilation Guide*, published by the IMF in 1995, offers practical direction for using established and emerging data sources and applying or adapting a variety of methods to compile statistics for the balance of payments and the international investment position. Publication of the *Balance of Payments Textbook* completes the trilogy that provides a comprehensive range of information on the compilation of balance of payments statistics and will, it is hoped, make a significant contribution to the understanding of balance of payments issues.

The *Textbook* is intended as one of the main reference materials for training courses in balance of payments methodology. Such courses may be conducted—under the aegis of the IMF Institute—by the Statistics Department at IMF headquarters in Washington, DC or organized externally. The *Textbook* is designed to provide illustrative examples and applications of concepts, definitions, classifications, and conventions contained in the *Manual* and to afford compilers with opportunities for enhancing their understanding of the relevant parts of the *Manual*.

The *Textbook* was produced by the IMF Statistics Department under the supervision of Mr. Mahinder S. Gill, assistant director, Balance of Payments and External Debt Division I (BOPED I). The task of drafting and finalizing the *Textbook* was undertaken by Mr. Peter Harper, an economist in BOPED I. Ms. Nancy W. Basham edited and coordinated print production of the *Textbook*, and Ms. Suzanna Persaud, administrative staff assistant in BOPED I, typed the final version.

I am hopeful that the *Textbook*, as part of the comprehensive range of documentation on balance of payments methodology now available, will make a significant contribution to the training of compilers as well as users of balance of payments statistics.

John B. McLenaghan
Director, Statistics Department
International Monetary Fund

I. The Balance of Payments Conceptual Framework

1. Balance of payments statistics are included in a broad set of economic statistics known as the **national accounts**. The *System of National Accounts 1993* (1993 *SNA*) presents the conceptual framework for the national accounts, and the fifth edition (1993) of the *Balance of Payments Manual* (the *BPM*) presents the conceptual framework and the structure and classification of the balance of payments. The high level of concordance between the 1993 *SNA* and the *BPM* is extremely important.[1] This first chapter of the *Balance of Payments Textbook* (the *Textbook*) presents the balance of payments conceptual framework and certain internationally agreed-upon accounting conventions that have influenced the shape of that framework. These concepts and specific aspects of methodology are elaborated in subsequent *Textbook* chapters.

Definition of the Balance of Payments

2. As defined in the *BPM*, the **balance of payments** (BOP) is *a statistical statement that systematically summarizes, for a specific time period, the economic transactions of an economy with the rest of the world. Transactions, for the most part between residents and nonresidents, consist of those involving goods, services, and income; those involving financial claims on, and liabilities to, the rest of the world; and those (such as gifts) classified as transfers, which involve offsetting entries to balance—in an accounting sense—one-sided transactions.* Each component of this important definition is subsequently examined.

3. The balance of payments is concerned with **transactions** and thus deals with flows rather than with stocks. That is, the balance of payments deals with economic events that take place during a reference period and not with outstanding totals of economic assets and liabilities that exist at particular moments in time.

4. The initial focus of the *Textbook* is on transactions (between an economy and the rest of the world) in goods, services, and income. Under what circumstances does an international economic occurrence constitute a transaction in the BOP sense of the word? In the framework of the national accounts, transactions in goods, services, or income are the provision, by one party to another, of real resources of this kind. Thus defined, a transaction involves two parties or transactors. It is not always clear, however, that there are two parties. Real resources are often transferred internationally from one constituent unit to another within the same legal entity. (For example, real resources may be transferred between a branch and the head office of a multinational enterprise.) It is equally difficult to determine whether transactions take place when individuals migrate and transfer assets from their former to their new countries. How should real resources that accompany migrating individuals be regarded? Such movements of resources do not involve two parties although, in the process, the wealth of some economies is diminished (countries of emigration) and the wealth of other economies is increased (countries of immigration). When individuals migrate, the economic impact of the shifts in real resources is similar to that of flows of resources between two parties. It is therefore possible to regard these shifts as transactions in a restricted sense. The determination of what constitutes a transaction must not be made strictly on the basis of logic but through adoption of generally agreed-upon conventions. For the sake of convenience, the term *transaction* is often used broadly in the *BPM* to refer to any sort of flow or change that is, by convention, shown in the balance of payments.

5. The *BPM* definition (see paragraph 2 on this page) of the balance of payments also includes transactions in an economy's external financial assets and liabilities. These transactions arise from (a) the creation or extinction of an external financial asset or liability or (b) from a change in the ownership of an existing external financial asset and

[1]The relationship between BOP statistics and national accounts statistics is described in detail in chapter 3 of the *BPM*.

liability. Transactions that involve external financial assets and two resident parties and transactions that involve external financial liabilities and two nonresident parties are, theoretically, included in the balance of payments.[2] Often, these transactions are transparent in the BOP presentation. However, some BOP presentations explicitly reflect these transactions if (for transactions in external financial assets) the two residents are in different sectors of the economy or if (for transactions involving external financial liabilities) the two nonresidents are residents of different countries.

6. An issue of frequent debate is whether BOP coverage should be restricted to transactions or whether, at the other extreme, the BOP statement should show all changes in the value of an economy's holdings of external financial items. Opinions have differed, and conventions reflecting different analytic approaches have been suggested. The conventions recommended in the fifth edition of the *BPM* generally require a narrow view of BOP coverage.

7. This narrow view of BOP coverage should be considered in relation to the closely connected, stock-oriented international investment position. The **international investment position** (IIP) is *a statistical statement (compiled as of a specific date such as year end) of the value and composition of an economy's claims on the rest of the world and the value of that economy's financial liabilities to the rest of the world.* The difference between an economy's stock of international financial assets and financial liabilities is that part of an economy's net worth attributable to, or derived from, its external sector.

8. Those who are more interested in changes in an economy's holdings of external financial items than in transactions in these items can obtain the necessary information by calculating the difference between IIP statements compiled for different periods. In addition to changes in BOP transactions, the difference will reflect valuation changes (such as those associated with movements in exchange rates or in prices of financial items) and other adjustments (such as uncompensated seizures and debt write-offs).

[2]Such transactions are included for pragmatic reasons and to increase the analytical usefulness of the statistics. For additional discussion on this topic, see paragraphs 454–455 of chapter 8 of the *Textbook*.

Double Entry System

9. The balance of payments is a statistical statement structured in systematic fashion; data in the statement are presented according to specific accounting rules. The basic accounting convention for a BOP statement is that every recorded transaction is represented by two entries with exactly equal values. In a BOP statement, the two entries are used to recognize the giving and receiving sides of every transaction. Therefore, the BOP statement is analogous to a typical financial statement prepared in accordance with the double entry system regularly used for business accounting.

10. The dual entry system underlying BOP accounting is governed by certain rules. Thus, in conformity with business and national accounting, in the balance of payments, the term *credit* is used to denote a reduction in assets or an increase in liabilities, and the term *debit* is used to denote a reduction in liabilities or an increase in assets. This usage has been supplemented by the rule that every recording of a debit movement shall be matched by the recording of a credit movement and vice versa. For example, Dromesia borrows 200,000 units in Cromanian currency from the government of Cromania and deposits the money with a Cromanian commercial bank. Dromesia then acquires an asset (the bank balance) as well as incurring a liability (the debt to the government of Cromania). The asset account is debited, and the liability account is credited. The Dromesian BOP entries to record the transaction are:

	Credit	**Debit**
Liabilities (obligation to Cromania)	200,000	
Assets (bank balance in Cromania)		200,000

11. In the preceding (and in succeeding) statements, credits are entered on the left-hand side, and debits are entered on the right-hand side. This traditional practice in BOP accounting differs from commercial accounting procedure in some countries.

12. Changes in assets are, of course, associated with many other types of change besides changes in liabilities. An increase in one asset may be associated with a decrease in another. For example, Mr. Jones in Cromania purchases goods from Mrs. Smith in Dromesia but does not pay for them. Mrs. Smith's claim against Mr. Jones is a trade credit and an asset of Dromesia. When Mr. Jones pays this debt in Cromanian currency, Dromesia's trade credit assets are decreased and its foreign currency assets are

increased. According to the rule stated in paragraph 10, the increase in one asset (foreign currency) is recorded as a debit, and the decrease in the other asset (trade credit) is recorded as a credit. As always, the debit is offset by an equal credit. If the goods purchased by Mr. Jones are worth 1,000 units, the two entries in Dromesia's balance of payments would be:

	Credit	Debit
Assets (trade credit)	1,000	
Assets (foreign currency)		1,000

13. An increase in one liability may be associated with a decrease in another. If the example in paragraph 12 is viewed from Cromania's perspective, the trade credit owed to Mrs. Smith is a liability. When Mr. Jones pays for the goods in Cromanian currency, the trade credit liability ceases to exist. In its place, the Cromanian banking system incurs a liability (in the form of a deposit in Cromanian currency) to a resident of Dromesia. The increase in the bank's liability is recorded as a credit, and the decrease in Cromanian trade credit liability is shown as a debit. The balance of payments entries are:

	Credit	Debit
Liability (bank deposit)	1,000	
Liability (trade credit)		1,000

14. On the basis of rules stating that an increase in assets is recorded as a debit, that an increase in liabilities is recorded as a credit, and that every credit entry is matched by a corresponding debit entry, accounting conventions can be formulated for credits and debits in the balance of payments. Under the conventions of the system, the compiling economy records credit entries for (a) exports of goods, provision of services, provision of the factors of production to another economy and (b) financial items reflecting a reduction in the economy's external assets or an increase in external liabilities. Conversely, the compiling economy records debit entries for (a) imports of goods, acquisition of services, use of production factors provided by another economy and (b) financial items reflecting an increase in assets or a decrease in liabilities. In other words, for real or financial assets, a positive figure (credit) indicates a decrease in holdings, and a negative figure (debit) indicates an increase. For liabilities in the form of financial instruments, the rule is reversed; a positive figure indicates an increase and a negative one, a decrease.

15. Most entries in the balance of payments pertain to transactions in which economic values are provided or acquired in exchange for other economic values. Offsetting credit and debit entries required by the recording system are often the automatic result of two entries of equal amount being made for two items that have been exchanged. For example, a commodity import is recorded in the statistics for goods, and payment for that import is recorded in the banking statistics for changes in assets or liabilities. When items are donated or when recordings are one-sided for other reasons, only one aspect of the transaction is recorded automatically in source data. Special types of entries called *transfers* are made in the balance of payments to provide the required offsets. Transfers are shown as credits when the entries for which the transfers provide offsets are debits and as debits when those entries are credits.

16. In summary form, double entry accounting conventions used in the balance of payments consist of:

Credit (CR) entries
Exports of goods and services
Income receivable
Offsets to real or financial resources received without a quid pro quo (transfers)
Increases in liabilities
Decreases in financial assets

Debit (DR) entries
Imports of goods and services
Income payable
Offsets to real or financial resources provided without a quid pro quo (transfers)
Increases in financial assets
Decreases in liabilities

17. Techniques of BOP analysis are largely based on the double entry recording system of BOP statements. BOP analysis identifies and groups transactions that are *autonomous* (undertaken for their own sake) and all other transactions that can be characterized as flows induced to finance autonomous transactions. When entries are divided—on the basis of these or any other characteristics—into two groups, the sums of the two groups will (in theory) be numerically equal and have opposite signs.[3] The principal focus of BOP analysis is on the selection of characteristics to be isolated and the subsequent examination of relationships between the resultant partial balances that can be constructed.

[3]The achievement of such equality is unlikely in practice because of errors and omissions.

Concept of an Economy

18. In general, the balance of payments is a record of economic flows occurring between residents of one economy and residents of the rest of the world. An *economy* is defined as an economic entity having a center of economic interest within a specific territory. *Economy* is thus nearly synonymous with *country* as the balance of payments (in practice) usually deals with transactions between nations. In theory, an economy can represent a small portion of a large national territory. An economy may also consist of more than one country—for example, the Economic Union of Belgium and Luxembourg. In addition, it is possible to consider the balance of payments of such regional groups as the European Union (EU) and the balance of payments of each group member. (See chapter 4 of the *BPM* and chapter 2 of this *Textbook* for the definition of resident economic entities and guidelines for distinguishing them from nonresident economic entities.)

Principles for Valuation and Time of Recording; Unit of Account and Procedures for Conversion

19. As BOP transactions are diverse, the *BPM* provides clear guidance on how to value transactions and in which periods the transactions should be recorded. In addition, because transactions may be denominated in many currencies, BOP statisticians should be sure to select the most appropriate unit of account in which to express the statement and the best procedures for converting flows from transaction currencies into the unit of account.

Valuation

20. The application of a uniform principle of valuation to all transactions recorded in the balance of payments is necessary for three reasons. First, as each transaction has two aspects, the double entry accounting rule would be violated if credit and debit entries did not possess the same values. Second, the absence of a uniform valuation principle would make it impossible to compare the BOP statement of one country with the BOP statements of other countries because the valuation of entries made by partner countries would lack symmetry. Third, were a uniform valuation system not used, items recorded in the balance of payments could not be compared with one another, and serious problems of interpretation would be created for data users. Questions concerning the valuation of transactions are not limited to BOP statistics; similar problems arise for compilers of national accounts. For both BOP and national accounting systems, the solution has been to adopt a uniform basis for pricing.

21. The assignment of value to an economic transaction on the basis of price is by no means straightforward. A range of prices may exist for any asset. For example, for commodities, there may be quoted prices or list prices at both wholesale and retail levels. The same commodity may be priced differently in geographically separated markets. Customs authorities of various countries may compile price lists for use in assessing duties to be paid. The balance sheets of enterprises may carry real assets valued in terms of production costs (if the enterprises produced the articles), in terms of acquisition or historical costs, in terms of depreciated replacement costs, or in terms of market values. In transactions conducted between affiliated enterprises, transfer pricing may be utilized. In general, however, transactions between such enterprises will be valued at the purchase or sales prices that would be realized in commercial exchanges made under "arm's length" conditions.

22. Market prices are widely used in the general field of economics as a means to measure the deployment of resources. The use of market prices for valuing transactions is therefore recommended in the *BPM* and is consistent with the 1993 *SNA*. Admittedly, there may be some practical problems in implementing this recommendation. Adjustments may be required for the reported values of a large number of individual transactions, and it may be difficult to determine suitable market price proxies for transactions that have not actually taken place in a market. Nevertheless, no other principle of valuation can measure the economic value of resources transferred between economies in an equally meaningful way.

23. *Market price* is defined, for both the balance of payments and the national accounts, as the amount of money that a willing buyer pays to acquire something from a willing seller when both are independent parties and when all considerations are solely commercial. A *market price* is the price paid in one specific exchange made under the previously stated conditions. A second exchange that involves an identical unit and is completed under exactly or nearly the same circumstances could be made at a different market price. Defined in this way, a market

price is clearly distinguished from a price quoted in the market, a world market price, a going price, a fair market price, or any price intended to express the generality of prices for a class of supposedly identical exchanges rather than the one price that the goods actually fetch. Furthermore, a market price should not necessarily be considered equivalent to a *free market price*. That is, a market transaction should not be interpreted as occurring exclusively in a purely competitive market. In fact, a market price could be determined in a monopolistic or monopsonistic market or in any other market that is not wholly free. Indeed, the market may be so narrowly defined that it consists of a sole transaction of the kind between independent parties.

24. The essential characteristic of the market in which prices used in the balance of payments are found is the absence of any relationship between the parties to a particular transaction. That is, the transactors are independent. If this condition exists, a particular transaction can be described as a market-oriented transaction. The criterion of independence between transactors is the **opposite** of this definition of associated transactors:

Two persons shall be deemed to be associated in business with one another if, whether directly or indirectly, either of them has any interest in the business or property of the other or some third person has an interest in the business or property of both of them. (Customs Cooperation Council, ***Brussels Definition of Value***, Article 11)

25. In concept, all stocks of assets and liabilities comprising a country's international investment position are recorded on the basis of market value. The underlying assumption is that such stocks are continuously (regularly) revalued at current prices by, for example, reference to actual market prices for financial assets such as shares and bonds or, in the case of some direct investments, by revalued enterprise balance sheets reflecting market value.

26. Chapter 5 of the *BPM* contains a complete discussion of problems related to the use of market prices for valuation of flows and stocks as well as proposed solutions to be effected through use of proxy measures when the conditions of a market transaction are absent.

Time of Recording

27. As previously stated, a BOP statement is constructed on the double entry system; every transaction is represented by a credit and a debit. Both sides of a transaction—each credit and corresponding debit—should be recorded simultaneously, and the same time or date of occurrence should be recorded by both parties to a transaction. To ensure uniformity, a principle is required to determine the time at which a transaction is entered in the balance of payments. The requirement for a uniform time of recording is analogous to that for a uniform basis of valuation.

28. Each economic transaction proceeds through a succession of stages to which specific dates can be assigned. For example, two transactors agree to conduct a set of transactions. A specific date, the time of contract or commitment, can be assigned to the time that the formal agreement is executed. Contract provisions are subsequently implemented. Commodities are delivered to the purchaser or services are rendered. Claims for payment then devolve. When payment is made, the financial claim—which was created when the seller provided real resources to the buyer—is settled. Specific dates can be assigned to all these events. The two most important events, which are usually relevant for any contract, are (1) the time of contract and (2) the time when legal ownership of the assets changes. While the change in ownership is effected by the delivery of an asset, the ensuing financial claim may not be settled until a later period.

29. Each successive stage of a contract has significance from an economic standpoint. At the time of commitment, the price—or the basis for determining the price—is generally fixed for each transaction covered under the contract. The risk is thereby assigned for any price changes that may subsequently occur. The date when the ownership of assets changes is of prime significance in economic analyses based on the national accounts and the balance of payments because both are mainly concerned with recording exchanges of economic values. By definition, such exchanges occur when ownership of assets changes. Usually, change of ownership is also, in the accounting records of enterprises, the most meaningful stage in contract fulfillment. Such records are often the source of BOP data. Thus, for many reasons, the *BPM* states that the time at which ownership changes is the time at which a transaction is recorded. The BOP principle for uniform time of recording conforms with that of the national accounts.

30. A common transaction consists of an exchange, which is made between two enterprises, of goods

for financial assets. Entries for such an exchange are made in each company's accounting records. The entries show dates for, in the accounting records of one company, the acquisition of goods and the relinquishment of a financial asset and, in the accounting records of the other, the acquisition of a financial asset and the relinquishment of goods. Ideally, both parties record their entries as of the same date. This method of recording provides a fixed point of time to which a BOP transaction may be related.

31. Under the change of ownership criterion and the conventions for implementing it, rules can be formulated to produce consistent times of recording for most other types of transactions. For further discussion of these rules and practical application of the change of ownership concept, see chapter 6 of the *BPM*.

Unit of Account and Procedures for Conversion

32. The numerous individual transactions that make up the balance of payments of any country are likely to be denominated in a variety of currencies (for example, the domestic currency, internationally used currencies such as the U.S. dollar, and currencies of trading partners). Transactions in diverse currencies must be converted to a single unit of account before being summed and combined under the headings of a single statement. A country's BOP statistics are normally expressed in domestic currency as the data are used in conjunction with other national statistics. However, if the domestic currency undergoes major changes in relationship to other currencies, it may also be necessary to compile the national balance of payments in a more stable currency. Compilation of a country's balance of payments in a non-domestic currency may be useful, as well, for international comparisons. Discussed in subsequent paragraphs are the selection of a currency or some other unit of account for the BOP statement and procedures for converting data expressed in transaction currencies to domestic currency or some other unit of account.

33. It is preferable that the balance of payments be expressed in a stable unit of account. Stability in this context is specifically defined. A unit of account is considered stable when the prices of international transactions expressed in that unit are not affected by changes (relative to the unit) in the values of the transaction currencies. For example, if there were—as a result of a general realignment of currency relationships—a decrease of 10 percent in the value of transactions conducted in deutsche marks, an increase of 5 percent in the value of transactions conducted in U.S. dollars, and little or no change in the value of transactions conducted in special drawing rights (SDRs), the latter could be described as a relatively stable unit of account. Transactions expressed in a unit that is stable in the defined sense may nevertheless reflect price changes attributable to factors other than exchange rate changes. That is, a series expressed in a stable unit of account is not the equivalent of a volume or constant price series from which all price variations have been isolated. A completely stable unit of account does not exist. Nor is it possible, especially during a period of marked fluctuation in relative exchange rates of transaction currencies, to construct an artificial unit of account that is completely stable.

34. To remain consistent with principles that require transactions to be valued at market prices and recorded at the time of change in legal ownership, the exchange rate used in converting values expressed in a transaction currency to values expressed in the unit of account is the market rate prevailing when change of ownership occurs for a particular transaction. If this conversion method is not used, the market value—in terms of a unit other than the transaction currency—is not a single, determinate value but one that varies as the relationship between transactors changes.

35. Actual dates may not be available for some transactions that must be converted from one currency to another. These cases require the use of market rates prevailing during the periods in which the transactions are recorded in the balance of payments. By applying these averages for limited periods (months are preferred to quarters and quarters are preferred to years) to data aggregated for use in the balance of payments, statisticians can obtain approximate equivalents in which a certain degree of distortion must be accepted.

36. The exchange rate prevailing on the statement date of the international investment position is recommended for use in converting data on stocks of external financial assets and liabilities.

37. The existence of multiple official exchange rates indicates implicit taxes and government subsidies of economic units involved in transactions. The imputed tax or subsidy can be estimated from the difference between the actual exchange rate applicable to a specific transaction and a rate

calculated as a weighted average of all official rates used for foreign exchange transactions. It is suggested that compilers use a single rate for the balance of payments; otherwise, transactions would be expressed at values that include elements of transfers—most of which involve two resident parties. For practical reasons, this rate may be the official exchange rate predominant in the economy rather than the weighted average of all official rates. For transactions involving parallel (black) market rates, actual transaction rates should be used to value both flows and stocks as there are no official taxes or subsidies implicit in these transactions. The use of actual exchange rates applicable to specific assets or liabilities is recommended, in the *BPM*, for conversions in the international investment position.

Coverage of the Balance of Payments

38. Many international transactions recorded in the balance of payments do not involve payments of money. To provide a comprehensive record of an economy's transactions with the rest of the world, the balance of payments includes some transactions that do not give rise to immediate money payments and some transactions that do not elicit any such payments. The inclusion of transactions other than those involving money payments constitutes the principal difference between a BOP statement and an exchange record.

39. In the following paragraphs, categories of transactions are discussed in the context of limits that should be set for BOP coverage.

Exchanges

40. Most transactions likely to be recorded in the balance of payments may be characterized as exchanges in which one transactor provides an economic value to another transactor and receives an equal value in return. Economic values are goods and services; incomes receivable for use of the factors of production; non-produced, nonfinancial assets (such as patents and copyrights); and financial resources. Within such exchanges, four types of economic transactions may be distinguished.

Exchanges of Goods and Services for Financial Items

41. For example, an exporter in Coonawarra sells commodities worth 10 units to an importer in Pokolbin and receives payment in foreign exchange. The exporter (one transactor) thus provides economic value in the form of commodities to an importer (the other transactor) and, in return, receives an equivalent amount of economic value in the form of foreign exchange. BOP entries for the economies of the two transactors are:

	Coonawarra		**Pokolbin**	
	Credit	**Debit**	**Credit**	**Debit**
Commodities	10			10
Financial claims		10	10	

42. A convention is applied for transactions involving exchanges of real resources by two parties that constitute a single legal entity. When a single legal entity is divided, according to the BOP definition of residence, into a domestic and a nonresident enterprise (i.e., a parent company and its branch), a change of ownership is imputed even when the same legal entity is both buyer and seller.

Payment for, or Receipt of Income on, the Factors of Production

43. These flows are included in the balance of payments if one of the transactors supplies economic value in the form of factors of production (e.g., labor and financial capital) and receives, in return, economic value in the form of financial resources.

Barter (Exchange of Goods and Services for Other Goods and Services)

44. BOP entries for both transactors are made in the **current account**.

Exchanges of Financial Items for Other Financial Items

45. Such exchanges may consist, for example, of securities sold for money or commercial debts repaid with money. In the first case, one transactor (the seller of the securities) provides economic value to the other transactor (the buyer) in the form of a financial instrument representing a claim payable in money, which is a financial instrument as well. In the second case, the transactors also exchange economic value in the form of financial instruments. The composition of the creditor's asset portfolio is affected as a result of the exchange of economic values, and the debtor's indebtedness is reduced.

46. Provision of a financial item may result, not only in a change in the ownership of an existing claim,

but also in the creation of a new claim or the cancellation of an existing claim. For instance, an existing loan may be refinanced. This act is recorded in the balance of payments as the settlement of an old debt and the creation of a new one. The entries are:

Repayment of an existing loan	debit
Drawing on a new loan	credit

In this case, contract terms pertaining to the maturity date of a financial item are altered by agreement between the parties; the refinancing extinguishes the claim under the original contract and replaces it with a different one.

47. The four types of exchanges discussed in preceding paragraphs are covered by the balance of payments if the transactors are residents of different economies or if both transactors are not residents of the economy that is the debtor for the financial item in which the transactors are dealing. The balance of payments primarily registers changes in economic relationships between transactors residing in different countries or economies. The structure of the BOP ***financial account*** provides for certain financial flows to be differentiated by economic sectors. If two resident transactors from different sectors in the reporting economy enter into an exchange involving financial claims on a nonresident, this intra-residential transaction in external financial assets would be recorded in the balance of payments. For example, banks of a reporting economy could acquire treasury bills of foreign governments from the private sector of the economy. This strictly domestic exchange nonetheless requires a BOP entry because of the way the ***financial account*** is structured. The entries are:

Short-term assets of private sector	credit
Short-term assets of banks	debit

48. The possibility of two resident transactors engaging in an exchange of liabilities is very slim; it is not likely that the debtor would be able to transfer his debt to another entity without the express consent of the creditor. The acquisition, by one resident entity, of the liabilities of another resident is therefore viewed as two separate transactions. The first resident redeems his indebtedness to the nonresident party who, in turn, re-lends to the second resident entity. For the debtor economy, the BOP entry is:

First resident's liabilities	debit
Second resident's liabilities	credit

Transfers

49. When, from the points of view of both transactors, the provision and acquisition of economic values is two-sided, the transaction is characterized as an exchange. However, one transactor sometimes provides an economic value to another transactor and does *not* receive an equivalent value in return. The lack of economic value on the one side must be balanced by an entry referred to in BOP and national accounts as a *transfer*. A transfer is simply a contra entry to the one-sided provision or acquisition of economic values.

50. For instance, if Coonawarra furnishes free clothing and food to alleviate the plight of earthquake victims of Nostaw, Coonawarra is not engaged in an exchange but in a one-sided provision of economic value. As a result of this action, Coonawarra's resources are diminished while those of Nostaw are augmented. Coonawarra receives no economic value in return, and Nostaw gives up no economic value in payment. Coonawarra might, of course, be said to receive an intangible return (gratitude or good will) for the real resources provided to Nostaw, but such intangibles are not tradable as economic values are.

51. Funds or goods recorded as transfers are not provided in exchange for specified amounts of goods, or services purchased voluntarily, or payment of loans or contractual obligations. Transfers between private parties are voluntary, but those to or from governments usually arise from legal obligations to, or legal commitments of, those governments. Whether voluntary or under commitment, the provision and receipt of an economic value without a quid pro quo is shown, by means of a contra entry, as a transfer in the balance of payments.

Territorial Change and Migration

52. The balance of payments deals primarily with transactions between residents of an economy and residents of other economies. As, for BOP purposes, an economy comprises the economic entities associated with its territory, the scope of an economy could be affected by changes in its territory or by changes in the status of entities associated with the economy.

53. A change in the territory of an economy results in a change in the status of any entities associated

with that territory. That is, with respect to the former economy, residents become nonresidents and, with respect to the new economy, nonresidents become residents. For example, the economy of Clintonstan extends its territory into area X, which is part of the economy of Bushland. Entities resident in area X become part of Clintonstan. With the change in territory, former domestic claims on area X are classified, from the perspective of Bushland, as external claims. Clintonstan acquires additional productive facilities, as well as the claims of area X on Bushland. In effect, the net worth of entities associated with area X is transferred from Bushland to Clintonstan. Therefore, if the real resources and capital that an economy provides to or receives from the rest of the world as a result of a change in territory are recorded in the balance of payments, a counterpart entry reflecting the transfer of net worth is also required, from the perspective of the new economy, to balance the statement.

54. The effect of the change in territory can be illustrated by the balance sheet of an enterprise located in area X.

	Assets	**Liabilities**
Fixed assets	1,000	
Deposits in a commercial bank in Bushland	500	
Net worth of owner		1,500

Were it considered desirable to portray in the balance of payments the shift in resources stemming from a territorial change, these entries would be made in the BOP statement of Clintonstan:

	Credit	**Debit**
Goods		1,000
Financial assets		500
Counterpart to territorial change	1,500	

55. However, it is recommended in the *BPM* that changes occurring in an economy's real and financial assets as a result of territorial changes be *excluded* from BOP coverage. The rationale for the exclusion is that territorial changes occur infrequently and can be appropriately viewed as changes in the coverage of reporting economies. Such changes will, however, be reflected in the reporting economy's IIP statistics. The *BPM* treatment of territorial change extends to the creation of new economies from the territory of existing economies (for example, Slovenia, which was created from the former Yugoslavia) or the full absorption of one economy by another (for example, East and West Germany).

56. In contrast to infrequent territorial changes, changes in the residence of individuals are commonplace. The impact of migrating individuals is, however, somewhat similar to that of the cession or acquisition of territory because international creditor or debtor positions are affected by a change in the coverage of individuals comprising an economy. Movable property owned by a migrant is, in effect, imported into the new economy. Fixed assets owned by the migrant and located in the former economy become claims of the new economy on the former economy. The migrant's claims on, or liabilities to, residents (including those of the former economy) of an economy other than the new economy become external claims or liabilities of the new economy, and the migrant's claims on, or liabilities to, residents of the new economy cease to be claims on, or liabilities to, the rest of the world for any economy. The net sum of all these shifts is equal to the net worth of the migrant.

57. The following example illustrates changes resulting from the migration of an individual. Prior to migration, a resident producer in Daniherland operated a business.

Balance Sheet of a Resident Enterprise of Daniherland

Domestic Assets		**Domestic Liabilities**	
Machinery and equipment	5,000	Bank loans	2,000
Inventories	1,500	Trade credits	1,500
Cash	200		
Securities	500		
	7,200		3,500
External Assets		**External Liabilities**	
Claims on residents of Essendonia	800	Trade credits due to residents of Essendonia	1,200
Claims on residents of Nostaw	1,200	Funds borrowed from residents of Nostaw	800
	2,000		2,000
		Net worth of proprietor	*3,700*
Total assets	*9,200*	Total liabilities and net worth	*9,200*

58. The producer ceases business activity in Daniherland and migrates to Essendonia with the intention of engaging in a similar line of economic activity there. The migrating producer takes the capital goods (machinery, equipment, and inventories) used by the enterprise in Daniherland and converts holdings of domestic financial assets

into foreign exchange. The producer also transfers her indebtedness and external financial claims to the new enterprise in Essendonia. As a result, the international investment position of both the country of emigration and the country of immigration are affected. Daniherland, the country of emigration, loses real resources in the form of capital goods and foreign exchange and no longer has 2,000 units of external assets in the form of migrant claims on residents of Essendonia and Nostaw. Simultaneously, Daniherland ceases to have external liabilities to Essendonia and Nostaw. However, Daniherland now has new external assets, in the form of claims on the migrant, of 3,500 units. Essendonia, the country of immigration, acquires real resources of 6,500 units, foreign exchange of 700 units, and external assets (claims on Nostaw) of 1,200 units. Essendonia also assumes external liabilities of 4,300 units (the migrant's debts to residents of Daniherland and Nostaw) and ceases to have external liabilities that were due to amounts (800 units) owed by Essendonian residents to the migrant and external assets (1,200 units) that other residents of Essendonia had extended in trade credits to the migrant. To record these shifts in the balance of payments, the following entries are required:

	Daniherland		**Essendonia**	
	Credit	**Debit**	**Credit**	**Debit**
Goods	6,500			6,500
Financial assets		800		700
Financial liabilities		2,000	3,500	
Transfer of net worth		3,700	3,700	

59. In the *BPM*, it is suggested that all such changes be recorded in the balance of payments. Thus, changes in assets and liabilities that are due to the migration of individuals from one economy to another are covered by the balance of payments. The net sum of all these shifts is equal to the net worth of the migrant, which must be recorded as an offset if the other shifts are recorded. This offset is conventionally included with transfers in the balance of payments.

60. Should transfers that are associated with migration and involve the movement of real and financial resources from one economy to another be considered transactions? In a national accounting sense, a transaction consists of the provision of economic value by one party to another. In this sense, migrants' transfers can be deemed transactions if the migrant is theoretically divided into two persons—one of whom is a resident of the former country and the other, a resident of the new country. Any transfer of real and financial resources from one of these persons to the other is considered a transaction as there is both a provision and an acquisition of economic value. Assigning the migrant dual status as a resident and a nonresident is a device by which migrants' transfers can be included in the balance of payments.

61. The effect of territorial changes on a country's creditor/debtor position and the effect of changes resulting from the migration of individuals are treated differently. Territorial changes occur infrequently and can be viewed as changing the coverage of the reporting economy; the migration of individuals occurs continually. Over a long period, wealth in the form of financial items or real capital brought into a country by immigrants may be a significant source of foreign exchange for the country's monetary authorities or may contribute substantially to the country's domestic capital formation. Conversely, wealth taken out of a country by emigrants may be a substantial drain on the resources of that country. It is therefore useful and appropriate to account, in the balance of payments, for international transfers of wealth accompanying migration.

Reclassification of Claims and Liabilities

62. The classification scheme used in the BOP ***financial account*** accentuates characteristics that reflect the motivation of the investor. The underlying intentions of the investor may vary over time and thereby affect the character of the investment and its classification—as can be seen from the distinctions made among *direct investment*, *portfolio investment*, *other investment*, and *reserve assets*. For example, several independent holders of equity capital in an enterprise located abroad decide to associate to acquire entrepreneurial control over the enterprise. As a result, the character of the investment changes from *portfolio investment* to *direct investment*. According to the *BPM*, reclassifications of this type are not reflected in the balance of payments but are recorded in IIP statements at the ends of the periods in which the reclassifications occur. Similarly, central monetary authorities may relinquish or assume effective control over the foreign exchange holdings of deposit money banks, and reclassification from *reserve assets* to *other investment-assets-currency and deposits-banks* (or vice versa) are therefore recorded

in the international investment position but not in the balance of payments.

Valuation Changes

63. The values of real resources and financial items are constantly subject to variation. Alterations in values may be due to either or both of two factors. One factor is price changes. The price at which a commodity transaction (or any other transaction) takes place may be subject to change in terms of the currency in which the transaction is quoted. The other factor is exchange rate changes. There may be a change in the exchange rate between the transaction currency and the unit of account in which the balance of payments is recorded. Valuation changes are included in the international investment position but not in the balance of payments. Realized capital gains and losses are, however, indirectly recorded in the balance of payments.

64. The following example illustrates the difference between realized capital gains and losses, which are recorded in the balance of payments, and unrealized valuation changes, which are excluded. During the course of a year, a financial asset (such as a security issued by a nonresident enterprise) is acquired from abroad for 50 units. At the end of the reporting period, the purchaser still holds this asset, the value of which has risen to 80 units. In accordance with the *BPM*, the security purchase should be recorded in the balance of payments as a debit of 50 units. The total change in holdings of financial assets is 80 units, of which 30 units constitute a valuation gain. This valuation gain is excluded from the balance of payments but reflected in the international investment position where the level of the investment at the end of the reporting period is recorded at the market value of 80 units. The difference between the level at the beginning of the period, which is nil, and the level at the end of the period comprises a transaction of 50 units and a valuation change of 30 units. Had the purchaser sold the asset for 80 units before the end of the reporting period, the balance of payments would show a net credit transaction in securities of 30 units (purchase, 50 units; sale, 80 units). The net entry relates to the realization of capital gains but is nevertheless included in the statistics as it is the net result of two transactions (a purchase and a sale) recorded at market values.

65. In the *BPM*, it is recommended that write-offs of bad debts be regarded as valuation changes and consequently excluded from BOP coverage. The write-off, by the creditor, of a bad debt is presumably prompted by the unwillingness or inability of the debtor to redeem his debt. The expropriation of property without compensation is analogous to a write-off of a bad debt; the former should be thought of as a valuation adjustment and excluded from the balance of payments.

II. Residents of an Economy

66. The *BPM* broadly defines the balance of payments as recording (a) transactions—which take place between an economy and the rest of the world—in goods, services, and income and (b) changes of ownership in that economy's monetary gold, special drawing rights (SDRs), and claims on/liabilities to the rest of the world. It is therefore essential to know how an economy is defined for BOP purposes. In chapter 2 of the *BPM,* the **economic territory of a country** is defined as *a geographic territory administered by a government within which persons, goods, and capital circulate freely. For maritime countries, geographic territory includes any islands subject to the same fiscal and monetary authorities as the mainland.* This concept is elaborated in chapter 4 of the *BPM*, which states that the economic territory of a country includes:

air space, territorial waters, and continental shelf over which a country enjoys exclusive rights or over which a country has jurisdiction in respect of the right to fish or exploit fuels or minerals below the sea bed;

territorial enclaves, which are clearly demarcated areas of land that are owned or rented by a foreign government for diplomatic, military, scientific, or other purposes with the formal political agreement of the government of the country in which the territorial enclaves are physically located;

any free zones, bonded warehouses, or factories operated by offshore enterprises under customs control. (These are part of the economic territories of the countries in which they are physically located.)

67. A special type of economic territory is that of international organizations. International organizations are mostly political, administrative, economic, social, or financial institutions in which the members are governments or other international organizations. The economic territory of an international organization consists of the territorial enclaves that the organization has jurisdiction over and uses for organizational purposes formally agreed upon with the countries in which the enclaves are physically located. For example, the economic territory of the International Monetary Fund (IMF) includes the headquarters building at 700 19th Street in Washington, DC. This building is not part of the economic territory of the United States. (International organizations are further discussed in paragraphs 137–140.)

68. It is also important to consider the economic units that operate within an economic territory. An economic unit that has a center of economic interest in the economic territory of a specific country is a resident of that country. This chapter focuses on the nature of such units and how a unit's center of economic interest is determined in practice.

69. Because of the scope of the balance of payments, the determination of resident units has important implications for recording and classifying transactions within an economy. For example, a worker employed by a corporation in the economy of Nostaw is paid a wage of 1,000 units during the reporting period. The worker spends 500 units on consumption of goods and services within Nostaw and saves 500 units, out of which he remits 300 units to relatives living in Coonawarra and deposits 200 units in a commercial bank in Nostaw.

70. If the worker is classified as a resident of Nostaw, the following BOP entries should be made for Nostaw:

	Credit	**Debit**
Personal remittance (in cash)		300
Commercial bank's external assets	300	

71. Presumably, the worker remitted his funds abroad through a bank draft payable in foreign exchange. The only entries are the worker's transfer of funds abroad (debit) and the reduction, by an equivalent amount, in a commercial bank's external assets (credit).

72. Conversely, if the worker is classified as a nonresident, the following BOP entries should be made for Nostaw:

	Credit	**Debit**
Wages		1,000
Expenditure on travel services	500	
Commercial bank's external liabilities	200	
Commercial bank's external assets	300	

73. The 1,000–unit debit represents the import of nonresident labor by Nostaw. The 500–unit credit represents the amount expended by the worker on travel services in Nostaw. As a nonresident, the worker is classified as being in travel status (see paragraph 84). The increase in the worker's balance with a commercial bank in Nostaw is considered an increase of 200 units in external liabilities because the worker is a nonresident. The last entry represents the sale of the bank draft to the worker.

74. Under either assumption, the BOP statement is in balance and the requirements of the double entry system used to construct the statement are satisfied.

75. The types of transactions and the gross amounts recorded under the assumption that the worker is a resident of Nostaw differ greatly from those that are recorded if he is assumed to be a nonresident. Under the first assumption, only two entries are required in the balance of payments—a transfer (debit) and a change in the commercial bank's external assets (a credit denoting a reduction). Under the second assumption, the same transactions require four BOP entries—use of labor (debit), provision of travel services (credit), an increase in the commercial bank's external liabilities (credit), and a reduction in the commercial bank's external assets (credit).

76. To ensure that BOP statistics are compiled on a uniform basis, economies must be delimited according to standard definitions. The *BPM* contains guidelines that enable IMF member countries to report BOP data that are closely comparable to those reported by other member countries. One of the most important guidelines is that which defines the residents of an economy.

77. It is also important for the BOP concept and coverage of residents to harmonize with those of other macroeconomic statistical statements. To this end, the definition of residence presented in the *BPM* is identical to that contained in the 1993 *SNA*.

Definition of Residents

78. The residents of an economy comprise the following types of economic units:

households and individuals who make up a household;

enterprises (which are corporations and quasi-corporations, such as branch offices of nonresident direct investors);

nonprofit institutions;

the government of the economy.

To be a resident of an economy, an economic unit must have a center of economic interest in that economy. A unit has a center of economic interest within a country when there exists some location (dwelling, place of production, or other premises within the economic territory of the country) on, in, or from which the unit engages and intends to continue engaging (either indefinitely or over a finite but lengthy period of time) in economic activities and transactions on a significant scale. Subsequent paragraphs present a detailed discussion of how to apply the concept of economic interest for each type of economic unit.

Households and Individuals

79. The *BPM* states that *a household has center of economic interest when members of that household maintain, within a country, a dwelling or succession of dwellings that the members treat and use as their principal residence.* All individuals who belong to the same household must be residents of the same economy. As applied to individuals, the concept of residence is designed to encompass all persons who may be expected to consume goods and services, participate in production, or engage in other economic activities in the territory of an economy on a continuing (that is, not temporary) basis. A member of a resident household who leaves the economic territory and returns to that same household after a limited period of time continues to be a resident even if that individual makes frequent journeys outside the economic territory. These are the persons who have centers of economic interest in a particular economy. For individuals, the concept of residence is *economic* rather than legal. An individual considered, in accordance with the BOP definition, to be a resident of a particular economy may not necessarily be a citizen of that country. The meaning of the term *resident* in the context of exchange control regulations or laws may also differ from the BOP definition.

80. In most instances, an individual's association with a country is determined by fairly simple criteria: where he lives, where he works, his citizenship, the language he speaks. All are factors indicating the extent of such an association. For some individuals, though, the determination may not be straightforward. A Dutch citizen may have lived all

her life in Indonesia; an army officer stationed abroad may not have seen his own country in many years; or an ambassador's children born abroad may never have been in the country of their citizenship. Of course, the number of such persons may be so small that determination of their associations with particular countries has a negligible effect on the balance of payments. However, the treatment of entire groups—such as diplomatic personnel abroad, an army overseas, or very wealthy individuals—may have significant effects.

81. The difficulty of making determinations in borderline cases is aggravated by the fact that the most satisfactory solution for one user of the statistics may not suit the requirements of another user. One statistician may consider persons living in Belgium but crossing the frontier daily to work in a French factory as residents of Belgium who sell their labor to France; another may consider them French residents who are buying travel services from Belgium. As many of these differences are minor, the benefits of using a particular definition for a particular analysis are generally outweighed by the advantages of using a commonly accepted definition that permits comparisons of results. Therefore, the definition of residence must be one that is widely acceptable, one that may be consistently applied for most purposes, and one that is consistent with the national accounts. (As BOP and national accounting systems are closely related, serious difficulties would arise if each system referred to a different set of persons and households.)

82. It is evident that citizens of a country who live there permanently have their centers of interest in that country. Diplomatic representatives, members of the armed forces, and patients undergoing medical care abroad do not change their centers of interest and therefore remain residents of their home economies. On the other hand, a businessman employed in another country may find it necessary to establish a home there. For BOP purposes, he has shifted his center of interest and, hence, his residence—even though he may retain his previous citizenship, may send his children to schools in his country of origin, and may be more interested in that country's politics than in those of the new country. Important factors in this determination are (1) the businessman is permanently living in the new country and (2) the product he creates can most realistically be considered part of the domestic product of that country. The most relevant consideration for ascertaining the resident status of an individual is whether he or she is expected to be involved in the productive and consumptive process of an economy with some degree of permanence.

83. The *BPM* criterion (which conforms with that of the 1993 *SNA*) for permanence is a period of one year. Thus, if an individual stays in an economy for a year or longer, or intends to stay in an economy for a year or longer, he or she is considered a resident of that economy. If not, he or she is considered a nonresident. Exceptions to this rule are discussed subsequently. The one-year length of stay is an objective, if arbitrary, benchmark for determining a person's resident status. Nevertheless, the consistent application of such a convention in the determi-nation of residence significantly enhances the analytical usefulness of BOP and other macroeconomic statistics.

84. Visitors (that is, persons remaining in an economy for less than one year for business; recreation or holiday; religious observances; family affairs; and participation in international sports events, conferences, meetings, study tours, or student programs) are classified as nonresidents from the standpoint of the host economy and, consequently, as residents of their home economies. All such individuals are classified as being in travel status and as having their centers of interest outside the economies to which they have traveled.

85. An exception to the one-year rule is made in determining the resident status of students because application of the one-year rule could lead to problems with interpretation and availability of data. Students are generally expected to return to their home economies upon completion of their studies. Consequently, their centers of interest may not be closely related to the length of stay abroad. Therefore, however long they study abroad, students should be treated as residents of their countries of origin if they maintain economic attachments to their countries. The factors to be considered in determining whether such an attachment is maintained include whether a student is dependent on a household, a nonprofit institution, or the government of the country of origin for the funds that finance his or her studies; whether he or she is funded by the host country under foreign aid or similar programs; and whether he or she plans to return to the country of origin on completion of his or her studies. Medical patients abroad are treated, in the balance of payments, in the same manner as students. That is, they are considered—regardless of

the length of stay in the economies in which they are receiving treatment—to be residents of their economies of origin.

86. Crew members of vessels or aircraft are not considered residents of economies in which they are stopping or lying over but not living. Similarly, commercial travelers who stay in an economy for less than one year are not considered residents of that economy, and employees of nonresident enterprises who go to an economy for less than one year for the purpose of installing machinery or equipment purchased from their employers are regarded, from the standpoint of the economy where the machinery is installed, as nonresidents.

87. Foreign officials, diplomats, consular representatives, members of foreign armed forces, and other foreign government personnel (except for technical assistance personnel) stationed in an economy are—under all circumstances—to be associated with their home economies. These persons and their dependents are therefore treated, from the viewpoints of the economies in which these persons are stationed, as nonresidents. This treatment is an exception to the general rule that a one-year sojourn constitutes resident status. Diplomats and military and similar personnel do not, for BOP purposes, change their centers of interest when they are stationed abroad. For instance, a U.S. army major stationed in Germany continues to be a resident of the United States even though he may have been stationed outside that country for more than one year. However, the residence of technical assistance personnel should be based on the one-year rule. Technical assistance personnel on long-term assignments should be treated as residents of the economies in which they work. A transfer of funds to cover the cost of salaries and allowances should be imputed to the host government from the government (or international organization) that employs the experts.

88. Employees of international organizations are regarded as residents of the economies in which the employees live if they have lived, or expect to live, there for one year or more. In most cases, that economy is the one in which the international unit that they work for is located or the economy in which the employees are engaged in technical assistance or other activities on behalf of the international organization. For example, a Swedish national who is permanently employed at United Nations headquarters in New York is considered to be a resident of the United States. However, if she is engaged in a technical assistance project of several years' duration in Indonesia, she would (for BOP purposes) be designated an Indonesian resident. Employees of international bodies and foreign governments who undertake technical assistance work of less than one year's duration are classified, not as residents of the economies receiving the technical assistance, but as residents of the economies in which the employees normally live. If the United Nations employee undertook technical assistance work for a period of less than one year in Malawi, she would retain her status as a resident of the United States.

89. Seasonal workers who enter economies for the sole, explicit purpose of harvesting a crop or working in hotels during the tourist season are treated as residents of their home economies rather than residents of the economies where they are employed for the season. For example, Italian residents working in Switzerland during prime tourist periods are classified as residents of Italy rather than residents of Switzerland. Border workers—persons who cross the border between two economies on a regular, frequent basis because they work in one economy but have homes in the other—are residents of the economy in which they have their homes and not of the economy in which they are employed. Workers living in Belgium but crossing daily into and out of France would be regarded as residents of Belgium rather than residents of France.

90. Refugees are considered residents if they stay, or are expected to stay, for one year or more in their host countries. Persons taking refuge in another country for only a short period remain residents of their home economies.

91. The basis for determining the residence of individuals may sometimes seem artificial, but specific guidelines are necessary to achieve consistency. The division between residents and nonresidents is based on a convention supported by the international community of BOP and national accounts statisticians.

Enterprises

Overview

92. The *BPM* states that an enterprise has a center of economic interest and is a resident unit of a country (or economic territory) when the enterprise

is engaged in (1) a significant amount of production of goods and/or services there or (2) transactions in land located there. *A significant amount of production* means that the enterprise maintains at least one production establishment in the country and plans to operate that establishment indefinitely or over a long period of time (that is, one year or more). However, other considerations—such as whether there is a complete and separate set of local accounts, whether taxes are paid to the host government, or whether funds for the local operation are locally managed—must be considered in determining the residence of an enterprise. In practice, these conditions are generally satisfied for enterprises engaged in longer-term activity.

93. The term *enterprise* includes (1) *corporations*, which are entities engaged in production for profit and recognized as legal entities separate from the owners, and (2) *quasi-corporations*, which are unincorporated entities owned by resident or nonresident institutional units and managed as separate entities.

94. Determining whether an enterprise is a resident or nonresident is synonymous with deciding whether enterprise production should be assigned to a specific economy or to the rest of the world. Classifying a particular entity as a resident of an economy is tantamount to ascribing the entity's production to the domestic product of that economy. Conversely, to assign nonresident status to a particular entity is to attribute its production to the domestic product of the rest of the world. Thus, the crucial factor in determining that a particular enterprise is a resident entity is whether or not the enterprise is engaged in significant productive activity within the domestic territory of an economy. Before determining that any entity significantly involved in producing goods and services within that territory is a resident of that economy, it is, of course, necessary to define the territory of an economy. (Refer to paragraphs 66–67 for a discussion of economic territory.) Enterprises may still be classified as residents even if, for example, the enterprises process—in an area designated by the government as a "free zone"—imported raw materials for re-export or mine the ocean bed off the shores of a country's physical territory.

95. There are two reasons that resident status is assigned to an enterprise only when the enterprise engages in significant production activity within the territory of an economy: (1) to ensure that the balance of payments and the national accounts remain analytically useful and, simultaneously, (2) to avoid practical problems associated with treating as residents those enterprises having limited activities in a particular economy (for example, short-term construction or installation activity). The treatment of enterprises engaged in these types of activities is subsequently described in more detail.

96. Resident enterprises are defined as including all actual or notional entities engaged in transactions in land. In accordance with conventions presented in the 1993 *SNA* and in the *BPM*, land can be owned only by a resident entity. Consequently, whenever a nonresident acquires land, the transaction is accounted for through the creation of a notional resident unit. For BOP purposes, the legal owner acquires a financial investment (equity) in a resident unit which, in turn, acquires ownership of the land. From the standpoint of BOP recording, such a transaction would be construed as an increase in external financial investment in the economy in which the land is situated. For that economy, entries in the ***financial account*** would be:

External liabilities	credit
Reserve assets (or other appropriate financial account item)	debit

97. The previously stated definition of resident enterprises has some special implications for certain types of enterprises. These enterprises comprise single enterprises operating in more than one economy, enterprises operating mobile equipment, enterprises leasing equipment, enterprises registered—as a result of legislation—in more than one country, commercial agencies, installation services, and construction enterprises.

Single Enterprises Operating in More Than One Economy

98. The general rules for determining the residence of an enterprise may necessitate the partitioning of a single legal entity (such as a parent company operating in one economy and an unincorporated branch operating in another economy) or a single economic or technical entity (such as a railway system or a pipeline spanning the territory of two or more economies) into two or more separate enterprises. For example, an automobile manufacturing company incorporated in the United States and engaged in assembly operations in Canada may be organized as a single legal entity. In BOP accounting, this legal entity must be divided.

The parts of the company that are engaged in operations in particular economies are assigned resident status in those economies. Thus, the parent company would be treated as a resident of the United States, and branch activity would be attributed to a resident producer unit in Canada. All flows between the executive office of the parent company and the unincorporated branch would constitute BOP transactions.

99. Each section of an oil pipeline running through several economies should be regarded as a separate unit of economic production. A section that is located in the territory of a particular economy should be treated as domestic fixed capital in that economy, and a notional resident production unit should be created in the national accounts and in the balance of payments. Ownership of the fixed assets in each country should be attributed to the resident production unit. The local part of the pipeline is viewed as rendering a transportation service (shipping oil) to nonresidents and as earning, for the pipeline's actual owners, income equal to the value of this service and of any service the pipeline may provide to residents. (The income earned is net of production costs, including depreciation and taxes.) A railroad enterprise operating in two or more economies is treated similarly. The enterprise should be divided into parts; each part should be regarded as a resident of the economic territory within which enterprise operations are carried out. The head office of the enterprise should be viewed as having a financial investment in the local enterprise(s).

100. In the *BPM*, it is suggested that costs and earnings of production units operating in economies other than those of the entities that direct unit operations be calculated at market prices. However, some or most or all of the economic values transferred between the units of an international complex of this type may be omitted from unit records or entered only at nominal values. Values reported to compilers may have to be replaced by compiler estimates of values. Additionally, BOP entries for each of the relevant economies should reflect the allocation–to each member of the international complex–of an appropriate share of any common operating costs, including head office expenses and charges for mobile equipment operating in more than one economic territory.

101. Recommendations presented in preceding paragraphs may be clarified by an example that relates the recommendations to specific BOP entries. A railway enterprise with headquarters in Nostaw operates in three adjacent economies: Nostaw, Daniherland, and Dromesia. According to the rules for determining the resident status of enterprises, the single unit is, for BOP purposes, divided into resident production units in Nostaw, Daniherland, and Dromesia. Data are assembled on the revenue collected by the resident production unit of the railway in each economy and on the associated costs. The revenue collected in each economy is for domestic transportation (that is, for transportation within the borders of the economy) and the transportation is purchased by residents only. Compensation of employees represents local labor costs only. The head office is able to calculate common operating costs and apportion them between the branch in Daniherland and the branch in Dromesia. Common operating costs consist of fuel costs, repair costs, depreciation on the rolling stock, and the cost of management services provided by the head office. Information exists on the investment in capital formation (such as construction of new railway stations and acquisition of office machinery) in each of the territories. All cash received and payments made in Daniherland and Dromesia are deposited to or made from accounts that are held by the head office with Nostaw banks. The data are:

	Head Office in Nostaw	**Branch in Daniherland**	**Branch in Dromesia**
Value of local production	1600	1000	1300
Export of services*	250		
	1850	1000	1300
Minus cost of production			
Local materials	550	300	450
Local wages	800	300	450
Import of services*		100	150
Operating surplus	500	300	250

*This item signifies common operating costs that are incurred by the head office and attributed to branches in Daniherland and Dromesia.

In addition, the head office provided funds of 210 units to Daniherland and 300 units to Dromesia for capital formation.

102. The BOP entries show that the single enterprise has been separated into a parent organization and subsidiary units and that each unit has been assigned resident status in the economy in which the unit is operating. The income generated (operating surplus) by subsidiary units is attributed to the head office and is recorded as *investment income* debits in the balance of payments of the

countries where the branches are located. The balance of payments of Nostaw shows receipt, by the head office, of entrepreneurial income and the expansion of external investment through additional capital outlays in branches located abroad is also shown. Common operating costs are recorded as miscellaneous services performed by residents of Nostaw for residents of Daniherland and Dromesia.

Balance of Payments of Nostaw

	Credit	Debit
Investment income	550	
Miscellaneous services	250	
Direct investment-abroad		510
Reserve assets (or other appropriate financial account item)		290

Balance of Payments of Daniherland

	Credit	Debit
Investment income		300
Miscellaneous services		100
Direct investment-in reporting economy	210	
Reserve (or similar) assets	190	

Balance of Payments of Dromesia

	Credit	Debit
Investment income		250
Miscellaneous services		150
Direct investment-in reporting economy	300	
Reserve assets (or other appropriate financial account item)	100	

Operation of Mobile Equipment

103. The attribution—in terms of the residency—of services provided by mobile equipment (such as aircraft, ships, highway and railway rolling stock, fishing vessels, and gas and oil drilling rigs) is based on the resident status of the enterprise *operating* the equipment in the production process. (The enterprise *owning* the equipment may or may not be the operator.) The residence of an enterprise operating mobile equipment outside any national territory (that is, in international waters or air space) is attributed to the economy in which the mobile equipment is, in some sense, based. In determining the residence of such an enterprise, consideration should be given to such attributes as the location of the company directing enterprise operations; whether the equipment is subject to the laws, regulations, and protection of a particular national economy; or whether the equipment is linked more closely to one economy than to another. For example, as a corporation engaged in international transportation, British Airways would be classified as a resident of the United Kingdom because the airline's operations are governed mainly by the laws of that country, and British Airways is more closely associated with the economy of the United Kingdom than with other economies. The aircraft owned by the company and operated in international commerce would be attributed to British Airways and would therefore constitute a portion of the real assets of the United Kingdom.

104. How should the residence of equipment that frequently moves among various economic territories be determined? For example, the rolling stock of the railroad enterprise operating in Nostaw, Daniherland, and Dromesia is regularly used in all three economies. Should the rolling stock be attributed to the head office in Nostaw? Or, for the periods that the rolling stock moves through Daniherland and Dromesia, should the stock be attributed to enterprises to which residence in Daniherland and Dromesia is ascribed? It is recommended that compilers consider such equipment to be operated by an enterprise in the economy in which the activity relating to that equipment occurs only if the equipment is accounted for separately by the operator and is separately recognized by local tax and licensing authorities. Otherwise, the activity should be attributed to the country of residence of the actual operator. It is unlikely that the actual operator of equipment moving frequently between or among economies will maintain separate accounts for each of the economies in which the equipment operates. Therefore, the economy of the actual operator is, generally, also the economy to which the production resulting from the use of the mobile equipment is attributed. In the example of the railroad operating in three economies, the operator of the mobile equipment would, for BOP purposes, most likely be the enterprise in Nostaw.

105. The treatment of mobile equipment operating outside the economy of the operator for a long period of time is subject to similar considerations. That is, compilers should consider the equipment to be operated by an enterprise in the host economy if the equipment is accounted for separately by the operator and separately recognized by local tax and licensing authorities. Otherwise, the activity should be attributed to the country of residence of the actual operator.

106. For example, an aircraft is operated by a resident of Cromania primarily within the borders of Essendonia. For BOP purposes, operation of the aircraft is attributed to Essendonia if aircraft

operations are separately accounted for and recognized by Essendonian authorities as part of that country's capital stock. A notional enterprise in Essendonia must be created in respect of the ownership of the aircraft used in the production output of that economy. The actual operator, who is a resident of Cromania, is construed to have a financial investment in the notional enterprise operating in Essendonia. Income earned from this investment by the Cromanian owners should be recorded (net of depreciation) as investment income, and the depreciation should be recorded as a withdrawal of investment. (The treatment of mobile equipment is further discussed in paragraphs 552–554 of chapter 9 of the *Textbook*. See also paragraphs 442–451 and 495–502 of the *Balance of Payments Compilation Guide*.)

Leasing of Equipment

107. The rules described in the preceding paragraphs should be used whether the enterprise *operating* the equipment is using leased or owned equipment. However, the leasing of mobile, or any other, equipment raises an additional issue. To which economy should *ownership*, in a BOP sense, of that equipment be attributed? Attribution of ownership is important because transactions are recorded in the balance of payments when things that have economic value change ownership.

108. There are, in a broad sense, two types of leases: financial leases and operational leases. Financial leases are those in which substantially all of the risks and benefits of ownership of an asset are transferred from the lessor (legal owner) to the lessee. Financial leases are characterized by arrangements that provide for the recovery of all, or substantially all, of the cost of goods and for carrying (finance) charges. Leases that are not classed as financial leases are considered operational leases.

Financial Leases

109. With regard to financial leases, it is recommended in the *BPM* that a change of ownership of the good being leased be imputed at the inception of the lease. In the balance of payments of the economy of the lessee, the entry for imports would be matched by an entry in the ***financial account*** for an increase in financial liabilities. The equipment would, of course, be valued at market value. The lease payments contain two elements: (1) interest on the outstanding liability and (2) repayments (amortization) of the liability. Upon termination of the lease, it may be necessary to reverse the entries recorded at inception. In the balance of payments of the lessee, the entries would then consist of an export of goods (credit) and a reduction in liabilities (debit). An example of a financial leasing arrangement follows.

110. At the commencement of a lease, the market value of equipment being leased is estimated to be 1,000 units. Lease payments are due over nine years at an annual rate of 100 units. Ten percent of the 100 units is estimated to be the interest element inherent in the lease payments.[4] The lease contract calls for the return of the goods to the lessor at the termination of the lease. In the first year, the BOP entries are:

Lessee's Balance of Payments—Year 1

	Credit	Debit
Goods		1,000
Investment income		10
Loans	1,000	90
Reserve assets (or other appropriate financial account item)	100	

In subsequent years (prior to the final year), the entries would be:

Lessee's Balance of Payments—Years 2–8

	Credit	Debit
Investment income		10
Loans		90
Reserve assets (or other appropriate financial account item)	100	

111. At the end of the lease, the market value of the asset is estimated to be 300 units, and the outstanding loan would thus have to be revalued from 190 units (the difference between the original 1,000 units and total repayments of 810 units) to 300 units.[5] In the balance of payments, the full market value of the equipment (300 units) must be shown as an export.

[4]This is a simple calculation of the interest. In practice, the calculation of interest in each period will be based on the outstanding liability during the period. By comparison with those for later years, higher interest payments (and lower repayments) will be due in earlier years.

[5]Such revaluations should be undertaken at regular intervals. Any unrealized gain or loss in the value of the loan outstanding would be reflected in the international investment position but not in the balance of payments. However, if the lease contract specified that the lessor could purchase the goods for a fixed value at the end of the lease and the fixed value was equal to the written-down value of the good, the lessee's liability at any point during the lease would be the written-down value of the good. This result may seem to violate the market price principle; however, it is the lessee's financial liability, which is not necessarily the same as the value of the good being leased, that is being valued.

The reduction in loans accompanying the return of the equipment would also be 300 units. Hence, BOP entries for the final period would be:

Lessee's Balance of Payments—Final Year

	Credit	Debit
Goods	300	
Loans		300

Operational Leases

112. Operational leases are treated straightforwardly in the balance of payments. The lessor (legal owner) is deemed to be providing a service to the lessee (operator) in the form of the temporary provision of an asset; the value of that service is equal to the lease payments. For example, an enterprise located in Pokolbin hires an aircraft belonging to an enterprise in Longa for operations carried out primarily in Pokolbin. The transaction is classified as a fee for a charter service; the producer of the charter service is Longa, and the production of that service is attributed to Longa. In Pokolbin's BOP statement, the following entries would be made:

Charter fees	debit
Reserve assets (or other appropriate financial account item)	credit

Registration of an Enterprise in More Than One Economy

113. Issues regarding the determination of residence may also arise when an enterprise operating aircraft, ships, or fishing fleets entirely in international commerce is jointly organized and owned by a number of governments and, under special legislation, registered in more than one country. For example, the Scandinavian Airlines System (SAS) is jointly owned and operated by Norway, Sweden, and Denmark. Three-sevenths of the capital of SAS is held by Sweden, and Denmark and Norway each hold two-sevenths. SAS personnel are divided among the three countries in approximately the same proportions. There are two methods of treating such an enterprise. One is to treat the enterprise as a resident of all the participating countries. Enterprise transactions are then attributed to the economies of owners in proportion to shares owned in the financial capital of the enterprise. Three-sevenths of company transactions are attributed to Sweden, and two-sevenths each are attributed to Denmark and Norway. If a resident of Sweden travels by SAS, three-sevenths of his fare represents a domestic transaction, and four-sevenths represents an international transaction. A second method is to treat the corporation as a resident of the economy in which headquarters are located and the premises of the corporation in other countries as branches (direct investment enterprises) that are residents of the countries in which they are located. On balance, the first method is preferred, but both treatments are consistent with the general principles of the *BPM* and the 1993 *SNA*. The choice between treatments may be made, with reference to consistent treatment by partner countries, on the basis of statistical convenience. (Paragraphs 449–450 of the *Balance of Payments Compilation Guide* provide additional information on these treatments.)

Commercial Agencies

114. How should the resident status of commercial agencies be determined? Agencies transacting business on behalf of nonresident principals should be treated as resident producers in the economies in which the agencies are located. Services rendered by an agent to the enterprise that the agent represents should be attributed to the economy in which the agent is a resident. Transactions conducted by an agent on behalf of a nonresident principal should, without exception, be attributed to the economy of the principal. For example, an exporter (a_1) in Domestica engages an agent (b_1) in Central Paradiso to sell a product to other enterprises (b_2) in Central Paradiso. The transaction in commodities is between the exporter (a_1) and the other enterprises (b_2); the transaction in services is between the exporter (a_1) and the agent ($b_{1)}$.

Installation Services

115. Sometimes the employees of an enterprise go abroad to install machinery or equipment that the enterprise has sold to residents of another country. The residency of such enterprises determines whether the installation services are entered in the domestic production accounts of the economy that has sold the equipment or whether the services are entered in the accounts of the economy that has purchased the equipment. As previously stated, the crucial consideration for deciding the resident status of an enterprise is whether the enterprise is engaged in a significant amount of production of goods and services within the domestic territory of an economy. Key tests include whether a complete and separate set of accounts is maintained in respect of local

activities and whether the operations are carried on over a long period of time.

116. For example, an enterprise located in the economy of Cromania sells equipment to the economy of Essendonia and sends employees to install the equipment in Essendonia. The work is completed in a period of less than a year, and the fee for installation amounts to 1,000 units. In performing the installation, the enterprise engages local labor for which it pays 100 units. Employees who are residents of Cromania spend 500 units on consumption of goods and services in Essendonia. Because the task is completed in less than a year, the installation services are viewed as being provided by Cromania. These entries would be made:

Essendonia's Balance of Payments

	Credit	Debit
Value of installation services		1,000
Goods and services acquired by nonresident workers (travel)	500	
Compensation of employees	100	
Reserve assets (or other appropriate financial account item)	400	

117. However, it could be assumed that installation took more than a year to complete. The cost amounted to 6,000 units—of which 3,000 units were paid to local labor. Cromanian employees sent to work in Essendonia were paid 2,000 units in the currency of Essendonia. There were no other costs associated with the provision, by the Cromanian firm, of installation services to the Essendonian firm purchasing the services. Furthermore, it could be assumed that the Cromanian enterprise maintained a separate set of accounts in respect of its operations in Essendonia. Under these assumptions, production would be allocated to a resident production unit in Essendonia, and entries recorded in Essendonia's balance of payments would differ from those recorded under the assumptions listed in paragraph 116.

118. The creation of a resident production unit in Essendonia requires the recording of a financial investment relationship between the firm in Cromania (the parent) and the resident unit that has been created. The firm in Cromania receives entrepreneurial income as a result of its investment in Essendonia. The profit of the firm is 1,000 units, which are recorded as *investment income*. The Cromanian employees sent to Essendonia are regarded as residents of Essendonia by virtue of the length of stay. These employees spend 900 units in Essendonia and save 1,100 units, which they deposit with a commercial bank in Essendonia. These transactions are domestic to Essendonia and are therefore not recorded in the balance of payments. Upon completion of their work, the Cromanian nationals return to their home economy and thus change their country of residence. The change requires that they be treated, for BOP purposes, as migrants. They repatriate their savings to Cromania in the form of foreign exchange. The BOP entry showing the decrease (credit) in Essendonia's reserve assets, which is assumed to be the result of the repatriation of savings, is offset by a counterpart entry in migrants' transfers. The BOP entries would be:

Essendonia's Balance of Payments

	Credit	Debit
Investment income		1,000
Migrants' transfers		1,100
Reserve assets (or other appropriate financial account item)	1,000	
	1,100	

119. An entry for migrants' transfers is always made, regardless of whether there is an actual transfer of funds, when an individual shifts his residence. For example, the individual workers in the example in paragraph 118 may choose not to repatriate their funds from Essendonia. Their deposits with commercial banks in Essendonia would then be recorded as an increase in Essendonia's external liabilities at the time of the workers' migration rather than as a decrease in Essendonia's reserve assets. In either case, a contra entry is made in migrants' transfers. The contra entry constitutes the offset to the transfer of net worth occasioned by the migration of the individual.

Construction Enterprises

120. Determination of residence for enterprises engaged in construction activity is often problematical for BOP compilers. However, the rules governing determination of residence for other enterprises also apply to construction enterprises. The initial determination to be made is the economy to which production should be attributed. Once this decision is made, the relevant BOP entries can be determined. Two examples may help to explain the treatment of enterprises engaged in construction activity. (For additional information on the treatment of construction activity, see paragraphs 340–342 of chapter 5 and paragraphs 545–549 of chapter 9 in the *Textbook* and paragraphs 452–455 of the *Balance of Payments Compilation Guide*.)

121. An enterprise located in Clintonstan is awarded a construction contract worth 10,000 units for a project located in the economy of Algornia. The contract is implemented over a six-month period, and the following expenditures are incurred by the enterprise:

Materials purchased in Algornia	5,000
Wages paid to residents of Clintonstan	2,000
Wages paid to residents of Algornia	1,000
Taxes paid to government of Algornia	1,000

122. Because the project is completed in less than one year, production should be attributed to a resident of Clintonstan. Accordingly the following entries would be required:

Algornia's Balance of Payments

	Credit	Debit
Other business services	5,000	
Construction services		10,000
Compensation of employees	1,000	
Transfers (taxes)	1,000	
Reserve assets (or other appropriate financial account item)	3,000	

123. An enterprise from Nostaw is awarded a construction contract worth 50,000 units for a project located in Coonawarra. The contract is implemented over a two-year period. Because of the long-term nature of the project, the enterprise sets up a site office in Coonawarra and maintains a complete set of accounts for its operations in that economy. To implement construction, the enterprise in Nostaw sends machinery worth 20,000 units to Coonawarra. At the end of the first year, the work in progress is valued at 22,000 units. This amount is paid by the Coonawarran client and used to cover expenditures incurred in Coonawarra. The balance is remitted to Nostaw. At the end of the second year, the remaining 28,000 units are paid by the client. The balance after payment for expenditures in the second year is remitted to Nostaw. Expenditures incurred for the project are:

	Year 1	Year 2
Value of construction work	22,000	28,000
Materials purchased in Coonawarra	4,000	8,000
Wages paid to residents of Coonawarra	6,000	3,000
Wages paid to residents of Nostaw*	3,000	2,000
Depreciation on machinery	2,000	1,000
Taxes paid to government of Coonawarra	1,000	4,000
Net profit	6,000	10,000

*Wages paid to Nostaw residents who work on the project for short (less than one year) periods of time

124. In the example in paragraph 123, criteria for attributing production to a resident of Coonawarra are satisfied. The following entries would be made:

Coonawarra's Balance of Payments—Year 1

	Credit	Debit
Goods (machinery)		20,000
Compensation of employees		3,000
Investment income		6,000
Direct investment—provision of machinery	20,000	
Direct investment—depreciation		2,000
Reserve assets (or other appropriate financial account item)	11,000	

Coonawarra's Balance of Payments—Year 2

	Credit	Debit
Goods (machinery)	17,000	
Compensation of employees		2,000
Investment income		10,000
Direct investment—return of machinery		17,000
Direct investment—depreciation		1,000
Reserve assets (or other appropriate financial account item)	13,000	

Nonprofit Institutions

125. Like enterprises, nonprofit bodies are resident entities of the economic territories in which the nonprofit bodies are located or conduct their affairs. Nonprofit bodies are generally engaged in furnishing educational, health, cultural, recreational, and other social and community services free of charge or at sales prices that do not fully cover the costs of production. Examples of nonprofit bodies are such entities as private hospitals, churches, cultural societies, foundations, universities, colleges, and the Red Cross.

126. In practice, the residence of the vast majority of nonprofit institutions may be determined without ambiguity. However, when such an institution is engaged in charity or relief work on an international scale, it is necessary to specify the residence of any branches the institution may maintain in individual countries. In this case, it is appropriate to use the guideline of length of time to determine the residence of such branches. If a nonprofit institution maintains a branch, or similar unit, for a year or more in a particular country, that branch should be considered a host country resident that is financed largely or entirely by transfers from abroad.

Government

127. This chapter concludes with an examination of the economic entities classified under general government. What is the scope of the resident general government sector? According to the *BPM*, the general government agencies of an economy include all central, state, and local government departments, establishments, and bodies located in the economic territory and all general government embassies, consulates, entities, and military establishments located elsewhere.

128. General government agencies comprise public authorities not classified as enterprises or as private nonprofit bodies serving households. Governmental agencies engaged in enterprise activity (for example, a government telecommunications department, postal authorities, or a government port authority) are not considered part of the general government sector. Classified in the general government sector are:

bodies with such governmental functions as administration, defense, regulation of the public order, promotion of economic growth and welfare, technological development, and the provision of education, health, cultural, recreational, and other social and community services rendered to the public free of charge or at sales prices that do not fully cover the costs of production;

other nonprofit organizations that are wholly, or mainly, financed and controlled by the government;

agencies for social security arrangements that are imposed, controlled, or financed by the government;

public saving and lending authorities that are financially integrated with a government.

129. A useful criterion for distinguishing between agencies to be classified in the general government sector and in the enterprise sector is whether the agency's product is characteristically sold in the market. If so, there is a strong case for including the agency in the enterprise sector.

130. Embassies and similar institutions are treated as residents of the economies they represent—rather than as residents of the economic territories in which they are physically situated—because of the affinity between such embassies and institutions and the governments of countries they represent. For example, the French embassy in the United States is linked much more closely to the French government than to the U.S. government. Therefore, entities such as embassies, consulates, military establishments, and other bodies of general government located abroad are considered extraterritorial and not parts of the economies in which the entities are physically situated.

131. As these embassies and similar institutions are considered resident entities of the countries represented, embassy transactions with residents of the economies in which the embassies are located (as well as embassy transactions with other economies) constitute a portion of the BOP transactions of the embassies' countries with the rest of the world. For instance, the construction of embassies, structures, and other works in extraterritorial enclaves by resident producers of the economy in which the enclaves are located would form part of the production and exports of the host economy. Wages and salaries paid to locally recruited staff of foreign diplomatic, military, and other establishments are also credits in the balance of payments of the host economy and debits in the balance of payments of the country represented by the embassy or other establishment.

132. A hypothetical case may be used as an illustration. For the Nigerian embassy in France, the Nigerian government arranges for a French construction firm to construct a building worth 20 million units. The building is completed during the reporting period, and payment is made in U.S. dollars. As the Nigerian embassy is treated as a resident of Nigeria, the construction of the embassy gives rise to BOP transactions for both France and Nigeria. Accordingly, in the French balance of payments, the value of the construction work is shown as a credit (that is, an export of the production of the construction industry in France). The increase in French holdings of U.S. dollars is shown as a debit. Thus, France's balance of payments shows the following entries:

French Balance of Payments

	Credit	**Debit**
Value of construction work	20	
U.S. dollar holdings		20

133. Conversely, in the Nigerian balance of payments, the acquisition of the embassy building is shown as a debit reflecting the increase—which has been brought about not through domestic production but through an import—in the stock of fixed capital assets owned by Nigeria. The financial

counterpart to the increase in real assets (debit) is shown as a decrease in holdings of U.S. dollars (credit).

Nigerian Balance of Payments

	Credit	Debit
Acquisition of embassy building		20
U.S. dollar holdings	20	

Similar BOP entries would be made if Nigeria purchased an existing building. For Nigeria, the transaction would still represent capital formation and, for France, negative capital formation.

134. While the acquisition of an embassy building is recorded straightforwardly in the balance of payments, there is a variation in principle for recording the purchase of land by a foreign government when an embassy building is to be erected on the land or the land is purchased for some other general government use. Under the conventions of the *BPM* and the 1993 *SNA*, land is always deemed to be owned by a resident of the country in which the land is located. However, when land is purchased by a foreign embassy or a similar institution, the land is considered to shift from one economic territory to another. The land is then located in the economic territory of the country of the embassy and is no longer part of the economic territory of the host country. In these relatively rare instances, a transaction in land is recorded as taking place between residents and nonresidents. This transaction is shown, in the ***capital account*** of the balance of payments, as the exchange of a non-produced, nonfinancial asset. The sale of embassy and similar land is treated in a like manner. In the previous example, when the Nigerian government bought a parcel of land (worth approximately US$5 million) for the construction of an embassy, that government was deemed to have purchased a non-produced, nonfinancial asset from France. Entries for the transaction would be shown as:

Nigerian Balance of Payments

	Credit	Debit
Non-produced, nonfinancial assets		5
U.S. dollar holdings	5	

In the French balance of payments, the same entries would be made with reversed sign.

135. While the previously stated recommendations always apply in principle, the purchase of an existing building will, in practice, be recorded at its total cost (including cost of land). The entire transaction should be classed as the acquisition of a produced asset and recorded in the **current account**.

136. It may also be useful to consider the Nigerian embassy's other transactions in France. When the embassy recruits residents of France as typists, chauffeurs, etc., the salaries and wages paid to such staff constitute part of the balance of payments of both countries. The salaries and wages received are shown as a credit item (export of labor) in the French balance of payments and as a debit item (import of labor) in the Nigerian balance of payments.

137. In some ways, international organizations receive the same BOP treatment as embassies. International bodies that cannot be classed as enterprises are treated as nonresidents in the balance of payments. Institutions in this category comprise most political, administrative, economic, social, or financial institutions in which the members are governments. Examples of such international bodies are the United Nations and its specialized agencies (such as the Food and Agriculture Organization), the International Labor Organization, the World Bank, the International Monetary Fund, and the regional economic commissions. Many regional organizations (for example, the African Development Bank, the Central American Clearing House, the institutions of the European Community, and certain intergovernmental commodity organizations) must be treated in the same way.

138. To be classified as nonresidents, international bodies must be intergovernmental organizations and must not be engaged primarily in enterprise activity. For example, although the International Tin Council is intergovernmental in membership, the council nevertheless functions as an enterprise. Among other things, the council is concerned with price stabilization for tin through the operations of a buffer stock. (For rules governing the resident status of enterprises, refer to paragraphs 92–97.)

139. From the standpoints of the economies in which international and regional bodies are located, such bodies should be given the same statistical treatment as foreign embassies and other agencies of foreign governments. (However, employees of these bodies are residents of national economies and not "residents" of international organizations.) Transactions of international organizations with the economies in which the organizations are physically

situated constitute BOP transactions. However, unlike embassies (which are parts of the economies of the countries represented), international and regional bodies are not part of any national economy. Therefore, any worldwide balance of payments system is incomplete without estimates of the transactions of international organizations.

140. Another category is that of regional central banks—international financial institutions that act as common central banks for groups of member countries. The official national offices of a regional central bank are resident units in the economy in which the offices are located. The financial assets and liabilities of a regional central bank should be allocated among the national offices in proportion to the claims that member governments have on the bank's collective assets.[6]

[6]This recommendation could be a source of asymmetry. The partner countries to transactions involving regional central banks are likely, in their BOP statements, to allocate these transactions to notional countries representing regional central banks rather than apportioning the transactions to member countries of regional central banks.

III. Classifying Balance of Payments Transactions

141. BOP statistics are arranged within a coherent structure to facilitate analysis, which is undertaken for many reasons—including policy formulation, policy monitoring, projections, studies of the behavior of real and financial markets, and bilateral and multilateral comparisons. The list of standard components contained in the *BPM* provides an international standard for the structural system within which BOP statistics are compiled. This chapter focuses on classifying international transactions according to the system of standard components.

142. The list of BOP standard components, which appears at the end of this chapter, reflects conceptual and practical considerations. The opinions of national BOP experts, generally accepted views of BOP analysis, and structures and classifications used in other international statistical systems (such as the national accounts) influenced the development of the list.

143. The selection of standard components was based on a number of considerations. Those given the greatest weight were:

Components should separately identify transactions that show distinctive economic behavior. For example, financial transactions are separated from transactions in real assets as the two types of transactions are generally undertaken for fundamentally different economic purposes. Conversely, transactions in bonds and transactions in debentures are grouped together in the same component as these two types of financial instruments are very similar.

Each standard component should be significant—in terms of the absolute size of transactions or because the transactions exhibit unusual variability—for a number of countries. For example, travel is a significant element of the balance of payments of many countries and, accordingly, *travel* is one of the standard components. On the other hand, international transactions in life insurance are insignificant for most countries; therefore, these transactions are recorded under the broader *insurance services* item.

Information about a standard component should be obtainable without undue difficulty. The desirability, in terms of other considerations, of collecting statistics for an item should not be the sole reason for its inclusion.

The item should be required for other purposes (such as incorporation into, or reconciliation with, the national accounts). For example, sectoral classifications applied in the ***financial account*** are necessary to satisfy national accounts requirements for financial accounts for each domestic sector.

The list of standard components should not be unduly long. While some countries would be capable of providing BOP information for a more extensive list of standard components, countries that are less statistically advanced would find it difficult to meet IMF reporting requirements if the list were expanded.

To the extent practicable, standard components should be in concordance with other international statistical systems. For example, the standard components in the **current account** of the balance of payments are designed to harmonize as fully as possible with the structure of the production and income accounts of the national accounts.

144. The list of BOP standard components should not constrain countries from compiling and publishing additional information of national importance. Most countries, for example, publish data on international trade in goods in addition to that required in the standard components.

Structural Overview of the Standard Components

145. The standard components are grouped under two major headings: the **current account** and the **capital and financial account**. The current account is further subdivided into three broad categories: ***goods and services*** (which is subdivided into ***goods*** and ***servies***), ***income***, and ***current transfers***. The **capital and financial account** includes, in the ***capital account***, capital transfers

and transactions (purchases/sales) in an economy's non-produced, nonfinancial assets (such as patents and copyrights) and, in the ***financial account***, transactions in an economy's external financial assets and liabilities.

146. The *BPM* describes transactions to be recorded as specific items under major BOP standard components and subcomponents. In this *Textbook*, *BPM* definitions are examined and illustrated.

Goods, Services, and Income

147. The standard components covering goods, services, and income are designed to reflect the provision or acquisition of real resources by the reporting economy to or from the rest of the world. Flows recorded as credits measure that portion of the reporting economy's domestic product provided to other economies (exports of goods and services) as well as the reporting economy's factors of production (compensation of employees and investment income) used in the productive process in the rest of the world. Flows recorded as debits measure acquisition of the rest of the world's domestic product (imports of goods and services in the reporting economy's balance of payments) and the reporting economy's use of nonresident factors of production. According to the *BPM*, transactions in goods, services, and income should be presented on a gross basis; that is, debit entries are shown separately from credit entries.

148. Effective compilation of data on goods, services, and income for the balance of payments requires classification as well as definition. While it is usually important to know the total value of an economy's exports, any meaningful analysis of year-to-year changes in the export total will require disaggregation. Total goods, services, and income represent an aggregate of many different elements responding to widely varying economic influences, and analysis of the separate movements of the major elements is obviously necessary. However, the balance of payments would become most unwieldy if every commodity traded, every service performed, and every type of income receivable were listed as separate components. Goods, services, and income must therefore be classified—that is, grouped into categories containing items that behave similarly in response to a particular stimulus. Also, it may be necessary to combine elements that are not entirely similar to prevent the creation of an unwieldy BOP statement. For this reason, flows of goods, services, and income that behave with only a certain degree of similarity may be classified in the same standard component or subgroup. Furthermore, classification on the basis of economic criteria must often be modified for statistical convenience. Transactions typically recorded together in source data may have to be classified in the same standard component.

149. The ***goods and services*** and ***income*** components cover three types of transactions: (1) changes in ownership—which can be legal or imputed—of goods, (2) performance of services, and (3) accrual of income. In spite of the clear theoretical distinction between commodities and services, it is sometimes difficult in practice to make the classification. For example, how should the sale of electricity be treated? Are Swiss generating plants that transmit power to France providing goods or services? Electricity may be considered a service because no physical commodity changes hands. However, gas, which has physical characteristics and is generally considered a commodity, is included in ***goods***. Should electric power, by analogy, be included in ***goods***? (In fact, electric power is classified under ***goods*** in the BOP standard components.)

150. The *general merchandise* item, which—for most countries—represents the majority of transactions in goods, is a prime example of the grouping of transactions that are not all similar. Some goods are less durable than others. Some goods are so perishable that they must be sold immediately or be lost; other goods may be stored to await stronger demand. Exports and imports of foodstuffs follow patterns of production and demand that differ greatly from those of capital goods.

151. The classification of all general merchandise in one item is purely the result of practical considerations. In the first place, almost every country is able to provide—as part of its international trade statistics—a detailed commodity breakdown, and these data will generally meet the requirements of those wishing to analyze trade movements on a commodity-by-commodity basis. To facilitate studies that take into account both international trade statistics and the ***goods*** component of the balance of payments, the *Balance of Payments Statistics Yearbook* published by the IMF customarily contains, for each country, a reconciliation of the BOP trade component with international trade statistics. In the second place, a standardized analysis of goods is almost an

impossibility. To facilitate international comparability, the standard components of the balance of payments were selected on the basis of relevance in most, rather than a few, countries. Thus, while rice may be an important export and warrant separate mention in the BOP statement of Thailand, rice would not be prominent in the BOP statement of Iceland. Only at the level of total exports can the trade in goods of the two countries be meaningfully compared.

152. For reasons such as these, the *general merchandise* item covers most of an economy's exports and imports of goods. However, some of an economy's transactions in goods should be separately identified (for example, transactions in *nonmonetary gold* and *goods for processing*). The rationale for separate identification (which enhances the analytic usefulness of the standard components) of these items is explained in chapter 4.

153. Transactions in services are similar to transactions in goods in the sense that both are outputs from the process of production and both are consumed—on an intermediate (input for further production) or final basis. However, a close—if not immediate—relationship generally exists between the production and consumption of services. Once produced, services generally cannot be stored for future consumption. The BOP standard components classification of ***services*** groups transactions in services by nature of production rather than by type of consumer. For example, a financial service provided to the insurance industry is classified as a financial, rather than an insurance, service. However, services and goods acquired by travelers are classified under ***services****-travel* rather than the produced form of the services or goods. For example, if a traveler acquires educational services while he is in an economy other than the one in which he is a resident, the transaction is classified as a travel, rather than an educational, service.

154. Whereas goods and services are outputs of the process of production, transactions involving use of the factors of production can only be inputs for the production process. For this reason, in the national accounts, a fundamental distinction is made between (1) the production of goods and services and (2) the use of the factors of production (income). This distinction is important in the BOP standard components in which income transactions are separately identified.

Current Transfers

155. The BOP **current account** includes ***current transfers*** as well as transactions in real resources. Transfers are offsetting entries to the provision, without a quid pro quo, of real or financial resources. Transfers are classified as ***current*** or *capital*. ***Current transfers*** offset the provision of real or financial resources that are immediately consumed or those that are consumed shortly after the transfer is made. For example, a cash grant from a nonresident is used to buy wheat for immediate consumption. The grant is a ***current transfer*** as the provision of cash and the consumption of wheat are closely related.

156. The relationship between ***current transfers*** and consumption is the basis for including them in the **current account**. ***Current transfers,*** along with transactions in real resources, have a direct and immediate impact on an economy's opportunities for consumption in any specific period.

157. Credit entries recorded under ***current transfers*** reflect offsetting entries to the compiling economy's receipt, without a quid pro quo, of real or financial resources. Debit entries are offsets to the compiling economy's provision, without a quid pro quo, of real or financial resources. As with transactions in goods and services and in income, gross credit and debit entries are separately shown for ***current transfers*** in the standard components of the balance of payments.

Capital Account

158. The ***capital account***, which is a subdivision of the **capital and financial account**, includes an economy's transactions with nonresidents in *non-produced, nonfinancial assets* (such as patents, copyrights, and licenses) and in *capital transfers*. These transactions are separated from transactions recorded in the **current account** because capital account transactions are not directly related to the processes of production and consumption. The ***capital account*** of the balance of payments is synonymous with the capital account of the national accounts. Gross credit and gross debit entries should be shown separately for capital account transactions.

159. There is an important distinction between (1) non-produced, nonfinancial assets and (2) services produced from these assets. These services, which are generically called *royalties and licensing fees*, are recorded (along with all other

transactions in services involving residents and nonresidents) in the ***services*** component of the **current account**. For example, the copyright to Beatles songs is a *non-produced, nonfinancial asset*, and transactions in this asset are recorded in the ***capital account***. However, royalty payments made to the owner of the copyright reflect productive output from the use of the asset. In other words, the royalties are payment for a service provided by the owner of the copyright to the user of the songs.

160. Offsets to transactions in *capital transfers* can be recorded in the **current account** or in the capital or financial components of the **capital and financial account**. A transfer is classified as *capital* if the transfer involves the provision of a capital asset or if the transfer involves the provision of a financial asset and that financial asset is linked to the acquisition or disposal of a capital asset. A capital asset is any nonfinancial asset that can produce a stream of services over time. For example, aircraft are capital assets because aircraft can provide passenger services for many years.

Financial Account

161. Transactions in the compiling economy's financial assets and liabilities are recorded in the ***financial account***, which is a subdivision of the **capital and financial account**. The ***financial account*** shows how an economy's BOP transactions are financed. If an economy's savings exceed its investment, the surplus must be reflected in net financial outflow or net financial investment in the rest of the world. This financial outflow finances, in turn, the acquisition of nonfinancial resources by other economies. If an economy's savings are less than its investment, the economy will be a net importer of nonfinancial assets from the rest of the world. These net imports must be financed by a net financial inflow from the rest of the world.

162. Financial account transactions are classified by (1) functional type of investment (*direct investment, portfolio investment, other investment*, and *reserve assets*); (2) assets and liabilities or, in the case of *direct investment*, direction of investment; (3) type of instrument (for example, equity, debt securities, and loans); and, in some cases, by (4) domestic sector and (5) original contractual maturity. The similarity of this classification to the one used for the *investment income* component of the **current account** permits consistency of analysis between these closely related BOP components.

163. Users of BOP statistics are generally interested in net, rather than gross, financial account transactions. For this reason, it is recommended in the *BPM* that—for the most part—financial account items be shown as net credit (financial inflow) or net debit (financial outflow) entries.

International Investment Position

164. The classification scheme presented in the *BPM* for the IIP statement, which shows an economy's stock of external financial assets and liabilities at a particular point in time, is similar to the classification scheme used for the ***financial account*** and the *investment income* portion of the **current account**. This similarity of classification reflects the close relationship between the IIP statement and these two components of the balance of payments.

165. It is suggested in the *BPM* that the IIP statement be presented in the form of a reconciliation between positions existing at two points in time. Changes occurring over time in an economy's international investment position can be the result of (1) transactions that are recorded in the ***financial account*** of the balance of payments or (2) other changes, such as changes in prices of assets and liabilities or changes in the exchange rate of the unit of account vis-à-vis the currency in which the assets and liabilities are denominated. Unilateral actions (such as the monetization of gold and debt write-offs) that create or destroy financial assets are another cause of non-transaction changes in stocks of financial assets and liabilities. Further information on the reconciliation between the balance of payments and the international investment position can be found in paragraphs 690–702 of chapter 13.

Standard Components of the Balance of Payments

	Credit	Debit
1. Current Account		
A. Goods and services.		
a. Goods		
1. General merchandise		
2. Goods for processing		
3. Repairs on goods		
4. Goods procured in ports by carriers		
5. Nonmonetary gold		
5.1 Held as a store of value		
5.2 Other		
b. Services		
1. Transportation		
1.1 Sea transport		
1.1.1 Passenger		
1.1.2 Freight		
1.1.3 Other		
1.2 Air transport		
1.2.1 Passenger		
1.2.2 Freight		
1.2.3 Other		
1.3 Other transport		
1.3.1 Passenger		
1.3.2 Freight		
1.3.3 Other		
2. Travel		
2.1 Business		
2.2 Personal*		
3. Communications services		
4. Construction services		
*5. Insurance services***		
6. Financial services		
7. Computer and information services		
8. Royalties and license fees		
9. Other business services		
9.1 Merchanting and other trade-related services		
9.2 Operational leasing services		
9.3 Miscellaneous business, professional, and technical services*		
10. Personal, cultural, and recreational services		
10.1 Audiovisual and related services		
10.2 Other personal, cultural, and recreational services		
11. Government services n.i.e.		
B. Income		
1. Compensation of employees		
2. Investment income		
2.1 Direct investment		
2.1.1 Income on equity		
2.1.1.1 Dividends and distributed branch profits***		
2.1.1.2 Reinvested earnings and undistributed branch profits***		
2.1.2 Income on debt (interest)		
2.2 Portfolio investment		
2.2.1 Income on equity (dividends)		
2.2.2 Income on debt (interest)		
2.2.2.1 Bonds and notes		
2.2.2.2 Money market instruments and financial derivatives		
2.3 Other investment		

*See Supplementary Information table on page 00 for components.

**Memorandum items: 5.1 Gross premiums
5.2 Gross claims

***If distributed branch profits are not identified, all branch profits are considered to be distributed.

Standard Components of the Balance of Payments *(continued)*

	Credit	Debit
C. Current transfers		
1. General government		
2. Other sectors		
2.1 Workers' remittances		
2.2 Other transfers		
2. Capital and Financial Account		
A. Capital account		
1. Capital transfers		
1.1 General government		
1.1.1 Debt forgiveness		
1.1.2 Other		
1.2 Other sectors		
1.2.1 Migrants' transfers		
1.2.2 Debt forgiveness		
1.2.3 Other		
2. Acquisition/disposal of non-produced, nonfinancial assets		
B. Financial account		
1. Direct investment		
1.1 Abroad		
1.1.1 Equity capital		
1.1.1.1 Claims on affiliated enterprises		
1.1.1.2 Liabilities to affiliated enterprises		
1.1.2 Reinvested earnings		
1.1.3 Other capital		
1.1.3.1 Claims on affiliated enterprises		
1.1.3.2 Liabilities to affiliated enterprises		
1.2 In reporting economy		
1.2.1 Equity capital		
1.2.1.1 Claims on direct investors		
1.2.1.2 Liabilities to direct investors		
1.2.2 Reinvested earnings		
1.2.3 Other capital		
1.2.3.1 Claims on direct investors		
1.2.3.2 Liabilities to direct investors		
2. Portfolio investment		
2.1 Assets		
2.1.1 Equity securities		
2.1.1.1 Monetary authorities		
2.1.1.2 General government		
2.1.1.3 Banks		
2.1.1.4 Other sectors		
2.1.2 Debt securities		
2.1.2.1 Bonds and notes		
2.1.2.1.1 Monetary authorities		
2.1.2.1.2 General government		
2.1.2.1.3 Banks		
2.1.2.1.4 Other sectors		
2.1.2.2 Money market instruments		
2.1.2.2.1 Monetary authorities		
2.1.2.2.2 General government		
2.1.2.2.3 Banks		
2.1.2.2.4 Other sectors		
2.1.2.3 Financial derivatives		
2.1.2.3.1 Monetary authorities		
2.1.2.3.2 General government		
2.1.2.3.3 Banks		
2.1.2.3.4 Other sectors		

Standard Components of the Balance of Payments *(continued)*

	Credit	Debit
2.2 Liabilities		
2.2.1 Equity securities		
2.2.1.1 Banks		
2.2.1.2 Other sectors		
2.2.2 Debt securities		
2.2.2.1 Bonds and notes		
2.2.2.1.1 Monetary authorities		
2.2.2.1.2 General government		
2.2.2.1.3 Banks		
2.2.2.1.4 Other sectors		
2.2.2.2 Money market instruments		
2.2.2.2.1 Monetary authorities		
2.2.2.2.2 General government		
2.2.2.2.3 Banks		
2.2.2.2.4 Other sectors		
2.2.2.3 Financial derivatives		
2.2.2.3.1 Banks		
2.2.2.3.2 Other sectors		
3. Other investment		
3.1 Assets		
3.1.1 Trade credits		
3.1.1.1 General government		
3.1.1.1.1 Long-term		
3.1.1.1.2 Short-term		
3.1.1.2 Other sectors		
3.1.1.2.1 Long-term		
3.1.1.2.2 Short-term		
3.1.2 Loans		
3.1.2.1 Monetary authorities		
3.1.2.1.1 Long-term		
3.1.2.1.2 Short-term		
3.1.2.2 General government		
3.1.2.2.1 Long-term		
3.1.2.2.2 Short-term		
3.1.2.3 Banks		
3.1.2.3.1 Long-term		
3.1.2.3.2 Short-term		
3.1.2.4 Other sectors		
3.1.2.4.1 Long-term		
3.1.2.4.2 Short-term		
3.1.3 Currency and deposits		
3.1.3.1 Monetary authorities		
3.1.3.2 General government		
3.1.3.3 Banks		
3.1.3.4 Other sectors		
3.1.4 Other assets		
3.1.4.1 Monetary authorities		
3.1.4.1.1 Long-term		
3.1.4.1.2 Short-term		
3.1.4.2 General government		
3.1.4.2.1 Long-term		
3.1.4.2.2 Short-term		
3.1.4.3 Banks		
3.1.4.3.1 Long-term		
3.1.4.3.2 Short-term		
3.1.4.4 Other sectors		
3.1.4.4.1 Long-term		
3.1.4.4.2 Short-term		

Standard Components of the Balance of Payments *(concluded)*

	Credit	Debit
3.2 Liabilities		
3.2.1 Trade credits		
3.2.1.1 General government		
3.2.1.1.1 Long-term		
3.2.1.1.2 Short-term		
3.2.1.2 Other sectors		
3.2.1.2.1 Long-term		
3.2.1.2.2 Short-term		
3.2.2 Loans		
3.2.2.1 Monetary authorities		
3.2.2.1.1 Use of Fund credit and loans from the Fund		
3.2.2.1.2 Other long-term		
3.2.2.1.3 Short-term		
3.2.2.2 General government		
3.2.2.2.1 Long-term		
3.2.2.2.2 Short-term		
3.2.2.3 Banks		
3.2.2.3.1 Long-term		
3.2.2.3.2 Short-term		
3.2.2.4 Other sectors		
3.2.2.4.1 Long-term		
3.2.2.4.2 Short-term		
3.2.3 Currency and deposits		
3.2.3.1 Monetary authorities		
3.2.3.2 Banks		
3.2.4 Other liabilities		
3.2.4.1 Monetary authorities		
3.2.4.1.1 Long-term		
3.2.4.1.2 Short-term		
3.2.4.2 General government		
3.2.4.2.1 Long-term		
3.2.4.2.2 Short-term		
3.2.4.3 Banks		
3.2.4.3.1 Long-term		
3.2.4.3.2 Short-term		
3.2.4.4 Other sectors		
3.2.4.4.1 Long-term		
3.2.4.4.2 Short-term		
4. Reserve assets		
4.1 Monetary gold		
4.3 Reserve position in the Fund		
4.4 Foreign exchange		
4.4.1 Currency and deposits		
4.4.1.1 With monetary authorities		
4.4.1.2 With banks		
4.4.2 Securities		
4.4.2.1 Equities		
4.4.2.2 Bonds and notes		
4.4.2.3 Money market instruments and financial derivatives		
4.5 Other claims		

Selected Supplementary Information

1. Liabilities constituting foreign authorities' reserves
- 1.1 Bonds and other securities
  - 1.1.1 Monetary authorities
  - 1.1.2 General government
  - 1.1.3 Banks
  - 1.1.4 Other sectors
- 1.2 Deposits
  - 1.2.1 Monetary authorities
  - 1.2.2 Banks
- 1.3 Other liabilities
  - 1.3.1 Monetary authorities
  - 1.3.2 General government
  - 1.3.3 Banks
  - 1.3.4 Other sectors

2. Exceptional financing transactions
- 2.1 Transfers
  - 2.1.1 Debt forgiveness
  - 2.1.2 Other intergovernmental grants
  - 2.1.3 Grants received from Fund subsidy accounts
- 2.2 Direct investment
  - 2.2.1 Investment associated with debt reduction
  - 2.2.2 Other
- 2.3 Portfolio investment: borrowing by authorities or other sectors on authorities' behalf—liabilities*
- 2.4 Other investment—liabilities*
  - 2.4.1 Drawings on new loans by authorities or other sectors on authorities' behalf
  - 2.4.2 Rescheduling of existing debt
  - 2.4.3 Accumulation of arrears
    - 2.4.3.1 Principal on short-term debt
    - 2.4.3.2 Principal on long-term debt
    - 2.4.3.3 Original interest
    - 2.4.3.4 Penalty interest
  - 2.4.4 Repayments of arrears
    - 2.4.4.1 Principal
    - 2.4.4.2 Interest
  - 2.4.5 Rescheduling of arrears
    - 2.4.5.1 Principal
    - 2.4.5.2 Interest
  - 2.4.6 Cancellation of arrears
    - 2.4.6.1 Principal
    - 2.4.6.2 Interest

3. Other transactions
- 3.1 Portfolio investment income
  - 3.1.1 Monetary authorities
  - 3.1.2 General government
  - 3.1.3 Banks
  - 3.1.4 Other sectors
- 3.2 Other (than direct investment) income
  - 3.2.1 Monetary authorities
  - 3.2.2 General government
  - 3.2.3 Banks
  - 3.2.4 Other sectors
- 3.3 Other investment (liabilities)
  - 3.3.1 Drawings on long-term trade credits
  - 3.3.2 Repayments of long-term trade credits
  - 3.3.3 Drawings on long-term loans
  - 3.3.4 Repayments of long-term loans

*Specify sector involved and standard component in which the item is included.

Selected Supplementary Information *(concluded)*

4. Services sub-items
- 4.1 Travel (personal)
  - 4.1.1 Health-related
  - 4.1.2 Education-related
  - 4.1.3 Other
- 4.2 Miscellaneous business, professional, and technical services
  - 4.2.1 Legal, accounting, management consulting, and public relations
  - 4.2.2 Advertising, market research, and public opinion polling
  - 4.2.3 Research and development
  - 4.2.4 Architectural, engineering, and other technical services
  - 4.2.5 Agricultural, mining, and on-site processing
  - 4.2.6 Other

Standard Components of the International Investment Position

	Position at Beginning of Year	Changes in Position Reflecting				Position at End of Year
		Transactions	Price Changes	Exchange Rate Changes	Other Adjustments	
A. Assets						
*1. Direct investment abroad**						
1.1 Equity capital and reinvested earnings						
1.1.1 Claims on affiliated enterprises						
1.1.2 Liabilities to affiliated enterprises						
1.2 Other capital						
1.2.1 Claims on affiliated enterprises						
1.2.2 Liabilities to affiliated enterprises						
2. Portfolio investment						
2.1 Equity securities						
2.1.1 Monetary authorities						
2.1.2 General government						
2.1.3 Banks						
2.1.4 Other sectors						
2.2 Debt securities						
2.2.1 Bonds and notes						
2.2.1.1 Monetary authorities						
2.2.1.2 General government						
2.2.1.3 Banks						
2.2.1.4 Other sectors						
2.2.2 Money market instruments						
2.2.2.1 Monetary authorities						
2.2.2.2 General government						
2.2.2.3 Banks						
2.2.2.4 Other sectors						
2.2.3 Financial derivatives						
2.2.3.1 Monetary authorities						
2.2.3.2 General government						
2.2.3.3 Banks						
2.2.3.4 Other sectors						
3. Other investment						
3.1 Trade credits						
3.1.1 General government						
3.1.1.1 Long-term						
3.1.1.2 Short-term						
3.1.2 Other sectors						
3.1.2.1 Long-term						
3.1.2.2 Short-term						
3.2 Loans						
3.2.1 Monetary authorities						
3.2.1.1 Long-term						
3.2.1.2 Short-term						
3.2.2 General government						
3.2.2.1 Long-term						
3.2.2.2 Short-term						
3.2.3 Banks						
3.2.3.1 Long-term						
3.2.3.2 Short-term						
3.2.4 Other sectors						
3.2.4.1 Long-term						
3.2.4.2 Short-term						

*Because direct investment is classified primarily on a directional basis—abroad under the heading **Assets** and in the reporting economy under the heading **Liabilities**—claim/liability breakdowns are shown for the components of each, although these sub-items do not strictly conform to the asset and liability headings.

Standard Components of the International Investment Position *(continued)*

	Position at Beginning of Year	Changes in Position Reflecting: Transactions	Changes in Position Reflecting: Price Changes	Changes in Position Reflecting: Exchange Rate Changes	Changes in Position Reflecting: Other Adjustments	Position at End of Year
3.3 Currency and deposits						
3.3.1 Monetary authorities						
3.3.2 General government						
3.3.3 Banks						
3.3.4 Other sectors						
3.4 Other assets						
3.4.1 Monetary authorities						
3.4.1.1 Long-term						
3.4.1.2 Short-term						
3.4.2 General government						
3.4.2.1 Long-term						
3.4.2.2 Short-term						
3.4.3 Banks						
3.4.3.1 Long-term						
3.4.3.2 Short-term						
3.4.4 Other sectors						
3.4.4.1 Long-term						
3.4.4.2 Short-term						
4. Reserve assets						
4.1 Monetary gold						
4.2 Special drawing rights						
4.3 Reserve position in the Fund						
4.4 Foreign exchange						
4.4.1 Currency and deposits						
4.4.1.1 With monetary authorities						
4.4.1.2 With banks						
4.4.2 Securities						
4.4.2.1 Equities						
4.4.2.2 Bonds and notes						
4.4.2.3 Money market instruments and financial derivatives						
4.5 Other claims						
B. Liabilities						
*1. Direct investment in reporting economy**						
1.1 Equity capital and reinvested earnings						
1.1.1 Claims on direct investors						
1.1.2 Liabilities to direct investors						
1.2 Other capital						
1.2.1 Claims on direct investors						
1.2.2 Liabilities to direct investors						
2. Portfolio investment						
2.1 Equity securities						
2.1.1 Banks						
2.1.2 Other sectors						
2.2 Debt securities						
2.2.1 Bonds and notes						
2.2.1.1 Monetary authorities						
2.2.1.2 General government						
2.2.1.3 Banks						
2.2.1.4 Other sectors						

*Because direct investment is classified primarily on a directional basis—abroad under the heading **Assets** and in the reporting economy under the heading **Liabilities**—claim/liability breakdowns are shown for the components of each, although these sub-items do not strictly conform to the asset and liability headings.

Standard Components of the International Investment Position *(concluded)*

	Position at Beginning of Year	Changes in Position Reflecting: Transactions	Changes in Position Reflecting: Price Changes	Changes in Position Reflecting: Exchange Rate Changes	Changes in Position Reflecting: Other Adjustments	Position at End of Year
2.2.2 Money market instruments						
2.2.2.1 Monetary authorities						
2.2.2.2 General government						
2.2.2.3 Banks						
2.2.2.4 Other sectors						
2.2.3 Financial derivatives						
2.2.3.1 Monetary authorities						
2.2.3.2 General government						
2.2.3.3 Banks						
2.2.3.4 Other sectors						
3. Other investment						
3.1 Trade credits						
3.1.1 General government						
3.1.1.1 Long-term						
3.1.1.2 Short-term						
3.1.2 Other sectors						
3.1.2.1 Long-term						
3.1.2.2 Short-term						
3.2 Loans						
3.2.1 Monetary authorities						
3.2.1.1 Use of Fund credit and loans from the Fund						
3.2.1.2 Other long-term						
3.2.1.3 Short-term						
3.2.2 General government						
3.2.2.1 Long-term						
3.2.2.2 Short-term						
3.2.3 Banks						
3.2.3.1 Long-term						
3.2.3.2 Short-term						
3.2.4 Other sectors						
3.2.4.1 Long-term						
3.2.4.2 Short-term						
3.3 Currency and deposits						
3.3.1 Monetary authorities						
3.3.2 Banks						
3.4 Other liabilities						
3.4.1 Monetary authorities						
3.4.1.1 Long-term						
3.4.1.2 Short-term						
3.4.2 General government						
3.4.2.1 Long-term						
3.4.2.2 Short-term						
3.4.3 Banks						
3.4.3.1 Long-term						
3.4.3.2 Short-term						
3.4.4 Other sectors						
3.4.4.1 Long-term						
3.4.4.2 Short-term						

IV. Goods

166. As defined in the *BPM*, the ***goods*** component of the balance of payments covers *general merchandise, goods for processing, repairs on goods, goods procured in ports by carriers,* and *nonmonetary gold. General merchandise* (sometimes referred to as *merchandise*) is defined for BOP purposes as covering (with a few specific exceptions) all movable goods for which actual or imputed changes of ownership occur between residents and nonresidents.

167. Certain commodities, although constituting real assets that undergo international changes in ownership, are nonetheless excluded from the ***goods*** component and included in other standard components of the balance of payments. Primary examples of goods excluded from the ***goods*** component and included in other portions of the **current account** are:

monetary gold, which is classified under *reserve assets* in the ***financial account;***

goods acquired by travelers and nonresident workers for their own use and recorded under *travel* (part of ***services***);

goods that are acquired from host countries by embassies, consulates, military missions and agencies, and related nonresident personnel and classified under *government services n.i.e.* (part of ***services***);

newspapers and periodicals (not in bulk) sent under direct subscription and included under *computer and information services* (part of ***services***);

goods that are acquired and relinquished within the same recording period, do not cross the frontier, and are recorded—on a net basis—under the *merchanting and other trade-related services* portion of *other business services* (part of ***services***).

168. Assets regarded as evidence of financial claims (even when such assets possess material form and are movable) are included in a BOP financial account component appropriate to the type of claim. Examples of such assets are paper money and coin in current circulation and securities that have been issued. Furthermore, if a change in the ownership of a real asset results from the acquisition of an existing enterprise by a resident of an economy other than the one in which the enterprise is located, the change of ownership is treated as a financial transaction and not included in ***goods***. (Exceptions are changes of ownership actually involving physical movement of goods across the frontier.) The change of ownership is treated thus because the enterprise is considered a resident of the economy in which the enterprise operates (see paragraph 92), and ownership of the enterprise is considered a financial investment.

169. As the previous paragraph indicates, the ***goods*** component does not cover all changes, between residents and nonresidents, in the ownership of commodities. Criteria for items to be included or excluded from ***goods*** are not always as clear as those for the exclusion of goods regarded as evidence of financial claims.

170. An explanation for the existence of exceptions to coverage, by the ***goods*** component of the balance of payments, of all exchanges in real assets may be found in the considerations (discussed in paragraph 143) for determination of BOP standard components. Two of these considerations are particularly important:

The item should exhibit distinctive behavior that demonstrates a unique response to a particular economic factor or combination of factors.

It should be possible to obtain statistics for the item without undue difficulty.

171. Therefore, transactions depicting similar behavioral characteristics are grouped together if separate data can be obtained for the group of transactions selected. For example, forces influencing the purchase of commodities by a nonresident traveler differ sufficiently from those affecting the host country's other exports to warrant the exclusion of such purchases from the ***goods*** component. In addition, it would be difficult to obtain statistics on individual purchases made by nonresident travelers.

Similar reasoning applies to the other exceptions cited in paragraph 167. For instance, goods that are acquired and relinquished within the same reporting period and do not cross the frontier are classified under *merchanting and other trade-related services* (rather than ***goods***) provided by an economy to the rest of the world because the provision of merchanting services is generally unrelated to a country's consumption of imports and production of exports.

172. While certain specific transactions are excluded from the ***goods*** component, other transactions are included—even though such transactions may be more akin to services. For example, an element of transportation is often included in the value of goods because of the BOP accounting convention requiring goods to be uniformly valued at the customs frontier of the exporting country. This basis of valuation differs from the pure concept of commodity transactions, which are usually used in constructing input-output tables for valuing goods at the establishment of the producer. The rationale for selection of the customs frontier as the point of valuation is discussed in paragraphs 220–227.

173. Within the ***goods*** component, four special types of transactions are separately distinguished from *general merchandise*. These are:

(1) goods sent abroad for processing and subsequently returned to the country of the original exporter (These goods are part of the *goods for processing* item.)

(2) goods (and services) used in the repair of other goods owned by nonresidents (These goods are part of the *repairs on goods* item.)

(3) fuels, provisions, stores, and supplies for carriers (Commodities purchased for commercial use in ships, aircraft, and other carriers are assigned to the *goods procured in port by carriers* item.)

(4) *nonmonetary gold*, which is subdivided into gold held as a store of value and other gold.

174. Although the commodities involved are clearly goods, the transactions are often undertaken for reasons other than the general level of economic activity within an economy. Also, the inclusion of such transactions in *general merchandise* could create a misleading impression about the volume of a country's merchandise transactions. For example, fuel purchased by carriers for use in operations is not recorded in the *general merchandise* category because purchases of fuel for carriers are more closely linked to transportation operations than to an economy's demand for oil. Classification of such fuel purchases as *general merchandise* transactions might be economically meaningful for the country selling the fuel but much less so for the country purchasing it. For similar reasons of symmetry, ships' supplies are grouped under *goods procured in port by carriers*. Transactions in *nonmonetary gold* are often motivated by considerations other than the use of gold as part of the processes of production and consumption. Including these transactions in *general merchandise* could create a misleading impression about an economy's production (in the case of exports) or consumption (in the case of imports). Accordingly, under the ***goods*** component, transactions in *nonmonetary gold* are shown separately from those in *general merchandise*. Transactions in *goods for processing* are often very large in a gross sense, but the net impact of these transactions on an economy is much smaller. Including these transactions in *general merchandise* could create a misleading impression about the overall size of a country's external trade.

175. In summary, the concept of transactions in goods excludes certain commodity exchanges between economies but includes certain distributive services. Furthermore, while most transactions in goods are classified under *general merchandise*, some transactions are separately identified. These classifications are the result of analytical considerations and statistical convenience.

Convention for Recording Change of Ownership

176. Aside from the exceptions noted previously, the content of the ***goods*** component is defined with reference to changes in the ownership of all movable goods subject to exchanges between residents and nonresidents. The change of ownership rule adopted for defining goods ensures, in principle, that the ***goods*** component is consistent—with regard to coverage and timing—with other items (especially financial items) in the balance of payments. According to the *BPM*, goods for export are generally considered to change ownership when the exporter ceases to carry the goods on his books as real assets and makes a corresponding change in his financial items. In this way, consistency is ensured between the ***goods*** component and the BOP ***financial account*** of the

compiling county. Consistent compilation of the ***goods*** component by exporting and importing countries is thus ensured as well. The following example illustrates the simultaneity, both internal and inter-country, of the pairs of entries.

	Exporting Country	**Importing Country**
Goods	credit	debit
Financial account	debit	credit

177. International standards for trade statistics, which are often used as a source for compiling the ***goods*** component of the balance of payments, are based—not on change of ownership—but on physical movements of goods across national (or customs) frontiers. Although goods that change ownership internationally are, for the most part, the same goods that move across frontiers, the change of ownership and the movement of the goods do not necessarily occur at the same time. International transactions reporting systems (such as those based on foreign exchange and similar bank records) are another possible source of information for the ***goods*** component. In these systems, transactions in goods are not generally recorded on a change of ownership basis. The nature of these differences should become clearer in the context of information presented, in subsequent sections of this chapter, on timing adjustments required to convert source data for use in the balance of payments.

Exceptions to the Change of Ownership Rule

178. While the scope of the ***goods*** component is restricted to commodities that have undergone a change—between a resident and a nonresident—of ownership, the *BPM* nevertheless introduces a few exceptions to the change of ownership principle. Each exception and underlying rationale is discussed in a subsequent paragraph.

Enterprises Operating in More Than One Economy

179. As noted in chapter 2, when a multinational enterprise has significant operations in more than one economy, a separate resident enterprise is assumed to exist in each of the economies where the multinational concern is operating. Goods exchanged between the constituent units of the multinational enterprise do not, in fact, change ownership as would have been the case for goods exchanged by units of separate legal entities. Transactions between a parent company and a branch cannot, in the literal sense, bring about a legal change of ownership because both parties are part of the same legal entity. However, it is recommended in the *BPM* that any international shipment of commodities exchanged between units that are part of a multinational enterprise and constitute a single legal entity be construed as a change in the ownership of the goods. The transaction is therefore included in the balance of payments.

180. In the situation described in the preceding paragraph, a change of ownership is ascribed on the basis of international shipment. The circumstances differ very little from those in which a commodity is exchanged between a parent company and its subsidiary (an incorporated enterprise). As the parent company and its subsidiary constitute separate legal entities, the change of ownership rule may be strictly applied. In this case, the ***goods*** component of the balance of payments would be comprised of commodities that had actually undergone a change, between a resident (e.g., the parent company) and a nonresident (e.g., its subsidiary), of ownership. In the *BPM*, however, international transactions between affiliated enterprises that are not legally distinct from one another are treated the same as international transactions between enterprises that are legally distinct. Thus, the *BPM* recommendation is that all transactions between direct investment enterprises and parent or other related enterprises be recorded as if changes of ownership have occurred. This general instruction does not apply, however, to the kinds of transactions in goods specified in paragraph 201.

Financial Leases

181. The possession of goods may also, in effect, change between a resident and a nonresident who are not affiliated and do not record a change of ownership in their accounts. A common means of transferring the control of goods without a legal change of ownership is through financial leasing. Such lease arrangements provide for the recovery of all, or substantially all, of the cost of the goods and for carrying charges. Furthermore, under a financial lease, most (if not all) of the risks and benefits of ownership are transferred from the lessor to the lessee. In consideration of the essential nature—rather than the legal form—of the transactions, the *BPM* recommendation is that goods covered by such

leasing arrangements be recorded in the balance of payments as exports and imports when the goods pass from a lessor resident in one economy to a lessee resident in another.

182. To distinguish financial leases from other forms of leasing, a suggested rule of thumb is that a lease arrangement expected to cover carrying charges and at least three-fourths of the cost of the goods is sufficient evidence of financial leasing and has the same effect as a change of ownership.[7] At the inception of the financial lease, the equivalent of the market value of the goods (not the cumulative total of expected lease payments) should be recorded under ***goods***, and an offsetting entry should be made in the ***financial account*** to record the credit extended to the lessee. (Refer to paragraphs 109–111 for more details on the methodology underlying the recording of transactions relating to financial leases.)

Goods for Processing

183. When there is no change of ownership, the treatment of goods sent abroad for processing and re-export depends upon whether the goods are returned to the economy of origin or exported to a third country. The *BPM* recommendation is that, when goods are shipped from one economy to another for processing and then returned to the first economy, transactions in these goods should be recorded under the ***goods*** component—but separately from *general merchandise* transactions—as if a change of ownership has occurred. However, when the processed goods are exported to a third country, no change of ownership is imputed; in this case, only legal changes of ownership are recorded in the balance of payments.

184. The rationale for the treatment of goods sent abroad for processing and returned to the original exporting economy is based upon requirements of the national accounts and can best be explained by an example. Cromania produces $100 of crude oil and sends the oil to a refinery in Dromesia for processing. A fee of $10 is paid for the processing. The oil is then returned to Cromania in the form of refined oil, which is valued at $110. In the "sources and uses of resources" approach employed in the national accounts, an imputed change of ownership is required to link the produced good (crude oil) with the consumed good (refined oil) in Cromania's national accounts. Were these imputations not made, Cromania's national accounts would show the "disappearance" of crude oil. That is, the crude oil would not be shown as being exported or used for intermediate consumption, and the refined oil would inexplicably appear without ever having been produced or imported.

185. As no legal change of ownership takes place when the crude oil is exported or when the refined oil is imported, imputed financial account entries are required in the balance of payments to preserve the balance between debit and credit entries. Cromanian BOP entries would be:

	Credit	**Debit**
Goods for processing	100	110
Other investment		
Assets		
Trade credits	100**	100*
Reserve assets (or other appropriate financial account item)	10**	

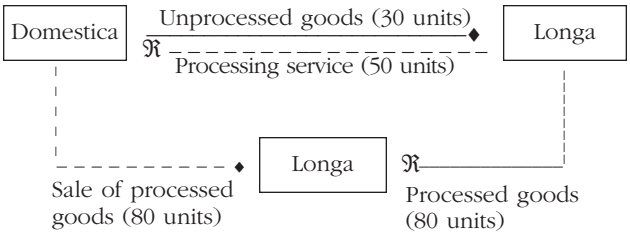
*Reflects the claim that Cromania has on Dromesia because of the oil that the first economy has sent to the second for processing

**Reflects (1) the extinguishment of this claim when the processed oil is returned to Cromania and (2) the payment for the processing

186. In the case of goods that are sent, without a legal change of ownership, from one economy to another for processing and then exported to a third country or ultimately acquired by the processing economy, there is no need to show the same link in the national accounts as production and consumption take place in different economies. In these instances, the *BPM* recommendation is that the change of ownership rule be applied and no transactions in goods are recorded in the balance of payments until legal changes of ownership actually take place. Accordingly, the value added to such goods by processing should be regarded as a service performed by a resident of one economy for a resident of another. For example, goods worth 30 units are shipped (without a transfer of ownership to the processing country) from Domestica to Longa for processing. After processing, the goods are sold by Domestica (the legal owner) to a third country (Pokolbin) for 80 units. In the balance of payments, there would be no transaction in goods between Domestica and Longa or between Longa and Pokolbin, although the external trade statistics of these countries would include those movements. There would, however, be a transaction in goods between Domestica and Pokolbin as well as a service transaction between Domestica and Longa.

[7]Certain leases not satisfying this rule of thumb can be considered financial leases if the leases are accounted for as financial leases in the accounting records of the transactors or if, in the compiler's opinion, most of the benefits and risks of ownership have passed from the lessor to the lessee.

187. The transactions of the three countries are illustrated in the following diagram. Solid lines show the movement of unprocessed goods (valued at 30 units) from Domestica to Longa and the movement of processed goods from Longa to Pokolbin. The processed goods are valued at 80 units (that is, 30 units for the unprocessed goods plus 50 units for the cost of processing). However, transactions to be recorded in the balance of payments consist of (1) the processing service for which Domestica pays a fee of 50 units to Longa and (2) the sale, by Domestica to Pokolbin, of the processed goods for 80 units. These two transactions are indicated by broken lines.



188. BOP entries for the three countries would be:

	Domestica		Longa		Pokolbin	
	Credit	**Debit**	**Credit**	**Debit**	**Credit**	**Debit**
General merchandise	80					80
Services		50	50			
Reserve assets (or other appropriate financia laccount item)		30		50	80	

Merchanting

189. Another exception to the change of ownership rule is made when goods are acquired from one economy and relinquished again to that or some other economy without ever crossing the frontier of the economy in which the temporary owner of the goods is a resident. Unlike the three previously discussed exceptions for which changes of ownership (although there were none in a legal sense) were ascribed, this exception negates the fact that the commodity has changed ownership. According to the *BPM*, the net amounts of the transactions are recorded and classified as transactions in ***services*** rather than transactions in ***goods***. The relevant services, which are merchanting (or commodities arbitrage), are classified under *merchanting and other trade-related services*.

190. The BOP treatment of merchanting transactions is in accordance with what may be termed the "real flows principle." In accordance with this principle, the balance of payments includes, on a gross basis, transactions that are regarded as gross flows of real resources into and out of the domestic economy. However, the balance of payments includes only the value added in the domestic economy by other transactions in goods and services that do not play an important role in relation to economic activity in the reporting economy. With such transactions, the net balance is usually small in relation to the gross turnover. This treatment is consistent with that in the national accounts.

191. If a merchanting transaction is completed within one accounting period, the value added is the difference between the purchase price and the sale price of the goods. For example, a merchant in Clintonstan buys a commodity for 100 units from a resident of Bushland and sells the commodity within the same reference period to an importer in Algornia for 110 units. The production attributable to lintonstan is 10 units, which represent services produced by an entity engaged as a middleman in this form of international trade. In the example, ownership of the goods changes from Bushland to Algornia. BOP entries for the three economies would be:

	Clintonstan		Bushland		Algornia	
	Credit	**Debit**	**Credit**	**Debit**	**Credit**	**Debit**
Goods			100			110
Merchanting and other trade-related services	10					
Reserve assets (or other appropriate financial account item)		10		100	110	

192. Entries made for the three economies under ***goods*** and *merchanting and other trade-related services* are asymmetrical. This asymmetry stems from the pragmatic assumption that the importer in Algornia would seldom, if ever, have information on the merchanting profit or loss realized by the intermediary in Clintonstan. Furthermore, asymmetries arising from the treatment of merchanting transactions are unlikely to have a significant impact on the comparability of international BOP statistics.

193. The treatment is more complicated if a commodity is purchased abroad in one accounting

period and sold abroad in another period. The *BPM* states that merchanted goods acquired in one recording period and relinquished in a subsequent period are recorded in the balance of payments of the temporary owner's economy as imports for the period in which the merchanted goods are acquired and that the same amount is deducted from imports in the period in which the merchanted goods are relinquished. In these cases, changes—from one recording period to another—in stocks of goods located abroad and valued at acquisition cost will constitute part of the ***goods*** component for the economy of the owner. Any difference between the value of the goods when acquired and when relinquished is to be entered under *merchanting and other trade-related services*. Had the merchanting transaction in the example in paragraph 191 taken place during two accounting periods (that is, if Clintonstan had purchased the goods in period 1 and sold them in period 2), the transaction would be recorded as:

Clintonstan's Balance of Payments

	Period 1		Period 2	
	Credit	**Debit**	**Credit**	**Debit**
Goods		100		–100
Merchanting and other trade-related services			10	
Reserve assets (or other appropriate financial account item)	100			110

194. The negative debit entry for imports in the second period is construed as a withdrawal from stocks held abroad. This transaction could have been recorded as a credit entry (exports) because a negative debit is mathematically equivalent to a positive credit. However, the treatment shown in paragraph 193 is preferred as this treatment ensures that, over time, an economy's transactions in goods are not "grossed up" unnecessarily.

Physical Movement of Goods and the Goods Component

195. What is the relationship between the physical movement of goods across customs or national frontiers and coverage of the ***goods*** component in the balance of payments? While there is significant correlation between goods that change ownership internationally and goods that move across the frontier, the changes and the movements do not usually occur at exactly the same times. Furthermore, certain goods that do not cross the customs border may undergo changes of ownership, whereas other goods may cross the border without changing ownership. These two situations and implications for BOP compilation are discussed in subsequent paragraphs.

Goods Not Crossing the Frontier

196. With the exception of merchanting transactions, international changes in the ownership of goods that do not cross the frontier are treated, in the balance of payments, as transactions in ***goods***. The following list contains examples of goods that might not cross the frontier but are nonetheless treated as ***goods*** because ownership has changed:

ships, aircraft, gas and oil drilling rigs, and production platforms;

goods consumed on offshore installations such as gas and oil drilling rigs and production platforms;

fish and other marine products caught and sold abroad directly from the compiling economy's ships;

goods lost or destroyed after the importer has acquired ownership but before the goods have crossed a frontier.

197. Ships and aircraft acquired by a reporting economy and put into international operation may never cross the customs frontier of the reporting economy but, on delivery, the ships and aircraft pass into the ownership of a resident enterprise and thus become part of domestic fixed-capital formation. The ships and aircraft, which are additions to the economy's capital assets, do not result from domestic production and therefore originate in imports of goods. The same is true of gas and oil drilling rigs and production platforms acquired from abroad by a resident enterprise and used in offshore operations. Such equipment may be acquired under a financial lease or be the property of a direct investment affiliate that is designated a resident enterprise. In both cases, transactions in ***goods*** should be recorded. (Refer to paragraphs 103–106 for a discussion of the treatment of mobil equipment.)

198. Once the residence of enterprises operating offshore installations (such as gas and oil drilling rigs and production platforms) is identified, any goods acquired from abroad and consumed by such installations are recorded as imports of goods by the economy operating the enterprise—even if the goods do not cross the actual frontier of that economy.

199. Fish and other marine products caught on the high seas and sold abroad directly from the

compiling economy's ships are part of the compiling economy's production sold abroad and, economically, are akin to exported goods that actually cross the border of the compiling economy.

200. As change of ownership is the criterion for establishing whether a transaction in commodities has occurred, the ***goods*** component includes goods lost or destroyed after the importer acquired ownership but before the goods crossed the exporting or importing country's frontier. For example, an importer in Coonawarra takes delivery, at the establishment of the seller in Nostaw, of goods worth 1,000 units. The goods are subsequently lost before leaving Nostaw. Because the goods are lost, their value is not recorded in the trade statistics of either the exporting or the importing economy. Nevertheless, from the standpoint of both economies, a change in the ownership of real assets, which are probably exchanged for financial assets, occurs. The BOP statements (shown subsequently) of the two countries show these transactions as exports and imports of goods, even though physical movement of the goods across national frontiers does not occur. Were entries of 1,000 units (credit for Nostaw and debit for Coonawarra) not made in the ***goods*** component, each country's statement would be out of balance for this transaction. The financial movements (assumed, in this case, to be in *reserve assets*) reflecting payment for the goods are recorded whether or not the goods are successfully delivered.

	Nostaw		**Coonawarra**	
	Credit	**Debit**	**Credit**	**Debit**
Goods	1,000			1,000
Reserve assets (or other appropriate financial account item)		1,000	1,000	

Goods Crossing the Frontier Without Changing Ownership

201. With some exceptions, goods that cross the frontier without changing ownership are not covered under ***goods***. Exception are goods exchanged between a parent and a branch (or between two branches of the same parent enterprise), goods obtained under financial lease arrangements, and goods exported for processing and returned to the original exporting country. The following list enumerates categories of goods that are always excluded from the ***goods*** component—even if the goods cross the frontier. Therefore, the recommendation that all transactions between direct investment affiliates be recorded as if changes of ownership have occurred is modified to exclude these categories of goods:

(a) goods sent abroad for processing and subsequently sold to a third country

(b) goods sent abroad for repair

(c) goods sent abroad for servicing and re-export by the servicing economy and goods to which some value is added without the occurrence of a physical transformation of the goods (e.g., storage, sorting, or inspection)

(d) returned exports and imports

(e) goods shipped under operational (i.e., nonfinancial) lease arrangements

(f) transportation equipment, fishing vessels, gas and oil drilling rigs, and other mobile equipment owned by nonresident enterprises

(g) direct transit trade

(h) shipments by a specific economy to that economy's military and diplomatic establishments located outside the territory of that economy

(i) goods lost or destroyed after having crossed the frontier but before having been delivered by the exporter

(j) goods that are temporarily exported and imported but are not for sale (e.g., display equipment for trade fairs and exhibitions; art exhibits; animals for breeding, show, or racing; and stage and circus equipment)

(k) samples of no commercial value.

Reasons for the exclusion of goods in these categories are presented, with corresponding letters, in the following paragraphs.

202. *(a) goods sent abroad for processing*

The treatment of goods that are exported for processing and not returned to the economy of the original exporter is explained in detail in paragraphs 186–188. These goods are recorded under the ***goods*** component only when actual changes of ownership occur and not when such goods cross customs frontiers.

203. *(b) repairs on goods*

The recommendation of the *BPM* is that *repairs on goods* be recorded under goods but in an item

seperate from *general merchandise*. However, only the value of the repairs—not the value of the goods before and after repairs—is recorded in the balance of payments. For example, the Australian Navy sends one of its ships to Singapore for a major refit. The cost of the refit is US$ 1,000,000. The following entries would be shown (in US$) in Australia's balance of payments:

	Credit	Debit
Goods		
Repairs on goods		1,000,000
Reserve assets (or other appropriate financial account item)	1,000,000	

The rationale for the BOP treatment of repairs on goods as transactions in goods (instead of transactions in services) is that the value added from such transactions primarily results from the provision of materials rather than from other inputs.

204. *(c) goods sent abroad for servicing and re-export*

The BOP treatment of goods sent abroad for servicing (without physical transformation of the goods) and re-export excludes these goods from the ***goods*** component. Instead, the services provided in connection with the goods are recorded under an appropriate item in the ***services*** component. For example, the servicing of aircraft is recorded under *air transport-other*, and the servicing of computer equipment is recorded under *computer and information services*. Storage, packing, and similar services are generally recorded under the *other transport-other* item of the ***services*** component. In some cases, however, it may be difficult to distinguish these goods from goods sent abroad for processing that involves physical transformation and re-export to the country of original export.

205. *(d) returned goods*

When a contract for the sale of goods is canceled after the goods have been shipped out of the exporting economy and the goods are consequently returned to the original owner, no change of ownership has taken place. In such cases, anticipation, at the time the goods originally cross the frontier, of the future return of the goods is highly unlikely. The *BPM* suggestion is that, for the sake of statistical convenience, compilers should make any adjustment necessary to eliminate such transactions from the ***goods*** component in the period when the goods are returned rather than revising entries for the period when the goods were originally (and incorrectly) recorded as exports or imports.

206. For example, during a particular period, the reporting economy's trade statistics show 100 units in returned goods (imports). These goods were exported in a prior period, and the nonresident buyer (presumably under the terms of the purchase contract) decided to return the goods to the seller in the reporting economy. The seller refunds the financial assets that he acquired at the time of the sale, so the foreign exchange holdings of the reporting economy are reduced by 100 units. How should the contra entry be made under the ***goods*** component? In the simplest terms, the return of the goods is a reversal of the change in ownership because the original seller of the commodity has repurchased it from the buyer. The return of the goods could be recorded as an import of goods, which would be denoted by a debit entry and appear thus in the balance of payments:

	Credit	Debit
Goods		100
Reserve assets (or other appropriate financial account item)	100	

207. However, it is suggested in the *BPM* that the contra entry to the decrease in reserve assets should be a negative entry in exports. BOP entries would be:

	Credit	Debit
Goods	–100	
Reserve assets (or other appropriate financial account item)	100	

The negative adjustment to the reporting economy's flows of goods in the current period is designed to reverse the change of ownership and to eliminate it from the balance of payments as if a change of ownership had never occurred.

208. If trade statistics are the source from which exports and imports are derived, the value of goods purchased and returned in the same period should be eliminated from total exports and total imports for that period.

209. *(e) operational lease arrangements*

Although goods shipped under operational (rather than financial) leases may physically move across national frontiers, these goods are excluded from coverage under the ***goods*** component. The lease payments due on these goods are recorded as *other business services-operational leasing* in the ***services*** component.

210. *(f) transportation equipment*

Excluded from the ***goods*** component—even though physical movement across national frontiers occurs—are transportation equipment, fishing vessels, gas and oil drilling rigs, and other items of mobile equipment that are operated in a host country's domestic territory or territorial waters but owned by nonresident enterprises. (Refer to chapter 2 of this *Textbook* and chapter 4 of the *BPM* for discussions on the residence of owners.) However, for BOP purposes, a change of ownership is said to occurr if (1) a resident enterprise operates mobile equipment under a financial lease arrangement or (2) a nonresident owner of mobile equipment separately accounts for the long-term operations of the equipment in the host country and the equipment is recognized by host country authorities as part of capital stock. In the first case, ownership is assumed to pass from the lessor to the lessee; in the second case, ownership is assumed to pass from the parent enterprise to a branch that is resident in the host economy.

211. *(g) direct transit trade*

Direct transit trade refers to goods that pass through a reporting country lying on a route between origin and destination. For instance, goods exported by the United States to Switzerland may be shipped to Rotterdam in the Netherlands and then sent by barge on the Rhine to Switzerland. Such goods are regarded as direct transit trade by the Netherlands and are omitted from the external trade statistics and balance of payments of that country. In such cases, there are no transactions in goods between nonresidents and residents of the country of transit. However, any transactions in transportation or any other services rendered by Netherlands residents in connection with goods in transit are recorded in the ***services*** component of the balance of payments of the Netherlands.

212. *(h) shipments to diplomatic and military establishments*

Although the goods move across national boundaries, shipments from an economy to extra-territorial military and diplomatic establishments of that economy are considered transactions between residents and are therefore excluded from the balance of payments.

213. *(i) goods lost or destroyed before change of ownership occurs*

Goods lost or destroyed inside the customs frontier of the importing economy will be recorded in the international trade statistics (ITS) of both the exporting and importing economies. Adjustments should be made to the statistics of both economies if the loss or destruction of goods took place before change of ownership occurred. Goods lost or destroyed between the customs frontiers of exporting and importing economies will be recorded in the exporting economy's ITS but not in those of the importing economy. An adjustment should be made to the statistics of the exporting economy if the loss or destruction of goods took place prior to a change of ownership. Goods lost or destroyed inside the customs frontier of the exporting economy will not be recorded in the ITS of either the exporting or importing economy. No adjustment to the statistics is required if no change of ownership occurs.

214. *(j) goods temporarily exported and imported*

Goods temporarily exported and imported and not intended for sale (for example, display equipment for trade fairs and exhibitions, art exhibits, and animals for breeding) are also excluded from the ***goods*** component on the grounds that no change of ownership occurs between residents of different economies. Although these goods cross national frontiers, there is an expectation that goods shipped for such purposes will be returned.

Time of Recording

215. The provision and acquisition of goods by an economy should be recorded in the balance of payments of that economy in the period in which the change of ownership takes place. The time assigned to a change in the ownership of goods is the time at which the two parties to the transaction record it in their books. The change of ownership criterion employed for the ***goods*** component is designed to promote and preserve consistency between the recording of goods and other items (particularly financial items) in the balance of payments.

216. Neither the physical movement of goods, on which customs statistics and similar returns are largely based, nor payment for goods, which is

reflected in foreign exchange or banking system records, will necessarily coincide with the time that ownership of the goods changes. Timing adjustments necessary for statistics derived from these two sources are detailed in paragraphs 257–280. Except in the case of large, discrete transactions (such as deliveries of ships or aircraft), the appropriate adjustments are often difficult to make. Information on the actual time that ownership changes is seldom available in a form that can be related to times of physical movement or payment for goods. However, if the total value of trade, the regional pattern of trade, and/or the terms of payment for trade at the beginning of the recording period change substantially by the end of the period, failure to make adjustments for timing is likely to be a major source of error in BOP statements. Timing differences in the recording of goods by different countries produce asymmetry between totals for world exports and imports.

217. Consignment goods that are intended for sale but are not actually sold at the time the goods cross the frontier of the compiling economy should (in principle) be included in ***goods*** only at the time when ownership changes. As a matter of convenience and in the expectation that a change of ownership will occur shortly thereafter, such goods are sometimes recorded at the time that they cross the frontier. If that treatment is used and the expected change of ownership does not materialize, the goods are returned to the exporting country. Then the goods must be recorded, by means of the procedure suggested in paragraphs 205–208, as a deduction from exports and imports. If such an adjustment is made in a period following the period in which the goods were originally consigned, timing errors will be introduced into the balance of payments. Furthermore, for goods that are actually sold after having been consigned, there will be timing errors to the extent that sales take place in periods that differ from the periods in which the goods were consigned.[8]

Valuation

218. The value at which goods are recorded in the balance of payments is the market value of the goods at the place of uniform valuation, which is the customs frontier of the economy from which the goods are exported. At least two aspects of this general statement require elaboration.

Market Valuation

219. The concept of market value and the specific application of the concept to internationally traded goods are discussed in chapters 5 and 10 of the *BPM*. The United Nations, in connection with its standards for related statistics, has dealt at length with the issue of valuing exports and imports. The Customs Cooperation Council has also provided an extensive analysis of the standards to be applied for customs valuation of imports. Paragraphs 282–286 also pertain to application of the market value concept to goods and to reconciliation of the standards of the United Nations and the Customs Cooperation Council with those recommended in the *BPM*.

Point of Valuation

220. Goods are provided or acquired when ownership passes from a resident of one economy to a resident of another; transfer of ownership is synonymous with delivery by an exporter or exporter's agent to an importer or importer's agent. The delivery of goods may take place at any time and any place agreed upon by the exporter and importer. "Time and place" may vary between the point at which the exporter originally produces or acquires the commodity and the point at which the importer consumes the commodity or provides it to a third party.

221. The value assigned to a transaction in goods depends on when and where the transaction is valued. The simplest point for valuing goods is at time and place of delivery. At any other point, valuation may (1) fail to cover the total value of the goods and services being provided by residents of one economy to residents of another economy or (2) fail to exclude from that value additional goods and services transferred between residents of the same economy.

222. For example, an exporter in Domestica contracts to deliver goods to an importer in Cromania. The contract requires the exporter to deliver the goods at the establishment of the

[8]Timing errors will occur because, in the period in which the goods are consigned, entries for the initial consignment will not be offset by entries in the financial account. Instead, the offsetting entries will be recorded in a subsequent period when the goods are actually sold (or returned to the exporter).

importer. The cost of the commodity and associated distributive costs are:

Value of commodity at place of production in Domestica	2,000
Cost of transportation to the border of Domestica	50
Cost of transportation from the border of Domestica to the border of Cromania	200
Transportation cost from border of Cromania to the establishment of the importer	25

Road transportation in Domestica is provided by a resident carrier of Domestica. Ocean transportation is provided by a resident carrier of Daniherland. The inland freight in Cromania is purchased by the exporter from a railroad enterprise in Cromania. The value of the commodity at the place of delivery in Cromania is the sum of all the separate cost elements (2,275 units). If any other point of valuation (such as the establishment of the exporter, the frontier of the exporting economy, or the frontier of the importing economy) were selected, the value placed on the goods would not include all of the services acquired by Domestica and provided, during the delivery of the goods to the Cromanian importer, to Cromania. Valuing the transactions at the point of delivery results in the following BOP entries:

	Domestica		**Cromania**	
	Credit	**Debit**	**Credit**	**Debit**
Goods	2,275			2,275
Freight		225	25	
Reserve assets (or other appropriate financial account item)		2,050	2,250	

223. Under a different scenario, contract terms could call for the importer to take delivery of the goods at the establishment of the exporter. All costs of transportation and other related distributive costs are direct purchases by the importer. The value of the goods at the time and place of delivery is 2,000 units. Failure to select this valuation point could result in the inclusion, in the value of the goods, of services that are not actually provided by Domestica to Cromania. In this case, the distributive services acquired by the importer are provided in part by Domestica, in part by Daniherland, and in part by other residents in Cromania. Valuing the transaction in goods at the point of delivery would result in the following BOP entries:

	Domestica		**Cromania**	
	Credit	**Debit**	**Credit**	**Debit**
Goods	2,000			2,000
Freight	50			250
Reserve assets (or other appropriate financial account item)		2,050	2,250	

224. While a convention of valuing goods at the point of delivery may have merit from the standpoint of registering flows (between residents and nonresidents) of goods and services, such a convention imposes severe problems with regard to the interpretation, and possibly the availability, of data. If goods were valued in accordance with the varying terms of individual contracts, the goods might be recorded *free on board* (f.o.b.) at some inland point in the exporting country; or f.o.b. at the customs frontier of the exporting country; or *cost, insurance, and freight* (c.i.f.) at the frontier of the importing country; or c.i.f. at some inland point of the importing country. Statistical trends reflecting economic developments could be masked by data changes that were merely the result of changes in the time or place at which deliveries of most goods were recorded. The distortion of other statistics (such as data on freight transactions) associated with transactions in goods would be proportionately much greater. From a practical and analytical standpoint, it is desirable to distinguish, on the basis of a uniform principle, between (1) goods and (2) related distributive transactions.

225. A possible approach would be to adopt the uniform physical valuation point utilized for construction of input-output tables. In these tables, the value assigned to a commodity is the market value of that commodity when it is located at the establishment of the producer. Any other services (such as transportation and distribution) performed in relation to the commodity are viewed as ancillary services supplied to the final or intermediate consumer of the commodity. Such an approach attempts to differentiate between (1) commodity output and (2) the rendering of services. In the example given in paragraph 222, use of this approach would produce the following BOP entries for Cromania:

	Credit	**Debit**
Goods		2,000
Freight		250
Reserve assets (or other appropriate financial account item)	2,250	

226. Use of this approach to distinguish between goods per se and related freight services is analytically appealing but difficult to implement statistically—especially for series of data produced at frequent intervals. It is assumed that inter-industry accounts can be used as a basic statistical framework in which flows of goods and services are integrated. With a few exceptions, most countries do not construct input-output tables on a quarterly, or even

an annual, basis. Quarterly BOP estimates are necessary for appraising current developments, and statistical sources from which totals of goods are derived must supply data on a quarterly (or at least annual) basis.

227. As it is desirable to adopt a uniform point of valuation for the ***goods*** component, some other approach must be recommended for producing quarterly or annual data. According to the *BPM*, the value existing at the customs frontier of the economy from which goods are exported shall, in principle, be the value recorded (in the ***goods*** component of the balance of payments) for goods and related distributive services. The value includes the costs of loading goods on board carriers at the frontier. (That is, exports and imports of goods are to be valued f.o.b. at the customs frontier of the exporting country.) In the application of this rule, customs bonded warehouses, customs bonded manufacturing plants, and free areas are considered to be within the customs frontiers of the economies that control and supervise them. Customs frontiers need not coincide physically with national boundaries and may be located in the interior at places such as airports.

228. Use of the *BPM* rule on uniform valuation of transactions in goods involves two theoretical concepts: (1) Freight, insurance, and other shipment charges incurred for transporting goods to the point of uniform valuation are always the result of transactions between a resident (usually the exporter) of the exporting economy and the carrier or insurer. (2) Similar costs incurred for transporting goods beyond the point of uniform valuation are always the result of transactions between the importer and the carrier or insurer.

229. The example given in paragraph 223 illustrates the system of entries made if the customs border of the exporting economy is designated as the uniform physical point for valuing goods. The exporter is located in Domestica; the importer, in Cromania; and the carrier, in Daniherland. (Valuation of the goods would be unchanged by different locations for contractual delivery.)

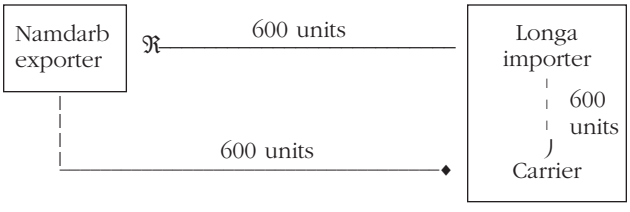
	Domestica		**Cromania**		**Daniherland**	
	Credit	**Debit**	**Credit**	**Debit**	**Credit**	**Debit**
Goods	2,050			2,050		
Freight				200	200	
Reserve assets (orother appropriate financial account item)		2,050	2,250			200

230. In the example, the importer in Cromania took possession of the goods at the establishment of the exporter in Domestica and purchased, from a carrier resident in Domestica, transportation services for moving the goods to the customs border of Domestica. In reality, these transportation services would have been contracted between the carrier and the importer. However, use of a uniform physical point for valuation of goods in the balance of payments requires that the internal transportation cost of 50 units be attributed to a transaction between residents of Domestica—the exporter and the carrier. In this particular case, the total domestic product of Domestica is provided to Cromania in a single component, ***goods***, rather than as a composite of ***goods*** and *transportation*. Although it is possible that nonresidents may, in fact, provide freight services inside the valuation boundary, this circumstance arises rather infrequently. Such a transaction (illustrated in the following paragraph) would arise if an importer hired, in his or her country, a truck to transport goods from a location in the exporting country.

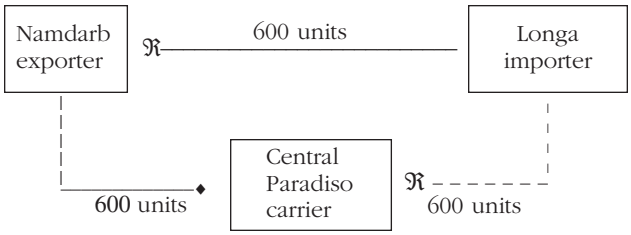
231. Clinstonstan and Bushland are contiguous countries. The importer, a resident of Bushland, takes delivery of goods worth 1,000 units at the establishment of the exporter in Clintonstan. The importer arranges with a trucking company in Bushland to transport the goods to her place of business in that country. Total transportation cost is 200 units, of which 100 units are the estimated cost of moving the goods from the exporter's establishment to the border of Clintonstan. In this case, the freight payment is a transaction between residents of the importing country. In accordance with the convention for distinguishing between goods and associated distributive costs in a uniform and consistent manner, the freight cost for transporting the goods to Clintonstan's border is included in the value of the goods when that value is recorded in the BOP statements of both countries. Consequently, it is necessary to make offsetting entries in the BOP statements of both countries to correct the overstatement of receipts and payments. A freight debit that cancels the overstatement of export receipts is recorded in the balance of payments of the exporting country. (The offsetting element represents a transaction between nonresidents.) In the importing country's BOP statement, the offsetting entry is a freight credit representing a transaction between residents and canceling the overstatement, on the goods account, of payments to nonresidents.

232. The second theoretical concept required by the use of a uniform physical point for valuation of goods is closer to fact. The exporter is regarded as an intermediary in arranging for goods to be shipped beyond the frontiers of his country. If the exporter pays freight charges, he is assumed to do so on behalf of the nonresident importer, who ultimately reimburses the exporter directly or indirectly.

233. For example, a purchaser in Longa agrees to pay a seller in Namdarb 6,600 units for a commodity delivered c.i.f. at the port of entry in Longa. The seller contracts with a Longan carrier to transport the goods for 600 units. Longa, however, wishes to record imports on an f.o.b. basis and therefore considers the 6,000 units to be the price of the commodity and the 600 units to be payment for transportation. There is no problem in recording the 6,000–unit value of the import; this amount is paid to the exporter in Namdarb, and the transaction is completed. The 600 units for transportation, however, are paid to the exporter in Namdarb, who returns the 600 units to Longa in the form of payment to the carrier. (The route of the 600 units is shown in solid lines in the following diagram.) From an economic point of view, however, the transportation service is performed by a resident of Longa (the carrier) for a resident of Longa (the importer). There is no economic significance to the payment being made directly by one resident to another resident or through some nonresident intermediary (the exporter) and, on an overall basis, the balance of payments is not affected. (The significant movement of the 600 units is shown in the diagram, by the broken line and arrow, as a transaction occurring within Longa.)



234. Similar reasoning would apply if the goods were transported in the ships of a third economy. For example, the exporter in Namdarb pays shipping charges to a carrier in Central Paradiso and is reimbursed by the Longan importer (as is indicated in the following diagram). The transportation service is viewed as being rendered to the importer rather than the exporter, who may be regarded as an intermediary. In accordance with the "real flows" principle, the significant movement of the transportation service is from Central Paradiso to Longa. The two offsetting movements in Namdarb's balance of payments (payment of 600 units to Central Paradiso and receipt of the same amount from Longa) are, therefore, excluded from Namdarb's balance of payments.



235. Freight, insurance, and other distributive payments made by residents of the exporting country to nonresidents for the transport of goods beyond the customs frontier of the exporting country are therefore omitted from the balance of payments of the exporting country. Also omitted are the direct or indirect reimbursements made by nonresident importers for such expenditures. While the omission of these transactions may be regarded as unimportant in the majority of cases, the omission in other cases is a clear departure from the resident/nonresident principle. However, as the amounts omitted from the credit and debit sides of the balance of payments are equal, the net balance is not affected.

236. Treating the exporter as an intermediary who arranges for transportation of goods beyond the frontier of the exporting country seems realistic when goods are sold to the nonresident importer before being shipped from the exporting country. This treatment is not so realistic when goods are sold while en route or upon arrival in the importing country. The treatment is clearly unrealistic when goods are shipped on consignment and stored (for the exporter's account) in the importing country before being sold there.

237. Another example illustrates some of the problems described in the preceding paragraph. An exporter in Pokolbin ships goods on consignment to an agent in Coonawarra for sale in that economy. The value of the commodities upon arrival in Coonawarra is 10,000 units, of which 1,000 units represent the cost of shipping the goods from Pokolbin to Coonawarra. Residents of Cromania have provided freight services. If these goods are sold in the same reporting period, the BOP statements of Pokolbin and Coonawarra will

(measurement problems notwithstanding) include the following entries:

	Pokolbin		Coonawarra	
	Credit	**Debit**	**Credit**	**Debit**
Goods	9,000			9,000
Freight				1,000
Financial assets/ liabilities		9,000	10,000	

238. The recording of flows of goods and the attribution of associated distributive costs is based on the uniform point of valuation recommended in the *BPM*. Although the direction of the financial flow in its entirety is from Coonawarra to Pokolbin, the direction of "real flows" is, in part, from Pokolbin to Coonawarra and, in part, from Cromania to Coonawarra. The balance of payments of Pokolbin omits from credit and debit entries the 1,000 units of freight services that the exporter in Pokolbin contracted for with a resident of Cromania. In this case, the exporter clearly was not acting as an intermediary for the importer because the goods had not been sold at the time the freight services were contracted.

239. If, the goods in the example in paragraph 237 were consigned in one reporting period and sold in a subsequent reporting period, BOP entries for the three economies would (measurement problems not withstanding) be:

Period 1	**Pokolbin**		**Coonawarra**		**Cromania**	
	Credit	**Debit**	**Credit**	**Debit**	**Credit**	**Debit**
Goods						
Freight		1,000			1,000	
Financial assets/ liabilities	1,000					1,000

Period 2	**Pokolbin**		**Coonawarra**		**Cromania**	
	Credit	**Debit**	**Credit**	**Debit**	**Credit**	**Debit**
Goods	9,000			9,000		
Freight		–1,000		1,000	(1,000 –1,000)	
Financial assets/ liabilities		10,000	10,000			

240. The negative entry shown for freight during period 2 denotes an adjustment to the services acquired by Pokolbin during period 1. As the *BPM* specifies that the shipment of imports beyond the border of the exporting country represents a transaction between the provider of the service and the importing economy, these flows should be attributed to Coonawarra and Cromania—regardless of the fact that the goods were not sold until the period following shipment.

241. An appropriate valuation for the goods item in period 2 could have been 10,000 units as that is the value of production supplied by Pokolbin to Coonawarra. However, the specification, by the *BPM*, of a place (the customs boundary of the exporting country) for the uniform valuation of goods precludes assignment of the 10,000–unit value to the goods.

242. In summary, it was desirable to designate a point at which goods should be uniformly valued. Any of several points could have been chosen as each has comparable analytic advantages. However, statistical problems exist with any valuation point selected. A principal difficulty is that shipping practices are not standard. Documents on which the BOP compiler must usually rely to make estimates of goods and freight will often cover shipping services performed on both sides of the customs frontier (or any other uniform point), and total shipping costs may not be broken down or related to the point of valuation. For example, goods may be shipped by truck from door to door, or goods in containers may be moved between central warehouses that are distant from customs frontiers. A primary consideration in specifying the customs frontier of the exporting country (rather than some other place) is the probability that customs officials value exports at that point. Imports, too, are valued at the customs frontier in a significant number of countries. As data generated by customs are often the basis of BOP entries pertaining to transactions in goods, it is convenient for both series to refer to this point of valuation.

243. Application of the rule for uniform valuation may result in inclusion, in the ***goods*** component, of some flows of services occurring between nonresidents or between residents of the same economy. Specifically, an exporter may deliver goods before the goods reach the customs frontier of the exporter's economy, and the importer may then employ a supplier of distributive services who is not a resident of the exporting economy to ship the goods to the customs frontier. To maintain uniform valuation for the ***goods*** component, an offset to such a flow of services occurring between nonresidents is required in the balance of payments of the exporting country. The *BPM* states that the offsetting entry is made in the freight item. Similarly, if the supplier of the services is the importer or a resident of the importer's economy, the flow of services occurs between residents of the same economy, and an offset in the freight item is also

required in the balance of payments of the importing country.

244. The f.o.b. valuation of goods at the customs border of the exporting country includes any costs incurred in loading the goods on board the carrier at that frontier. However, when the service of loading goods on board the carrier at the customs frontier is actually performed, the service is frequently performed by or for the carrier. In these cases, customs statistics are likely to exclude the cost of such services, and data on freight charges will almost certainly include them. For practical reasons, the BPM does not suggest that attempts be made to reallocate such charges from the freight item to the **goods** component. There is explicit recognition that, in practice, most goods are recorded on a *free alongside ship* (f.a.s.), rather than an f.o.b., basis.

245. Goods delivered to an importer at some location within the exporting economy may not be shipped to the customs frontier of that economy during the same recording period. In such a case, an entry for the value of the goods at the point of delivery is made in one period, and another entry for the cost of freight from that point to the customs frontier is made in a subsequent period. Both of these entries are included in the ***goods*** component.

246. There may be practical difficulties in readily distinguishing the distributive service element in imports that are valued on a c.i.f. basis in the basic data source. However, users of the balance of payments would experience real inconvenience if there were no single standard. Lack of comparability between statements compiled on different bases is perceived as a more serious drawback than difficulties (or errors) in allocating certain flows between the ***goods*** component and freight items. Therefore, the *BPM* rule for uniform recording of goods should be followed—even if adherence involves rough estimates.

247. How should services performed by agents in connection with transactions in goods be treated? In principle, fees and commissions paid by exporters to nonresident brokers and agents reflect services rendered to exporters by brokers or agents, and these fees and commissions are classified as such in the balance of payments. Thus, for example, fees paid to nonresident agents by exporters are entered as an integral part of the value of goods (credit) and an offsetting entry (debit) is made in *merchanting and other trade-related services*. For the importing country, these entries are reversed if the agent is a resident of the importing country.

248. What about services rendered to an importer by an agent in the exporting country? Are these services separately portrayed as service items or included in the values of goods? Likewise, how are fees paid by an importer to a resident agent for services pertaining to imports treated in the balance of payments? Are these services—although they may be included in the customs values of imports—construed as transactions between residents? It is recommended in the *BPM* that, for practical reasons, fees paid in connection with transactions in goods by the importer to an agent in the exporting country be included in the value assigned to goods at the customs frontier of the exporting economy. These fees are usually included in the customs values of imports; the exporting country will probably have to add these fees to the customs values of exports. Agent fees paid by the importer to an agent in the importer's country or to an agent in a third country are not included in the value of imports. If these fees are included in customs valuations, the fees should be deducted. This recommendation is made because the exporting country cannot know the value of these fees and therefore cannot incorporate the fees in the customs values of exports. The treatment of agent fees is further discussed in chapter 5.

249. In some cases, fees are paid by exporters to consulates of importing countries. The *BPM* rule is that such fees are not included in the valuation of goods at the frontier of the exporting country. A consular fees is thus treated as a cost incurred beyond the customs frontier of the exporting country; that is, a consular fee is incurred in the importing country.

Adjustments to Basic Data

Overview

250. Basic data from which statistics on the ***goods*** component are derived are seldom available in a form that fits concepts presented in the *BPM*. The two most common sources are external trade statistics, which are usually derived from customs records, and bank records, such as records of foreign exchange transactions. Statistics obtained from these two sources are, or were, collected for purposes other than BOP compilation. Trade statistics based on customs returns are generated as

a by-product of customs administration, and exchange records are primarily used as a means of monitoring and controlling foreign exchange. To satisfy *BPM* requirements for compilation of the ***goods*** component of the balance of payments, compilers must usually make adjustments to source data.

251. Discussed in the following paragraphs are adjustments that must be made to compensate for conceptual differences between the ***goods*** component and external trade statistics for which coverage, valuation, and timing are defined by the United Nations,[9] and between the goods component and foreign exchange and similar bank record data covering (at the time of settlement) all transactions in goods paid for through the banking system.

252. However, trade statistics and bank records available to BOP compilers may not conform entirely to the definition stated by the United Nations. Compilers should not adjust source data to conform to these definitions and subsequently adjust data further for use in the balance of payments. Adjustments described in the *Textbook* should be applied only when source data already conform to the United Nations definition and are, thereby, at variance with BOP definitions. Other discrepancies between source data and the ***goods*** component should be eliminated.

253. Adjustments to bring source data into conformity with standards for compilation of the ***goods*** component of the balance of payments are described under the headings of coverage, classification, timing, and valuation. (For additional information on these adjustments, refer to chapter 11 of the *Balance of Payments Compilation Guide*.)

Adjustment for Coverage

254. Coverage adjustments are required when statistics that are the source of BOP ***goods*** component entries (a) include certain goods that have not, in fact, changed ownership and (b) fail to include certain other goods that have, in fact, changed ownership internationally. If external trade statistics are the source of information on transactions in goods, such statistics usually cover all goods that cross the border. To adjust external trade statistics for use in the balance of payments, additions must be made for goods that change ownership (or are construed as changing ownership) without crossing the border, and deductions must be made for goods that cross the border without changing ownership. If foreign exchange records are the source of information on transactions in goods, such data generally cover all goods that are paid for through the banking system. Therefore, additions to foreign exchange and similar bank record data must be made when payment is not made through the banking system for goods that change ownership.

Adjustments for Classification

255. In source data, some transactions may be inappropriately—for BOP purposes—classified as transactions in goods. In addition, transactions that are, for BOP purposes, classified under goods may be otherwise classified in source data. Adjustments are required to correct the improper classifications.

256. One important classification adjustment is the deduction of distributive items from import totals obtained from external trade statistics. When imports are recorded in external trade statistics at c.i.f. valuations that include international freight, insurance, and other distributive services, such services must be eliminated so that goods may be recorded at f.o.b. valuations in the balance of payments. If such services have been provided by nonresidents, the values that have been deducted are included in the freight item or the insurance item or, as appropriate, in other items under services. Certain import transactions may also be valued on a c.i.f. basis (or some basis other than f.o.b.) in bank records. Classification adjustments should be made in these statistics as well.

Adjustments for Timing

257. Timing adjustments are required for BOP purposes when flows of goods are recorded in source data at times that do not coincide with changes in ownership. Goods are usually recorded in external trade statistics when the goods cross the border. Goods are recorded in bank records when payment for the goods is made through the banking system. The time at which the ownership of goods changes may differ from the time at which goods physically move across a border or the time at which payment for the goods is made.

258. For example, an exporter in Essendonia ships goods to an importer in Nostaw in December 1991. The importer in Nostaw acquires ownership of the

[9] "International Trade Statistics: Concepts and Definitions," *United Nations Statistical Papers*, Series M, No. 52, Rev.1 (New York, 1982).

Table 4.1 Timing Adjustments for External Trade Statistics Used as Source Data for BOP *Goods* Component Entries

	Period in Which Goods		Period in Which Adjustment Is Made to Data on Goods		
	Change Ownership	**Cross Frontier**	**Previous**	**Current**	**Subsequent**
Exports					
1	subsequent	current	none	deduction	addition
2	current	previous	deduction	addition	none
3	current	subsequent	none	addition	deduction
4	previous	current	addition	deduction	none
Imports					
5	current	subsequent	none	addition	deduction
6	previous	current	addition	deduction	none
7	subsequent	current	none	deduction	addition
8	current	previous	deduction	addition	none

goods in January when she receives documents forwarded to her bank for collection and accepts, as an account payable, a three-month draft falling due in April 1992. The goods are cleared through customs in Nostaw in March 1992.

Summary of Events

December 1991—exports recorded in customs returns of Essendonia
January 1992—goods change ownership; importer in Nostaw accepts draft as an account payable
March 1992—imports recorded in customs returns of Nostaw
April 1992—draft paid

259. According to the timing principle stated in the *BPM*, a transaction in goods should be recorded, in the balance of payments of both Essendonia and Nostaw, in January. Simultaneous entries ensure that the transaction is recorded symmetrically and on a basis consistent with transactions in the ***financial account*** of each country's balance of payments. In the balance of payments of Essendonia, the export (credit) is offset by the acquisition of a draft (a debit to trade credits). In the balance of payments of Nostaw, the import (debit) is offset by the corresponding increase in trade credits (credit).

260. If external trade statistics in which Essendonia and Nostaw record this transaction serve as source data for BOP entries, a timing adjustment is required only in Essendonia. (It is assumed that Nostaw prepares its BOP statement on a quarterly basis.) The adjustment is made by eliminating the export from 1991 statistics and adding it to 1992 statistics. As both the change of ownership and the recording of the transaction by Nostaw customs officials took place during the first three months of 1992, no timing adjustment is required in Nostaw unless BOP statements are prepared monthly, rather than quarterly, in that country.

261. If bank records in which this transaction is recorded serve as the source from which BOP entries are derived and if quarterly BOP statements are prepared, a timing adjustment is required in the balance of payments of both Essendonia and Nostaw. Whereas bank records attribute the transaction in goods to April (when settlement was made through the banking system), the actual change of ownership took place in January. The adjustment is made by deducting the amount of the transaction from April totals and adding the amount to January totals. Thus, the use of timing adjustments applies to source data from external trade statistics and from bank records.

262. Table 4.1 summarizes timing adjustments that should be made when data from external trade statistics are used as a source for BOP entries in the ***goods*** component.

263. Table 4.1 shows additions and deductions that must, for the purpose of compiling imports and exports for the balance of payments, be made to external trade statistics in various periods. Adjustments made for a current period may require offsetting adjustments in previous or subsequent periods. As line 1 of table 4.1 indicates, when exports move across the frontier in the current

Table 4.2 Timing Adjustments for Bank Records Used as Source Data for BOP *Goods* Component Entries

	Period in Which		Adjustment Made to Current Period Data on Trade Credit		
	Ownership Changes	**Payment Is Made**	**Goods**	**Assets**	**Liabilities**
Exports					
1	subsequent	current	deduction	none	addition
2	current	previous	addition	none	deduction
3	current	subsequent	addition	addition	none
4	previous	current	deduction	deduction	none
Imports					
5	current	subsequent	addition	none	addition
6	previous	current	deduction	none	deduction
7	subsequent	current	deduction	addition	none
8	current	previous	addition	deduction	none

period and change of ownership occurs in a subsequent period, the amount of the transaction in goods is subtracted from the external trade statistics of the current period and added to the statistics for the period in which the goods are sold. The physical movement of goods across the frontier does not alter the ownership of the goods; goods that do not change ownership before crossing the frontier are considered an addition to the exporting economy's stocks held abroad.

264. According to the conventions of the 1993 SNA and the BPM, capital formation in the form of commodity stocks can take place abroad. If goods that are shipped abroad but not sold in the current period relate to current production, the reporting country's domestic product should include an addition to stocks, rather than an export, as indicated by external trade statistics of the current period. The decline in stocks and the actual exports are reflected in the period in which the goods are sold (see line 2 of table 4.1).

265. If goods sold in the current period are shipped abroad in a subsequent period (see line 3 of table 4.1), the reporting economy should add the amount of the transaction in goods to exports of goods for the current period. The nonresident importer would add the goods located in the compiling economy to his stock of goods. These goods should be subtracted from the external trade statistics of the reporting economy for the period in which the goods are shipped (see line 4 of table 4.1). The nonresident importer would then have drawn down his stock of goods held in the reporting economy.

266. Line 5 of table 4.1 illustrates changes, which come about through purchases made abroad, in a country's stocks held abroad. Goods bought in the current period are shipped to the importing country in a subsequent period. The amount of the transaction in goods is added to the external trade statistics for the current period and deducted from the statistics for the period in which the goods cross the frontier of the importing country. There is a reduction in stocks held abroad during the period in which the goods physically enter the country (see line 6 of table 4.1).

267. Some goods do not change ownership until sometime after they arrive in the reporting country. For BOP purposes, these goods are said to be owned by nonresidents from the time the goods arrive until the goods are sold. A deduction is therefore made to exclude the amount of such goods from the external trade statistics of the compiling economy (see line 7 of table 4.1). An addition to the statistics is subsequently made for the period in which the goods are purchased by residents (see line 8 of table 4.1). Both of these adjustments are linked to changes in stocks held by nonresidents in the compiling economy.

268. Table 4.2 summarizes timing adjustments that should be made when data from foreign exchange and similar bank records are used as a source for BOP entries in the **goods** component.

269. Table 4.2 shows additions and deductions that must, for BOP purposes, be made to bank records containing data on exports and imports as well as

adjustments that must be made to transactions in trade credits. Trade credit adjustments follow from and serve as offsets to timing adjustments made for exports and imports. As table 4.2 indicates, when banking system data such as foreign exchange records are used to derive the BOP **goods** component, timing adjustments are made to trade credits rather than to changes in stocks. Trade credits may be postpayments (when payment is made after the change in ownership) or prepayments (when payment precedes the change of ownership).

270. Line 1 of table 4.2 refers to prepayments received for exports. Prepayments are not classified as export receipts but as trade credits received (liabilities). These prepayments are deducted from total exports of goods (as shown in bank records), and a corresponding increase in *trade credit liabilities* is entered in the balance of payments. Upon delivery of the goods (see line 2), the prepayment amounts are added to the bank record figure for current year exports, and a corresponding entry is made in the BOP ***financial account*** to record liquidation of the liabilities.

271. When exported goods change ownership before payment is rendered (see line 3), an addition must be made to the bank record figure for exports of goods. The resulting amount is recorded in the balance of payments as a reduction in real assets (exports), and an offsetting increase in financial assets (trade credits) is also recorded. Line 4 refers to adjustments made in the current period when payment is received for exports delivered in a previous period.

272. A country may acquire ownership of goods in the current period and pay for the goods in a subsequent period (see line 5). When postpayments for goods are made, the figure (contained in the importing country's bank records) for imports of goods in the current period must be adjusted by the addition of an amount representing goods imported but not yet paid for. A contra entry must be made in the balance of payments under trade credit liabilities. When goods are paid for through settlement of the trade credit (see line 6), the import total (shown in bank records) for the period in which payment is received must be adjusted to exclude the amount of the settlement. The settlement is recorded as a financial transaction (reduction in trade credit liabilities).

273. When prepayments are made for imports (see line 7), such prepayments are deducted from the estimates of goods contained in bank records and shown in the balance of payments as the creation of a financial claim (assets). When the imports are received (see line 8), the prepayment amounts are added to the amount recorded for goods in bank records, and a contra entry representing the corresponding reduction in trade credit assets is made.

274. If unadjusted statistics from bank records were used in the balance of payments, a number of errors and omissions would ensue. A significant number of transactions in goods would be recorded in the wrong period. Serious omissions would occur in the recording of increases and decreases in international indebtedness as total trade credits for an entire country can constitute a sizeable amount and change rapidly. Statistics portraying the economic relationship between output and capital would be distorted, and an incorrect ratio would be implied.

275. While the principles and the importance of timing adjustments should be understood and appreciated, in practice, it is not always possible to make these adjustments. When basic data for transactions in goods are derived from customs returns, it is generally assumed that there is a rather constant time lag between actual change of ownership and entry of the goods in customs records. No timing adjustments would be required if (1) the level of trade and (2) the lag between change of ownership and recording by customs both remained constant. If trade were expanding or contracting, however, timing adjustments would probably be necessary if substantial time lags existed—even if such lags were constant. If trade were constant, changes in time lags might also create the necessity for major adjustments.

276. There is no clear evidence that changes of ownership normally take place when goods are shipped (in which case a timing adjustment for imports may be required) or when goods arrive at their destination (in which case a timing adjust for exports may be required). A sample survey could be used to obtain information on actual practices in different countries. Timing adjustments could then be made to correct statistics in categories of goods for which changes of ownership and customs entries are recorded at different times. If BOP statistics do not reflect simultaneous recording of exports and imports, aggregations and comparisons of such BOP data are

much less meaningful. Discrepancies in times of recording are most apt to arise in periods when rapid changes are occurring in prices, in volumes, or in relationships between the times that goods change ownership and are recorded in source data.

277. In practice, timing adjustments are made to data generated by customs only when it is known that the time at which goods were recorded in customs documents differs from the time at which ownership of the goods changed. It may be necessary to obtain direct records of purchases or sales and to substitute such records for customs documents. For example, wheat is shipped by Canada to the United States for storage. Usually, none of the wheat is sold to the United States; instead, the wheat is sold overseas and shipped directly from the storage location. Shipments of wheat for storage are eliminated from exports in Canada's balance of payments, and wheat sales from storage abroad are added to exports on the basis of special reports obtained from the Canadian Wheat Board. A second example is that of Colombian coffee. The Colombian Coffee Growers Association provides data that enable Colombian BOP compilers to adjust customs returns in respect of coffee stocks held abroad. In countries where marketing boards or special procurement agencies exist, data on actual sales and purchases are often available and can, if necessary, be substituted for customs data.

278. Timing adjustments may also be made to data generated by customs when a single or discrete bulk commodity purchase (especially transportation equipment) is made by an official entity or a large corporation in the reporting country. For example, Australia makes a timing adjustment to the external trade statistics to compensate for the time lag between the acquisition, by Australian enterprises, of items such as aircraft and the recording of the aircraft in the customs returns.

279. The necessity for timing adjustments is much greater when foreign exchange or other bank records serve as the source of data on transactions in goods. Unadjusted statistics for transactions in goods may be misleading if substantial changes have occurred in the terms of payment. For instance, in countries that have exchange controls, it may be customary to make advance cash payments for imports. Nonresident exporters may be unwilling to extend credit to these countries because of uncertainty regarding the allocation of foreign exchange to importers for payment of their debts. If—from the perspective of nonresident exporters—the creditworthiness of such a country improves greatly, or if the market for major categories of goods imported by that country changes from a seller's to a buyer's market, nonresident exporters may decide to extend credit. If changes in credit policy occur suddenly, unadjusted bank records may seriously understate imports during the period of transition.

280. A bank record can be adjusted for timing if data recorded for each transaction include the time of payment and the time of the transaction. It will, of course, be impossible to ascertain the specific date on which the legal change of ownership took place, but that information is not required. Timing adjustments may be made on the basis of some simple rule of thumb. For example, it may be assumed that changes of ownership for both exports and imports coincide with shipment from the exporting country. In this case, a record of the shipment date (which is usually indicated on documents available to the foreign exchange control) will be sufficient as an approximate indication of the time that ownership changed. (However, in the case of postpayments, the necessary adjustments can only be made retroactively.) Alternatively, data available from an official record of export credits extended or import credits received could be used to make timing adjustments to foreign exchange records on total transactions in goods. For example, rice—one of Myanmar's major export commodities—is sold through a state corporation that extends credit on exports. As information on changes in rice credits can be obtained from the accounts of the state corporation, this data can be used to adjust receipts for rice exports from a payment basis to a transaction basis.

Adjustments for Valuation

281. Valuation adjustments are necessary when goods are recorded in source data at other than market values. Thus, when customs-generated data on imports and exports refer to valuations made for the purpose of levying customs duties on goods, adjustments must be made to account for any differences between those values and the market values of the goods.

282. The *BPM* and the United Nations standards for external trade statistics cite market values as the basis for valuing flows of goods; therefore, adjustments on this basis are unnecessary. However, fees payable to consulates of importing countries are treated differently by the two systems. Inclusion of consular

fees in the value of exported goods and in imports recorded f.o.b. at the frontier of the exporting country is recommended in the standards for external trade statistics, whereas exclusion of such fees is recommended in the *BPM*. Therefore, international trade statistics valuations of goods must be adjusted for BOP purposes.

283. In some countries, Customs Cooperation Council standards for valuation of imports are used to asses *ad valorem* duties. Values assigned for this purpose to imported goods may differ from those recommended for the balance of payments, and adjustments should be made for (a) differences between contract-stipulated market prices at which goods have been sold and prices at which import duties have been assessed and (b) special quantity discounts.

284. For BOP purposes, goods should generally be recorded at contract prices (adjusted for transfer pricing, taxes, subsidies, etc.) at which the goods were sold. As the customs valuation for goods is also generally based on the purchase/sale price of bona fide sales, no adjustment is necessary in most cases. In a period of abnormal price fluctuations or in the event of an unusually long delay between the purchase/sale contract date and the payment date for customs duty (for example, if goods are stored for some time in a bonded warehouse), the customs valuation may be based on the price fetched by the goods at the time that the duty became payable. In these circumstances, the price used for customs duty valuation will not be the same as the price required for BOP purposes, and an adjustment will be required.

285. Occasionally, a single purchase/sale contract may cover goods destined for import into more than one country. Under such a contract, the buyer may receive a quantity discount that would not be available if the purchase were made in installments. The Customs Cooperation Council recommends that customs statistics reflect the price that the goods would fetch if the special quantity discount were not available. The BOP item for imports, however, should reflect the discount price as it represents the market value of these goods. For example, a multinational enterprise resident in Algornia agrees, under the terms of a single contract, to make a bulk purchase from an enterprise in Coonawarra. Commodities purchased by the multinational enterprise are shipped to three branches located in Cromania, Dromesia, and Essendonia. If three separate purchases were made, the market price of the commodities would be 100 units per purchase or 300 units in total. However, the multinational enterprise receives a 20 percent discount for buying in bulk and therefore pays only 240 units. According to the Customs Cooperation Council, Cromania, Dromesia, and Essendonia should value the imports at 100 units each. In accordance with the *BPM* concept of market price, however, Cromania, Dromesia, and Essendonia should value the imports at 80 units each. Upward adjustments made by customs officials for the purpose of eliminating special quantity discounts received by importers should not be recorded in the balance of payments.

286. As foreign exchange and other bank records covering transactions in goods settled through the banking system reflect prices actually paid for goods, valuation adjustments generally need not be applied to data contained in such records. An exception is any adjustment required to convert a transaction price to a market price for goods such as those transferred, at prices significantly distorted from market values, between related enterprises.

V. Services

287. According to the *BPM*, the BOP **current account** is divided into three broad categories: ***goods and services*** (which is subdivided into the same two components), ***income***, and ***current transfers***. The ***goods*** component is discussed in chapter 4. Chapter 5 deals with issues associated with the recording of transactions in ***services***. Definitions and treatments of each of the items in this component are elaborated upon.

288. Unlike the production of goods, the production of a service is generally linked to an arrangement between a particular producer and a particular consumer. Thus, international trade in services is closely linked with international production of services as the production process involves a resident and a nonresident. Despite the conceptual difference between goods and services, the boundary is sometimes blurred in practice; conventions are therefore necessary to assist compilers in classifying borderline transactions for the balance of payments.

289. The significance of particular types of transactions in services varies from country to country. Nevertheless, a standard classification for transactions in services is recommended in the *BPM* for a number of reasons. These include the increasing global importance of numerous types of transactions in services; the desirability of linking BOP classifications with those of the Central Product Classification (CPC); the analytic value, for users, of a standard classification; and the statistical requirements for multilateral negotiations on international trade in services. The classification framework is also designed to encompass transactions expected to assume greater importance in the future.

Transportation Services

Definition

290. In the *BPM*, *transportation* is defined as covering services provided by all modes of transportation performed by residents of one economy for those of another. Modes of transportation consist of sea, air, and other—which includes land, internal waterway, space, and pipeline. *Transportation* includes the carriage of passengers and the movement of goods (freight), as well as rentals (charters) of carriers *with* crew. Related supporting and auxiliary services (such as cargo handling, navigation fees, and maintenance and cleaning of carriers) are also included in *transportation*. Excluded from transportation services are freight insurance (included in *insurance services*); repairs of transportation equipment (included in ***goods***); repairs of railways, harbors, and airfield facilities (included in *construction services*); and rentals (charters) of carriers without crew (included in *other business services*).

291. Most transportation services, for both passengers and freight, are provided by enterprises through the operation of carriers or similar equipment. Because carriers such as ships or aircraft may operate in the territory of more than one economy or outside the territory of any economy, determination of the residence of the enterprise that operates the carrier—and, consequently, the economy to which the services provided by the carrier should be attributed—is not always straightforward. (Refer to chapter 4 of the *BPM* and paragraphs 103–106 of the *Textbook* for further information on this issue.)

292. In the BOP standard components, transportation services are classified by type of carrier (sea transport, air transport, and other transport) and by functional category of service (freight, passenger, and other). This section of the *Textbook* focuses on the functional classification of transportation services because assignment of carrier classification is usually quite straightforward. Issues associated with rentals of transport equipment, which can impact on more than one transportation item, are discussed at the end of the section.

Freight

293. The freight item is closely related to the ***goods*** component of the balance of payments. *Freight*, as

defined in the *BPM*, refers mainly to the carriage or transport of goods. The definition excludes shipping service for baggage that accompanies passengers on international journeys; the cost of this service is usually included indistinguishably in statistics for passenger services. Freight services are almost always performed in connection with an economy's exports and imports of goods, and any borderline in the balance of payments between ***goods*** and freight is, in a sense, artificial. Nevertheless, the distinction between ***goods*** and freight is important as the distinction permits comparison of the ***goods*** component for economies that provide few freight services with the ***goods*** component of economies that provide many such services internationally.

Freight on Imports and Exports of Goods

294. Freight services provided to or acquired from abroad by the reporting economy will mostly, but not always, relate predominantly to that economy's exports and imports of goods. Goods may be owned by the exporter at the time of shipment abroad, or the importer may have accepted delivery of the goods prior to implementation of international shipment. In the case of the reporting economy's exports and imports of goods, the BOP compiler is usually not able to ascertain (from information it is feasible to collect on goods or freight services) who owned the goods when shipment took place. This information is required to determine whether transactions between residents and nonresidents have taken place as freight services are performed for, or on behalf of, the legal owners of goods. Any necessity for relating changes of ownership to freight services can be obviated by the use of a convention for limiting entries for freight services on imports and exports of goods to the carriage of the compiling country's goods beyond the customs frontier of the exporting country. Under a convention of this kind, certain categories of transactions that take place—in a strictly legal sense—between residents are entered as mutually offsetting credits and debits, and certain offsetting transactions between residents and nonresidents may be excluded from the balance of payments. The use of such a convention is, of course, at variance with the general rule for including in the balance of payments only gross flows of services between residents and nonresidents. The problems of data collection are minimized, however, because entries made on the basis of this convention represent identifiable types of services performed (whether or not the relevant goods are, at the time, owned by a resident or a nonresident) by residents or nonresidents.

Freight Services Provided by the Compiling Economy

295. Freight services performed in connection with exports can be performed on behalf of the exporter or the importer. Strictly speaking, export-related freight services performed by resident operators on behalf of exporters are transactions between residents. For example, the cost of freight service on goods transported from the border of an exporting country to the point of sale in an importing country is estimated to be 100 units. The goods are sold for an all-inclusive price of 1,000 units. From the standpoint of flows between residents and nonresidents, the value of the transaction in goods amounts to 1,000 units. However, as the *BPM* convention is to record the value of goods at the customs border of the exporting country, the total value of 1,000 units is split between goods (valued at 900 units) and freight services (valued at 100 units). The flow of services proceeds from (1) the producer of the service to (2) the exporter to (3) the importer, rather than directly from resident enterprises furnishing the freight services to the importer. The service flows occur in this way because goods may be sold in one reporting period but freight services may have been rendered by the producer to the exporter in a preceding period.

296. When freight services are performed by resident transport operators on behalf of a nonresident importer, there is no ambiguity in interpreting a flow of services from resident to nonresident inasmuch as the importer is the owner of the goods. The direction of the service flow is from the producer (a resident enterprise) to the importer (a nonresident enterprise).

297. Freight services related to the compiling country's imports may be performed, on behalf of the nonresident exporter, by resident enterprises. The nonresident exporter may sell the commodities only upon arrival of the commodities in the compiling country. Until that time, the exporter is the owner of the commodities. For example, if the cost of freight services is 200 units and the all-inclusive sales price of commodities is 1,200 units, the flow (from the standpoint of the compiling country) between resident and nonresident consists of an export of services (200–unit credit) and an import of goods (1,200–unit debit). However, as goods are—according

to the *BPM* convention—valued at the customs border of the exporting country (that is, at 1,000 units), the additional value of 200 units becomes a service element provided by a resident producer to a resident consumer (the importer). Hence, in this instance, the service flow is:

producer (resident)	♦	exporter (nonresident)	♦	importer (resident)

When freight services related to the compiling country's imports are rendered—on behalf of the importer—by resident carriers, these services unambiguously represent a transaction between two residents and are therefore excluded from the scope of BOP statistics.

Freight Services Acquired by the Compiling Economy

298. What are the freight services that a reporting economy acquires from abroad in respect of exports and imports of goods? Services are performed in connection with exports when the exporter consigns goods abroad for subsequent sale. When goods are provided to a nonresident, the shipping service performed in connection with these goods is clearly an international transaction. Because valuation uniformly takes place at the customs border, value added through shipping of the goods is construed, ultimately, as a service flow from the exporter to the nonresident importer. The direction of the service flow is:

producer (nonresident)	♦	exporter (resident)	♦	importer (nonresident)

299. Freight services that are purchased from abroad and relate to the compiling country's imports consist of services performed (a) on behalf of the exporter and (b) on behalf of the importer. Services performed on behalf of the nonresident exporter are clearly transactions between nonresidents. However, because of the uniform valuation of goods, these services are shown in the balance of payments as service flows from nonresident exporters to importers rather than as integral parts of the value of goods. In these cases, the direction of the service flow is:

producer (nonresident)	♦	exporter (nonresident)	♦	importer (resident)

When freight services are acquired from abroad and performed on behalf of a resident importer, it is clear that such services are international transactions. The direction of the service flow is from the producer (nonresident enterprise) to the resident importer.

Conventions for Recording

300. How do freight service flows between residents and nonresidents compare with BOP entries made according to the method recommended in the *BPM* for recording the transactions? The *BPM* method, in effect, is to treat freight services that are performed (a) in connection with the compiling country's goods and (b) beyond the customs frontier of the exporting country as though such services were performed for residents of the importing country. The treatment is the same whether the freight services are provided by residents of that country or by residents of any other country. The procedure is for the compiling country to (a) enter as credits all export-related services performed by resident carriers after the exports have been loaded on board the carriers at the customs border and (b) enter as debits all import-related services performed by nonresidents after the imports have been loaded on board the carriers at the customs borders of the countries from which the commodities are being exported.

301. For example, an exporter in Longa sells two commodities to an importer in Pokolbin. According to the terms of the sale contract, the exporter is to deliver the goods to the importer at a port of entry in Pokolbin. The exporter hires, for 200 units, the services of a resident carrier to ship one of the commodities. To ship the second commodity, the exporter hires, for 300 units, the services of a carrier belonging to Central Paradiso. In accordance with the method recommended in the *BPM*, transportation services performed beyond the customs border of the exporting country are construed as transactions between the carrier and the importing country. Therefore, 200 units of the freight cost incurred by the exporter represent the provision of a service by a resident (the transportation enterprise) of Longa to a resident of Pokolbin (the importer). The other 300 units of freight cost represent the value of shipping services supplied by a resident carrier of Central Paradiso to the importer in Pokolbin. BOP entries for the freight item for Longa, Pokolbin, and Central Paradiso would be:

	Longa		**Pokolbin**		**Central Paradiso**	
	Credit	**Debit**	**Credit**	**Debit**	**Credit**	**Debit**
Freight	200			500	300	

302. The disadvantage with the approach recommended in the *BPM* is that such an approach may bring about the exclusion of offsetting flows between residents and nonresidents. If the recommendation for recording freight is followed,

entries are not recorded in the balance of payments as offsetting credit and debit entries. When the transactions occur in different periods, the entry recorded in the second period should reverse the entry recorded in the first period rather than recording an additional service flow. However, exclusions of offsetting entries accord with the economic reality that, in the final analysis, the cost of freight is borne by the importing economy—whatever arrangements may have been made for shipping the goods.

303. The primary purpose of the *BPM* convention is to establish a method of recording freight (and other distributive services) performed in relation to goods on a basis that is (1) consistent with uniform f.o.b. valuation for the ***goods*** component and (2) easier to follow in practice than the regular procedure for recording, in the **current account**, gross resident-to-nonresident transactions. Use of this convention admittedly does not obviate all the statistical problems that may arise in compiling the items for ***goods*** and freight. When these two items are derived from trade returns based on c.i.f. valuations of imports at the frontier of the importing country, a separate estimate must be made of the amount spent on distributive services performed beyond the customs frontier of the country from which the goods were exported. This disaggregation simply reallocates, between ***goods*** and ***services***, the distributive services element in the c.i.f. valuation of imports; therefore, any error in estimation will not affect the two items in combination. Furthermore, if the compiling country performs any of the distributive services in connection with its own imports, the amount of such services must be estimated separately from a total that includes similar services performed by the compiling country in connection with exports or other goods owned by nonresidents. While disaggregated data may be considerably more difficult to obtain than data on total earnings, any error in estimating disaggregated data will produce equal over- or understatement of the credit and debit sides of components for freight and other distributive services and will not affect the net amount of the item.

304. For example, the total value of imports assessed on a c.i.f. basis is 15,000 units. A sample shows that the ratio of imports valued f.o.b. to imports valued c.i.f. is 0.9—that is, 10 percent of the value of imports assessed on a c.i.f. basis constitutes the cost of freight. The difference between the c.i.f. and f.o.b. valuations is attributable to freight services that were provided by nonresident enterprises. In this case, the value of freight services acquired from nonresidents would be estimated at 1,500 units, and the value of goods assessed on an f.o.b. basis would be 13,500 units. BOP entries for the **current account** would be:

	Credit	Debit
Goods		13,500
Freight		1,500

Alternatively, if the transportation component represents 11 percent of the total value of imports assessed on a c.i.f. basis, the value of freight services and imports of goods valued f.o.b. would be 1,650 units and 13,350 units, respectively. From the standpoint of the reporting country, the total value of debits (in respect of the sum of ***goods*** and freight) in the **current account** remains the same in both cases, although the allocation between the two items is different.

305. Some freight services performed in respect of the reporting country's imports may be provided by resident enterprises. To determine the value of freight services provided by nonresidents, the cost of distributive services supplied by resident enterprises must be deducted from the total cost of transporting imports of goods beyond the customs border of the exporting country. Resident transport enterprises are normally able to provide data for total earnings on the international movement of goods and may be able to provide a disaggregation of these earnings into earnings on imports, earnings on exports, and other earnings from abroad. For example, such data could indicate that total earnings of domestic enterprises engaged in international transportation services amounted to 400 units, 150 units of which were attributable to earnings on imports. On the basis of this information and the assumption that the value of goods assessed on a c.i.f. basis was 15,000 units, 10 percent of which represented international freight, the following BOP entries can be constructed:

	Credit	Debit
Goods		13,500
Freight	250	1,350
Reserve assets (or other appropriate financial account item)	14,600	

306. If the accounting systems of resident transport enterprises do not contain information on earnings from the shipment of imports, the BOP compiler may have to resort to indirect methods of estimation, such as sample inquiries. The compiler may err in disaggregating total freight services between resident and nonresident suppliers of these services.

However, any over- or understatement of credit entries is balanced by the probability that debit entries are equally over- or understated. For example, if the estimated 150–unit value of freight services performed by domestic enterprises in connection with imports was actually 200 units, then the value of freight services performed in connection with the country's exports (credit) would be overstated by 50 units. However, the value of freight services attributable to nonresidents, which is a derived figure, would also be overstated by the same amount. That is, instead of being 1,300 units, the nonresident freight services would be calculated as 1,350 units. The net amount of the freight component would not be affected.

307. According to the *BPM* rule for uniform valuation, the performance of distributive services in connection with goods always begins at the customs frontier of the exporting economy. To achieve symmetry between partner country recording of separate credit and debit entries for freight, another rule stipulates the place at which the performance of goods-related freight and other distributive services ceases—whether at the frontier of the importing country or at an interior point in that country. A rule is necessary because the recommended method for recording distributive services performed in connection with the compiling country's goods can yield entries that are partly net, while the method used for recording other distributive services always shows gross transactions between residents and nonresidents. The rule states that distributive services are regarded as being part of those performed in connection with goods if such services are (a) performed within the territory of the importing country and (b) covered in a single contract (for example, a "through bill of lading") that also pertains to the freight charged on goods up to the frontier of the importing country. Stated conversely, the rule stipulates that services performed within the territory of the importing country (for example, freight forwarding from the frontier to an interior point) and arranged under a separate contract are considered to be part of freight on goods other than imports or exports and are recorded on a full gross basis. This rule is intended to simplify the compilation of the figures by conforming to underlying data most likely to be available.

Other Freight Services

308. Only those services performed in connection with distribution of goods beyond the customs frontier of the country from which the goods were exported are recorded under the convention designed to ensure uniform valuation. For other distributive services, the usual recording practice for items in the **current account** must be followed. That is, the gross service flows between residents and nonresidents must be recorded. For example, ownership of a commodity may change from the economy of Namdarb to the economy of Hughesavia. Distributive services performed in shipping the commodity beyond the customs border of Namdarb to the point of destination in Hughesavia are provided by a resident of Clintonstan. From the standpoint of Hughesavia, the transaction represents the purchase of freight services relating to the import of goods; from the perspective of Clintonstan, the transaction represents the provision of distributive services for moving non-domestic goods. Freight may also include shipment of goods that are not exports or imports of any country (such as goods transported within a country by coastal shipping or some other means); shipment of goods to or from entities located outside the territories of which the entities are residents (such as goods sent from a country to its agencies and agency personnel located abroad); and shipment of goods lost or destroyed after crossing the frontier but before being delivered to the importer.

309. As the physical point for uniform valuation of goods is defined in the *BPM* as the border of the exporting country, any distributive services performed up to that point constitute an integral part of the value of goods assessed on an f.o.b. basis. Consequently, offsets are made in freight to certain resident-nonresident flows that may be included in the ***goods*** component when goods are valued uniformly at the customs frontier of the exporting country. Specifically, freight service debits are recorded by the exporting country and freight service credits are included by the importing country for freight services that the importing economy provides within the exporting country's customs frontiers.

310. For example, the economies of Algornia and Coonawarra are contiguous. An importer in Coonawarra takes delivery of a commodity at the seller's establishment, which is located at an inland point in Algornia. At the establishment of the Algornian exporter, the value of the goods is 100 units. The importer hires a trucking firm from Coonawarra to transport the goods to his place of business, and the cost of transporting the goods from the establishment of the seller to the border of

Algornia is 20 units. In the BOP statements of both economies, the value of the goods would be shown as 120 units. To offset the overstatement, which is caused by the uniform point of valuation, of the goods export figure (credit) for Algornia, a contra entry (debit) is made under freight. Conversely, to offset the overstatement of the goods import figure for Coonawarra, a contra entry (credit) is also made in the freight component. The entries reflect the distributive services rendered by residents of Coonawarra in moving the goods from an inland point to the border of Algornia. BOP entries in respect of the ***goods*** and freight components are:

	Algornia		**Coonawarra**	
	Credit	**Debit**	**Credit**	**Debit**
Goods	120			120
Freight		20	20	

Treatment of Loading (Stevedoring) Charges

311. Freight refers mainly to the carriage of goods. However, as used in the *BPM*, the term also includes any ancillary services provided by a carrier in conjunction with the service of transport. In particular, freight includes the services of loading goods on board a carrier and unloading goods from a carrier if the contract between the owner of the goods and the enterprise operating the carrier requires the latter to provide that service. If such a service is performed at the customs frontier of the country from which goods are exported and if the service is provided by or on behalf of the carrier, the loading charge is included as part of freight. Otherwise, the loading charge is included in the value of goods. For example, an importer in Cromania takes delivery of goods at the border of the exporting country. The goods are worth 1,000 units. The importer contracts with a carrier belonging to Dromesia to transport the goods to his place of business, and the freight cost is 100 units. Furthermore, the carrier is to arrange for the stevedoring services, which cost 5 units and are provided by a resident of Dromesia. In this case, the freight charge would include the 5 units in respect of loading costs. BOP entries for Cromania would be:

	Credit	**Debit**
Goods		1,000
Freight		100
Reserve assets (or other appropriate financial account item)	1,100	

312. If the freighter were instead operated by a Cromanian enterprise, the balance of payments of Cromania would contain the following entries:

	Credit	**Debit**
Goods		1,000
Transportation-other		5
Reserve assets (or other appropriate financial account item)	1,005	

313. Alternatively, if the importer arranges for stevedoring services, these should be included in the value of the goods. In this case (if the operator of the carrier is a not a resident of Cromania), the BOP entries would be:

	Credit	**Debit**
Goods		1,005
Freight		95
Reserve assets (or other appropriate financial account item)	1,100	

314. This treatment is used because the statistics collected on freight usually cover indistinguishably all services performed by or on behalf of carriers, whereas statistics collected on goods are unlikely to include loading charges if loading is provided by or on behalf of the carrier. (Refer to paragraphs 321–324 for further discussion on the recording of stevedoring transactions in the balance of payments.)

Passenger Services

315. Passenger services are described in the *BPM* as services provided by carriers for the transport of passengers between countries and services provided, within a specific country, to residents by a carrier operated by a nonresident enterprise. These examples illustrate the definition.

Example 1 Clintonstan Air, which is operated by an enterprise resident in Clintonstan, transports residents of Bushland between airports in Clintonstan and Bushland. Clintonstan Air's receipts from these passenger fares are 100 units.

Example 2 Clintonstan Air transports residents of Bushland from airport A^1 to airport A^2 in Clintonstan. The tickets for the trips are purchased by Bushland residents inside the borders of Clintonstan. The trips do not constitute a continuation of an international journey. Clintonstan Air's receipts from passenger fares are 50 units.

Example 3 Clintonstan Air transports residents of Bushland from airport B^1 to airport B^2 in Bushland. The trips do not constitute a continuation of an international journey. Clintonstan Air's receipts from passenger fares are 25 units.

The balance of payments of Clintonstan should reflect the following entries:

	Credit	Debit
Passenger services	100 (example 1) 25 (example 2)	
Travel	50 (example 2)	
Reserve assets (or other appropriate financial account item)		175

316. In examples 1 and 3, the transportation of nonresident passengers by a domestic carrier is treated as part of passenger services; in example 2, the transaction is treated as part of *travel*. There are two primary reasons for this treatment.

317. The first reason is that, in practice, it is very difficult to collect data on carrier services provided to nonresidents and performed within the economies in which the carriers reside. When selling tickets to passengers, carriers normally do not obtain information on the residence of passengers. Compilers of BOP statistics often assume that fares sold by domestic carriers in the domestic market are sold to residents and, therefore, represent transactions that should be excluded from the balance of payments. Likewise, fares sold abroad by domestic carriers are assumed to be sold to nonresidents and to represent passenger services that should be recorded under other transport. In example 2, the fares to nonresidents are sold domestically from the viewpoint of Clintonstan. Identification of passenger services rendered to nonresidents is probably not possible because Clintonstan Air does not request information on the residence of passengers. Furthermore, it is likely that expenses incurred by Bushland residents in Clintonstan for passenger services provided by Clintonstan Air will—regardless of whether foreign exchange records or sample surveys of nonresident travelers are used to estimate *travel*—be included in overall estimates of travel expenses of nonresident visitors.

318. The second reason is that all goods and services (including passenger services) acquired by nonresidents in a particular country must be recorded in the BOP statement under *travel* (if the goods and services are acquired by travelers or by nonresident workers) or under *government services n.i.e.* (if the goods and services are acquired by foreign official personnel stationed in that country). Such classification is dictated by both analytical and practical considerations.

319. According to the *BPM*, passenger services include actual fares paid to carriers and all incidental expenditures that passengers incur in connection with carrier transportation or for which they pay fees to carriers. Thus, on-board expenditures of passengers for food, gifts, souvenirs, etc. and any charges for excess baggage or personal effects (such as automobiles) accompanying passengers on their journeys constitute part of passenger services.

Other Transportation Services

320. The ***services****-transportation*-other category comprises distributive services that are performed during the course of shipment but are incidental to shipment. Such services include storage and warehousing; loading and unloading (stevedoring) services not classified under ***goods*** or freight; packing and repacking; binding and packaging; cartage, drayage, and haulage; forwarding, handling, and transferring; airport and harbor dues; towing, pilotage, and other navigational aid for carriers; maintenance and cleaning of transport equipment; and salvage operations. Included as well are commissions and agent fees associated with passenger and freight transportation.

321. The recording of most transactions relating to the ***services****-transportation*-other category is generally straightforward. However, the treatment of stevedoring services warrants further discussion. Paragraphs 311–314 present information about the recording of transactions relating to stevedoring when the stevedoring is provided in the exporting economy. Two other cases of stevedoring transactions—stevedoring services provided in the importing economy and stevedoring services provided in connection with goods other than exports or imports of the country of the stevedoring enterprise— are discussed in subsequent paragraphs.

322. It is recommended that stevedoring transactions taking place in the importing economy be recorded on a strict resident/nonresident basis. Thus, when stevedoring services are arranged by an enterprise that is not a resident of the importing economy and provided by a resident stevedoring enterprise, an entry should be made in ***services****-transportation*-other. The offset to this entry will be, in all cases, part of the freight item. For example, if a Cromanian importer pays an Essendonian exporter 1,000 units

for arranging freight services and 10 units for arranging stevedoring in Cromania, the following entries would (if it is assumed that the good are transported by a carrier that is not a resident of Cromania) be made in Cromania's balance of payments:

	Credit	Debit
Freight		1,010
Transportation-other	10	
Reserve assets (or other appropriate financial account item)	1,000	

If, on the other hand, the goods are transported by a Cromanian resident carrier, the debit entry for freight would be 10 units, and the net transaction in reserve assets would be nil.

323. Recording transactions in this way classifies stevedoring services performed in the importing economy as part of freight services rather than as services ultimately attributed to the importer in the way that international freight services are. The reason for this treatment is that stevedoring services performed in the importing economy and provided to nonresidents will generally be an indistinguishable part of overall freight services.

324. Stevedoring services provided in connection with goods that are not exports or imports of the country providing the stevedoring services should also be treated, on a strict resident/nonresident basis, as other transportation services. For example, if a Hughesavian importer purchases goods from Domestica and the goods are unloaded and loaded in Nostaw en route, the stevedoring should be shown, in the balance of payments of Nostaw, as a credit under **services**-*transportation*-other and as a debit under the same item in the balance of payments of the country of the enterprise that arranged the stevedoring service. The country could be that of the importer, or the exporter, or the operator of the carrier.

Rental of Transportation Equipment

325. A transportation service often performed by one economy for another is the rental (charter) or lease of mobile equipment such as ships, aircraft, trucks, and railroad cars. A rental or lease should be reflected in the balance of payments when an enterprise resident in one economy retains legal ownership of equipment but hires or leases the equipment to an enterprise resident in another economy. According to the *BPM*, however, equipment (including transportation equipment) obtained under financial leases should not be treated as charters in the balance of payments. Instead, these goods should be added to the capital stock of the economy of the lessee, and an imputed change in the ownership of these goods should be recorded in the balance of payments. A full discussion of the treatment of these cases is provided in chapter 2.

326. For rentals of transportation equipment that are not financial lease arrangements, a distinction should be made between equipment rented with and without crew. When transportation equipment is rented with crew for a limited period, a transportation service is provided, and the value of this service is equivalent to the rental payment. If equipment is rented without crew, the rental should be recorded under operational leasing in the *other business services* item. In these cases, it is the lessee—rather than the lessor—that is producing the transportation services, and the rental of equipment without crew is treated the same as the rental of any other equipment.

327. For example, an enterprise in Central Paradiso charters an aircraft with crew from an enterprise resident in Domestica for a period of two weeks. In this and similar cases, the *BPM* recommendation is that the charter should, depending on the use of the aircraft, be treated as a freight or passenger service. By providing the crew, the Domestican owner of the aircraft continues to operate the aircraft.

Travel

Definition

328. The *travel* component should cover all goods and services acquired for personal use by travelers during their visits in host countries. A traveler is defined in the *BPM* as an individual who stays for less than one year in a country where he or she is not a resident. The following types of persons are **not** regarded as travelers:

(a) official diplomatic and consular representatives; members of the armed forces; other government personnel of a foreign economy; and the dependents, who are stationed in the foreign economy, of these individuals

(b) diplomatic and military personnel who are stationed on a military base or in an embassy and nonresident experts employed by a foreign

government (These personnel are not, from the viewpoint of the countries where these individuals are stationed, considered travelers. Therefore, the expenditures of these individuals in the foreign economy should be included in *government services n.i.e.* rather than in *travel*.)

(c) persons who are temporarily engaged in a productive activity in another economy and who are paid for their work by an entity of that economy. (However, any expenditures, on goods and services in the economy in which they work should be recorded under *travel*.)

329. The one-year rule does not apply to students and medical patients who remain residents of their economies of origin even if the length of stay in other economies is more than one year. Therefore, host economies should—regardless of the length of stay—consider students and medical patients as travelers. All goods and services, including education and medical services, acquired by students and medical patients while in host economies are regarded as travel expenditures and not recorded under any other items in the ***goods*** or ***services*** components.

330. Services pertaining to the international carriage of passengers—that is the carriage of travelers between countries—are not recorded under the *travel* item. Such services are recorded in the passenger services category. For example, if a resident of Hughesavia travels to Essendonia and decides there to undertake a trip by bus from Essendonia to neighboring Cromania, the passenger service provided to the resident of Hughesavia by the carrier of Essendonia should be excluded from *travel* and included in the passenger services category. However, in practice, it may be difficult to obtain the relevant data from a carrier in Essendonia because carriers normally do not collect information on the residence of passengers to whom they sell tickets.

331. The scope of the *travel* item, as described in the *BPM*, is similar to the definition and coverage of *visitors* in World Travel Organization (WTO) recommendations relating to statistics on international tourism. However, there is an important difference between the *BPM* and WTO definitions. The former includes the expenditures of seasonal and border workers, but the latter excludes these expenditures.

Types of Travel

332. Two types of travel, business and personal, are described in the *BPM* and reflected in the BOP standard components. For analytical purposes, further disaggregation, such as the separate identification of education- and health-related expenditures, may be useful under the personal category of the *travel* item.

Business Travel

333. Business travelers are commercial travelers who visit an economy for sales campaigns, market exploration, or commercial negotiations on behalf of the nonresident enterprise that employs them. Government employees who are traveling on official business and are not stationed in the economies they visit and employees of international organizations on official missions are business travelers. Employees installing machinery or equipment (if the enterprise that employs them is not a resident of the economy where the installation takes place) and crew members of carriers stopping off or lying over are classified as business travelers. Excursionists traveling for the purpose of business, such as attendance at meetings, should also be regarded as business travelers. Personal expenditures on goods and services by seasonal, border, and other nonresident workers in the economies in which they are employed are also recorded under *travel*-business.

Personal Travel

334. This category covers travelers going abroad for purposes other than business (for example, holidays for pleasure; participation in sports; visits to relatives and friends; and religious, educational, and health purposes). Also included in this category are government employees on leave in economies other than those in which they are resident or those in which they are stationed. For example, U.S. military personnel who are stationed in Germany and holiday in Switzerland should be treated as travelers while they are in Switzerland.

Goods and Services Covered

335. Included as part of the *travel* item are all goods and services acquired by travelers. It does not matter—as long as the goods and services are acquired by the traveler for personal, rather than

commercial, use—whether the goods and services are consumed immediately or later, or whether the goods and services are finally consumed by the traveler himself or by a third person. For example, an automobile purchased by a traveler during her stay in a host country and shipped to her home country for personal use should be included as part of the *travel* item. Goods that are obtained and later given away by the traveler should also be included in the *travel* item.

336. The *travel* item should also cover goods and services acquired by travelers whether the goods and services are paid for by the traveler or provided to him without a quid pro quo. In practice, information on goods received free of charge (such as free room and board received by official visitors or free instruction received by students) will be difficult to obtain. If information is available, offsetting entries should be made in *travel* and ***current transfers***.

337. The most common goods and services that nonresident travelers acquire when staying in a host country are meals, lodging, entertainment, sightseeing excursions, gifts, and souvenirs. It is also recommended that fees such as airport taxes or tickets for traffic violations be recorded under *travel*—although such fees are, strictly speaking, transfers. This recommendation is predicated on grounds of practicality, and these transactions are unlikely to be internationally significant.

338. For example, a resident of Coonawarra travels in Daniherland for six months to attend a training course. During this time, the traveler spends 850 units on goods and services, 500 units of which are spent on an automobile that the traveler subsequently takes back with him to Coonawarra and 30 units of which are spent on gifts for relatives in Daniherland. The traveler stays in accommodations provided by the Daniherland government. The accommodations are provided free of charge but valued at 125 units. The following entries should be recorded in Daniherland's balance of payments:

	Credit	Debit
Goods		30
Travel	975	
Current transfers		
General government		125
Other	30	
Reserve assets (or other appropriate financial account item)		850
	1,005	1,005

The *travel* item includes the accommodation services received by the traveler without a quid pro quo, as well as the purchase of the automobile. The gifts provided to the traveler's relatives are shown as imports of goods and are offset by a transfer.

Other Services

339. Transactions in international services not covered under *transportation* or *travel* items are covered under other services. In the BOP standard components, other services comprise nine broad categories: *communications services*; *construction services*; *insurance services*; *financial services*; *computer and information services; royalties and license fees*; *other business services*; *personal, cultural, and recreational services*; and *government services not included elsewhere (n.i.e.)*. Chapter 13 of the *BPM* provides a detailed description of the types of transactions covered by each of these categories. The discussion in this *Textbook* is limited to particular transactions for which the recording is somewhat complicated.

Construction Services

340. *Construction services* cover work on construction and installation projects performed by construction enterprises that are residents of economies other than those in which the work is taking place. The BOP compiler often faces problems in determining the residence of enterprises engaged in construction activity. However, the rules (which are discussed in chapter 3 of the *BPM* and chapter 2 of the *Textbook*) used to determine the residence of enterprises should be applied to construction enterprises as well. The initial determination is the economy to which production should be attributed. If production is deemed to be undertaken by the country in which the construction enterprise is resident, the host country should record construction service imports. Correspondingly, the country in which the construction enterprise is resident should record construction services. The value of these construction services should equal the *full value of the construction project* and not another amount such as net profit or net foreign exchange received by the construction enterprise. If production is deemed to be undertaken by the host economy, a direct investment enterprise that is resident in the host country is created, and no construction services are recorded in the balance of payments. The following two examples illustrate the treatment of enterprises engaged in construction activity abroad.

341. An enterprise in Daniherland is awarded a construction contract worth 8,000 units for a project

located in Pokolbin. The contract is implemented during a six-month period. The enterprise incurs these expenditures:

Materials purchased in Pokolbin	3,000
Materials purchased in Daniherland	1,000
Wages paid to residents of Pokolbin	1,000
Taxes paid to government of Daniherland	1,000

Because the duration of the project is less than one year, production should be attributed to the enterprise resident in Daniherland, which is deemed to be providing a construction service to Pokolbin. Accordingly, these entries would be required in Daniherland's balance of payments:

	Credit	Debit
Construction services	8,000	
Other business services		3,000
Compensation of employees		1,000
Reserve assets (or other appropriate financial account item)		4,000

The materials purchased in Daniherland and taxes paid to the government of Daniherland are resident-resident transactions and, therefore, not recorded in the balance of payments.

342. An enterprise from Namdarb is awarded a construction contract worth 60,000 units for a project located in Jaymaranda. The contract is implemented during a two-year period. Because of the long-term nature of the project, the enterprise sets up a site office in Jaymaranda and maintains a complete set of accounts for operations in that economy. To undertake the project, machinery worth 12,000 units is sent from Namdarb to Jaymaranda. At the end of the first year, the value of the work in progress is 25,000 units. This amount is paid by the client in Jaymaranda. After the expenses incurred in Jaymaranda are paid, the balance is remitted to Namdarb. At the end of the second year, the remaining 35,000 units are paid by the client. These expenditures are incurred on the project.

	Year 1	Year 2
Materials purchased in Jaymaranda	6,000	12,000
Wages paid to residents of Jaymaranda	7,000	4,000
Wages paid to residents of Namdarb*	2,000	2,000
Depreciation on machinery	1,000	1,000
Taxes paid to government of Jaymaranda	3,000	5,000
Total expenses	19,000	24,000
Net profit	6,000	11,000
	25,000	35,000

*Wages paid to Namdarb residents who work on the project for short (less than one year) periods of time

In this example, the criteria for attributing production to a resident of Jaymaranda have been satisfied; therefore, a direct investment enterprise, which undertakes the construction, is established. The following BOP entries would be made in Namdarb's balance of payments:

Year 1	Credit	Debit
Goods (machinery)	12,000	
Compensation of employees	2,000	
Direct investment income	6,000	
Direct investment-provision of machinery		12,000
Direct investment-depreciation	1,000	
Reserve assets (or other appropriate financial account item)		9,000
Year 2	**Credit**	**Debit**
Goods (machinery)		10,000
Compensation of employees	2,000	
Direct investment income	11,000	
Direct investment-return of machinery	10,000	
Direct investment-depreciation	1,000	
Reserve assets (or other appropriate financial account item)		14,000

As the direct investment enterprise is a resident of Jaymaranda, transactions between this enterprise and other Jaymarandian residents are obviously not recorded in Namdarb's balance of payments.

Insurance Services

343. *Insurance services* cover the provision of various types of insurance to nonresidents by resident insurance enterprises and vice versa. This item covers many types of insurance, including insurance on freight, accident insurance, marine insurance, fire insurance, reinsurance, life insurance, and commercially provided pension and annuity services. To classify insurance services correctly in the balance of payments, a distinction should be made between nonlife (casualty) insurance and life insurance, which includes commercially provided pension and annuity services.

Nonlife Insurance

344. Conceptually, the "normal" service charge that an insurer takes into account in setting premiums during a specific period may not be the same as the *net premiums* (premiums minus claims) payable during that period. Losses may be greater or lesser than those expected in the longer run; claims may not yet be payable on losses that have already occurred; and premiums may have been paid in

advance on risks to which the insurer has not yet been exposed. Therefore, in principle, net premiums may reflect not only a service charge but also capital gains/losses and pre- or postpayments. Furthermore, insurers will invest their *unearned premiums* (premiums paid in advance of periods in which any claims that may result from these premiums are incurred), and the income earned from these investments will also be taken into account by the insurer in determining the "normal" service charge. Because of the practical difficulties in sorting out these various elements, net premiums are customarily considered—for BOP purposes—the measure of insurance services *from the point of view of the insurer*. This method is therefore recommended in the *BPM* for determining exports of all types of insurance services and imports of reinsurance services.

345. However, if each individual insurance transaction (or a subset of an insurance enterprise's transactions) is considered, net premiums become a very poor proxy of the measure of insurance services. When a premium of 10,000 units is paid on a policy, the service charge represents only a fraction of this amount. The remainder represents money transferred to the insurance enterprise to pay future claims in respect of this or other policies. Likewise, a claim of 50,000 units does not represent a "negative service" provided by the insurance enterprise. The claim simply reflects a transfer of funds from the insurance enterprise to the claimant. For these reasons, the *BPM* recommendation is that, for *imports* of insurance services, the service provided should be calculated—in the case of insurance on goods—by applying to gross premiums paid to nonresident insurers the ratio of insurance services to gross premiums for exports of insurance services or—in the case of other direct insurance—by applying to gross premiums paid to nonresident insurers the ratio of estimated service charges to total premiums for resident insurers. Other flows of money between the resident insured and the nonresident insurer—that is, premiums payable minus the estimated service charge and claims receivable—are regarded as transfers.

346. The following example illustrates the recording of insurance services in the balance of payments. An insurance company resident in Algornia insures residents of Coonawarra, Cromania, Dromesia, and Essendonia against the risk of damage from hurricanes. Premiums of 4,000 units are received from each country. During the accounting period, a claim of 10,000 units is made as a result of storm damage suffered in Coonawarra. In accordance with recommendations in the *BPM*, the insurance services provided by the insurer are equal to the premiums received minus any claims paid. Thus, the following BOP entries would be made for Algornia:

	Credit	**Debit**
Insurance services	6,000	
Current transfers	10,000	10,000
Reserve assets (or other appropriate financial account item)		6,000

The transfer items represent, for debits, claims payable and, for credits, premiums receivable minus the insurance service charge. While these entries are net across all transactions, such will not be the case at the regional level.

347. On the basis of information contained in paragraph 346, the insurance service charge per unit of premium for this type of insurance may be calculated as 6,000 units (net premiums) divided by 16,000 units (gross premiums), or 0.375. Therefore, the insurance service received by Coonawarra, Cromania, Dromesia, and Essendonia is 0.375 times the premium paid (4,000 units), or 1,500 units each. This result makes sense, as each country received exactly the same insurance coverage from Algornia.

348. BOP entries for Coonawarra, Cromania, Dromesia, and Essendonia may now be constructed. Entries for Cromania, Dromesia, and Essendonia are identical.

	Credit	**Debit**
Insurance services		1,500
Current transfers*		2,500*
Reserve assets (or other appropriate financial account item)	4,000	

*The transfer debit entries represent premiums paid minus the service charge.

For Coonawarra, the following BOP entries are required:

	Credit	**Debit**
Insurance services		1,500
Current transfers*	10,000	2,500*
Reserve assets (or other appropriate financial account item)		6,000

*The transfer debit entry is equal to premiums paid minus the service charge. The transfer credit entry is equal to Coonawarra's claims receivable.

349. As the statistician has the necessary information, it is possible to allocate, for domestic transactions and exports of insurance services, insurance service charges to classes of policyholders in proportion to premiums paid. However, it is difficult to do the same for imports of insurance services as the importers are generally not in a position to determine the proportion of service charges attributable to them. (Therefore, the *BPM* recommendation is to use ratios derived from the domestic insurance industry.) For imports of insurance services, other proxies must be used to estimate insurance service charges. If this procedure is not feasible (for example, if the type of insurance services under consideration are not exported or if there is no domestic insurance industry for a particular type of insurance), the long-term relationship between premiums paid to nonresidents and claims received from nonresidents could be used to determine approximate service charges. Alternatively, BOP compilers in the exporting country could be contacted for information regarding service charges.

350. Before the discussion of nonlife insurance services is concluded, it may be useful to consider measures to be taken if claims exceed premiums for exported insurance services or for imports of reinsurance services. Use of the difference between premiums and claims would result in a "negative" service charge, which is a concept that makes no economic sense. Therefore, it is recommended that the compiler use the "normal" service charge per unit of premium, which is calculated by using the long-term relationship between premiums and claims, to determine the service charge for the period under consideration. This recalculated insurance service charge would then be used in the calculation of items for insurance services and related transfers.

Life Insurance

351. Two main features distinguish life insurance from nonlife insurance. There is often a substantial lag between the payment of life insurance premiums and the payment of claims arising from these premiums. For example, a 20–year-old person takes out a life insurance policy that matures when she turns 60. The payout value is based upon total payments made during the life of the policy. Forty years will elapse between initial payments and actual payout of the policy. The income earned on these premiums, which conceptually should be considered in the calculation of the insurance service charge, is often significant. The second distinguishing feature of life insurance is the certainty that a claim will occur. (Insurance policies that pay claims only in the event of death before a particular age are not considered life insurance for BOP purposes.) Because of this certainty, payment of premiums may be viewed by the insured as savings, and claims may be viewed as withdrawal of these savings. Furthermore, with many life insurance policies, the policyholder has a "surrender option"; that is, he or she can cash in his or her policy before maturity. On the basis of these attributes, the life insurance policyholder is considered to have a claim on the life insurance enterprise.

352. It is recommended in the *BPM* that the service element in life insurance be calculated on the same basis as the service element associated with nonlife insurance. However, this practice could produce misleading results in the balance of payments—particularly if international transactions in life insurance are significant.[10] If this is the case, an alternative and more meaningful way of calculating the service charge associated with life insurance would be to divide the sum of the operating costs and profits of life insurance enterprises into total premiums payable. As with nonlife insurance, the service charge is more easily calculated for exports of insurance services than for imports. Similar ratios, which could be obtained from the domestic life insurance industry or from BOP compilers in other countries, could be used for imports. As life insurance transactions between residents and nonresidents tend to be relatively insignificant and service charges tend to be a relatively small percentage of premiums, an alternative is to ignore entirely the service element of life insurance transactions.

353. Because of the investment nature of life insurance premiums and claims, life insurance premiums (minus any service charge calculated) are recorded as increases in the policyholder's claim on the life insurance enterprise (or mutual pool, in the case of mutual funds); claims (and surrenders of policies) are recorded as decreases in this investment. Investment in life insurance is recorded, in the ***financial account*** and the international investment position, under the *other investment*-other assets/liabilities items. The subject is not addressed in the *BPM*, but the compiler may wish to record

[10]Subtracting claims from premiums to determine a proxy for the insurance services item is more likely to result in the calculation of a "negative" service charge for life insurance than for nonlife insurance—even if the calculation is made with average premiums and claims from a number of years.

"bonuses" on life insurance policies. (Bonuses arise from the investment, by insurance enterprises, of policyholder funds.) Such bonuses could be recorded as income payable from insurance enterprises to policyholders and offset by an increase in policyholder claims on insurance enterprises.

354. An example may clarify the treatment of life insurance in the balance of payments. Residents of Pokolbin pay 12,000 units in premiums to a nonresident life insurance enterprise and receive 22,000 units in claims. Furthermore, analysis of Pokolbin's domestic life insurance industry shows that the ratio of operating costs and profits to premiums receivable is 0.05. The following entries would be recorded:

Pokolbin's Balance of Payments:

	Credit	Debit
Insurance services		600
Financial account		
Other investment-other assets*	22,000	11,400
Reserve assets (or other appropriate financial account item)		10,000

*In BOP presentations, these entries would be shown on a net basis (10,600–unit credit). Gross entries are shown for illustrative purposes only.

The insurance services item was calculated by multiplying the 12,000 units of premiums by 0.05. The increase in investment (debit entry) was calculated as the difference between premiums and the estimated service charge.

Financial Services

355. *Financial services* cover a number of transactions in services related to the financial industry. A full description of this item can be found in chapter 13 of the *BPM*. One type of transaction—foreign exchange trading—that gives rise to financial services is considered in the *Textbook*. According to the *BPM*, transactions denominated in foreign currency should be converted to the unit of account by using the midpoint between the buy and sell rate applicable at the time of the transaction. As the midpoint rate is unlikely to be the rate actually used in the transaction, how should transactions involving the exchange of one currency for another be recorded in the balance of payments? The midpoint rule should still be applied. The difference between the value of the part of a transaction involving foreign exchange converted to the unit of account by using a midpoint rate and the value of the part of the transaction involving the unit of account represents an implicit service normally provided by a financial intermediary (such as a bank or other foreign exchange dealer) to a customer (such as a corporate client). This service should be classified under *financial services* in the balance of payments.

356. For example, an Australian bank uses Australian dollars (A$) to buy United States dollars (US$) at the rate of A$1.39 to US$1 and sells US dollars at the rate of US$1 to A$1.41. The midpoint rate is US$1 to A$1.40. An American resident wishes to exchange US dollars for A$10,000, which will be deposited with the Australian bank. At the Australian bank's buy rate, the American resident will pay US$7,194. Entries in Australia's balance of payments show that the Australian bank increases its holdings of US dollars by US$7,194. Converted at the midpoint rate, this amount is shown in Australia's balance of payments as a debit of A$10,072. The bank's liabilities (in the form of deposits) increase (a credit entry) by A$10,000. The A$72 credit required to balance the entries represents a financial service provided by the bank to a nonresident.

Australia's Balance of Payments

	Credit	Debit
Financial services	72	
Other investment-assets		10,072
Other investment-liabilities	10,000	

357. Consumers are unlikely to know the value of services that they have implicitly purchased and, in many cases, the producer will be unable to provide information on services provided to nonresidents. Proxies for service charges could be calculated by determining the average *spread* (difference) between buy and sell rates and then multiplying foreign exchange transactions with nonresidents by half of this spread.[11] However, care must be exercised in determining which party is the consumer and which party is the producer of the service—particularly with regard to transactions between foreign exchange dealers located in different economies. The same dealer can be a price-taker (consumer) in one transaction and a price-maker (producer) in another transaction. (Additional information on this topic can be found in paragraphs 562–568 of the *Balance of Payments Compilation Guide*.)

[11]Similar adjustments will be required for financial account entries if the entries have been recorded at buy or sell rates rather than at midpoint rates.

Merchanting and Other Trade-Related Services

358. Two aspects of this item warrant consideration in the *Textbook*: (1) commissions and similar fees on exports or imports of goods and (2) merchanting.

Commissions and Similar Fees on Exports and Imports of Goods

359. According to the *BPM*, agent fees on exports and imports are regarded as part of the value of goods if such fees are paid by the exporter (regardless of whether the agent is a resident of the exporting country or some other country) or if such fees are paid by the importer to an agent resident in the exporter's country. When agent fees are paid by the exporter to a nonresident agent or paid by an importer to an agent in countries other than the importing or exporting economy, entries should be made in the balance of payments in the merchanting and other trade-related services item. No entries are required in this item for agent fees paid by the importer to agents in the exporting country. While such transactions involve residents in different economies, the fees constitute part of the value of transactions in goods to which the agent fees are related.

360. The following example illustrates the material in paragraph 359. These transactions take place between Domestica and Nostaw in a particular year.

[a]Value (excluding agent fees) of goods exported from Domestica to Nostaw	200
[b]Fees charged on Domestica's exports (see[a]) by an agent in Nostaw and paid by the importer	10
[c]Fees charged on Domestica's exports (see[a]) by an agent in Domestica and paid by the importer in Nostaw	20
[d]Value of goods imported by Domestica from Nostaw	300
[e]Fees charged on Domestica's imports (see[d]) by an agent in Cromania and paid by the importer	40

In this case, the balance of payments of Domestica should show the following entries:

	Credit	Debit
Goods		
Exports f.o.b.	220	
Imports f.o.b.		300
Merchanting and other trade-related services		40
Reserve assets (or other appropriate financial account item)	120	

Thus, entries under exports include agent fees that were paid in connection with transactions in goods by the Nostawan importer to an agent resident in Domestica. Fees paid by the Nostawan importer to the agent in Nostaw are not reflected in the value of exports as the transaction is strictly between two nonresidents.[12] The debit entry recorded for merchanting and other trade-related services relates to agent fees paid by the importer in Domestica to a resident of a third economy, Cromania. Had these fees been paid to a resident of Nostaw, the fees would have been included in the value of goods recorded in the balance of payments rather than being shown as a separate transaction under merchanting and other trade-related services.

Merchanting

361. The acquisition and subsequent sale of goods that do not cross the frontier of the economy in which the temporary owner of these goods is a resident is called *merchanting*. These transactions are not recorded as imports and subsequent re-exports of goods. The *BPM* recommendation is that any difference in the value of the goods be regarded as a fee for a service rendered to nonresidents and that this fee be included in merchanting and other-trade related services. Speculative gains or losses realized from transactions in commodity arbitrage are also recorded under this item. However, speculative gains or losses occurring in connection with financial items constitute part of the value of these items and, when realized, such gains or losses are reflected in the ***financial account***. Paragraphs 189–194 of the *Textbook* provide additional details on the treatment of merchanting.

362. An enterprise in Bushland purchases coffee from a resident of Central Paradiso for 300 units and sells the coffee to a resident of Jaymaranda for 330 units. The goods are shipped directly from Central Paradiso to Jaymaranda, and the goods do not cross the border of Bushland. In another transaction, the enterprise in Bushland speculates in oil stocks held abroad and loses 10 units in the transaction.

The balance of payments of Bushland should show the following entries:

	Credit	Debit
Merchanting and other trade-related services	30	
	–10	
Reserve assets (or other appropriate financial account item)		20

[12]Furthermore, BOP compilers in Domestica would generally not have access to this information. However, customs authorities in Nostaw may include these fees in their valuation of Nostaw's imports, in which case the fees should be deducted by Nostaw's BOP compilers.

Thus, the credit entry for merchanting represents the merchanting gain of 30 units, which is calculated as the difference between acquisition and sale prices of the coffee, and the debit entry for that item reflects the loss from oil trading.

Government Services n.i.e.

363. *Government services n.i.e.* include (1) transactions between the compiling country's government and other governments (or international organizations); (2) transactions between the compiling country's government and nongovernment nonresident entities; (3) transactions between foreign governments (including international organizations) and the compiling country's nongovernment units; and (4) personal expenditures by foreign diplomatic, military, and other personnel of official entities in the economy in which the entities are located. However, not all of the transactions satisfying this criterion should be recorded as *government services n.i.e.* Transactions that can be classified under other BOP items should be recorded accordingly. Subsequent paragraphs describe in detail some of the principal transactions classified as *government services n.i.e.*

Embassies, Consulates, and Other Official Entities

364. Transactions of embassies, consulates and other official entities of foreign governments (such as military units, aid missions, tourist and information offices, libraries, and offices to encourage immigration) with residents of countries where the entities are located should be recorded in the balance of payments of both the host countries and the countries represented by the entities. According to the *BPM*, these entities are residents of the countries represented rather than the countries where the entities are located. Goods and services acquired from host economies by these entities should be regarded as transactions in the *government services n.i.e.* item in the balance of payments of both countries. On the other hand, cash remittances, shipments of goods, and any other transactions between these official entities and their home countries should be excluded from the balance of payments of host countries because these transactions represent transactions between nonresidents.

365. Transactions of the nonresident personnel of foreign official entities (such as embassies) with residents of the economies in which the entities are located should also be recorded in the balance of payments. The residence of personnel from embassies, consulates, and other government offices is not defined by the usual one-year rule of residence but by center of interest. On the basis of the center of interest concept, persons posted from their home countries to work in official entities located in other countries maintain centers of interest in their home countries—regardless of whether the employees reside in host countries for less or more than one year. Therefore, such personnel are always treated as nonresidents of host countries, and transactions of these personnel with residents of host countries should be included in the balance of payments.

366. The following summary represents the principal types of transactions engaged in by embassies, consulates, other official entities, and related personnel and classified as *government services n.i.e.*:

expenditures in host countries by embassies, consulates, etc. for goods and services such as office supplies and furniture, fuel and utilities, rent or purchases and sales of embassy buildings, official cars and the operation and maintenance thereof, and official entertainment;

personal expenditures in host countries by diplomatic, military, and other personnel of foreign official entities.

367. Several examples show how transactions relating to embassies and other official entities located abroad should be recorded in the balance of payments. In the first example, the Cromanian embassy in Hughesavia buys, for embassy use, an office building located in Hughesavia. The embassy pays 500 units for the building. The balance of payments of Cromania should show the following entries:

	Credit	**Debit**
Government services n.i.e.		500
Reserve assets (or other appropriate financial account item)	500	

However, purchases and sales of land by foreign embassies should not be recorded as *government services n.i.e.* Rather, these transactions should be recorded under the *acquisition* or *disposal* of *nonproduced, nonfinancial assets* in the ***capital account***.

368. In the second example, during a particular year, Cromania's embassy in Hughesavia collects the following receipts and makes the following payments through commercial banks in Hughesavia:

Receipts

[a]Cash received from government in Cromania	1,000
[b]Interest on bank deposits in Hughesavia	50

Payments

[c]Wages paid to Hughesavian staff	200
[d]Wages paid to Cromanian staff	500
[e]Expenditure for office supplies in Hughesavia	50
[f]Rent for embassy building	150

These transactions should be recorded in the balance of payments of Hughesavia in the following manner:

	Credit	Debit
Government services n.i.e.	50[e]	
	150[f]	
Compensation of employees	200[c]	
Investment income		50[b]
Other investment-assets-currency and deposits-banks		1000[a]
Other investment-liabilities-currency and deposits-banks*	1000[a]	200[c]
	50[b]	50[e]
		150[f]

*In BOP presentations, this item would be shown on a net basis (650–unit credit). Gross entries are shown for illustrative purposes only.

369. In the third example, a resident of Cromania is stationed for three years with the embassy of his country in Hughesavia. The Cromanian resident collects the following receipts and makes the following payments through commercial banks in Hughesavia:

Receipts

[a]Salary paid by embassy into local bank account	500
[b]Interest on bank account in Hughesavia	10
[c]Dividends (on shares from an enterprise in Cromania) paid into local bank account	50

Payments

[d]Expenditures for food and clothing in Hughesavia	100
[e]Rent for apartment in Hughesavia	150
[f]Purchase of a car in Cromania	1,000*

*The funds were transferred from the diplomat's bank account in Hughesavia to Cromania prior to the purchase.

The balance of payments statement of Hughesavia should reflect the following entries:

	Credit	Debit
Government services n.i.e.	100[d]	
	150[e]	
Investment income-interest		10[b]
Other investment-assets-currency and deposits-banks*	1000[f]	500[a]
		50[c]
Other investment-liabilities-currency and deposits-banks*	500[a]	100[d]
	10[b]	150[e]
	50[c]	1000[f]

*Entries are shown on a gross basis for illustrative purposes.

In practice, it often may be difficult to obtain data on the expenditure by nonresident staff of embassies, consulates, military units, etc. Therefore, an estimate of their expenditures may be based on information received from those entities on wages and salaries paid to nonresident personnel.

370. In addition to transactions between foreign government entities located in a country and the residents of that country, receipts and contributions made under joint military arrangements constitute another group of transactions recorded in the category of *government services n.i.e.* Also recorded under this item are general administrative expenditures associated with aid.

VI. Income

Definition

371. Income, in economic accounts such as the balance of payments, consists of earnings arising from the provision of the factors of production: land, labor and capital. Ownership of land, according to BOP concepts, is always attributed to residents. Consequently, income receivable (such as rent) for the use of land will generally be a transaction between residents and, therefore, outside the scope of the balance of payments.[13] Accordingly, the ***income*** component of the balance of payments is restricted to income earned from the other two factors of production: labor and capital. Income earned from the former is called *compensation of employees*, while income earned from the latter is called *investment income*.

372. In principle, any earnings derived from the provision of nonfinancial assets is not considered income for BOP purposes. The most common types of earnings from the provision of nonfinancial assets are royalties and licenses, earnings from film rentals, and earnings from rentals or charters of equipment. *Royalties and license fees* comprise an item in the ***services*** component of the current account. Rentals and charters of transportation equipment with crew are recorded under *transportation*-other in the ***services*** component. Rentals of other equipment are recorded in *other business services*-operational leasing in the ***services*** component. Earnings from film rentals and other distribution rights are recorded in *personal, cultural and recreational services*-audiovisual and related services in the ***services*** component.

[13]In rare circumstances, a nonresident may rent land from a resident. For example, a traveler could rent land while traveling in an economy other than his or her own or an enterprise operating temporarily in another economy could rent land as part of the temporary operation. In these cases, the rental would be recorded in the balance of payments as part of the ***services*** component; the rent from the traveler would be recorded under *travel*; and the rent from the enterprise would be recorded under miscellaneous business, professional, and technical services.

Compensation of Employees

373. *Compensation of employees* includes wages, salaries, and other compensations (whether paid in cash or in kind) earned by nonresident individuals for work performed for residents of the economy in which the work is performed. (The definition of a nonresident worker can be ascertained by referring to chapter 4 of the *BPM* and chapter 2 of the *Textbook*.) Included as part of *compensation of employees* are contributions paid by employers to social security schemes or similar private insurance or pension funds. However, interest and other income received by nonresident workers from financial investments made in host economies are classified as *investment income*.

374. In editions previous to the fifth, the treatment recommended in the *BPM* for expenditures of nonresident workers in host economies was to record these expenditures under the same item—labor income—as nonresident worker salaries, etc. However, this treatment of workers' expenditures resulted in disharmonization with the national accounts. The BOP entries contained amounts relating to both income and consumption, which are two distinct concepts within the national accounting framework. Consequently, the treatment of workers' expenditures, which are now part of *travel*, was changed to harmonize with the national accounts. However, in practice, information available to many countries on compensation of workers is net of the expenditures of these workers. (Paragraphs 580–588 of the *Balance of Payments Compilation Guide* describe the data sources that could be used to measure *compensation of employees*.)

375. An example illustrates the recording, in the balance of payments, of transactions relating to nonresident workers. A worker from Namdarb is employed for three months by an enterprise located in Cromania. In Cromania, the worker receives certain amounts and makes certain payments.

Receipts	
Salary from enterprise in Cromania	500
Interest on bank deposit in Cromania	50
Rent from an apartment owned by the worker in Cromania	200
Payments	
Food consumed in Cromania	110
Clothing purchased in Cromania	100
Property tax paid to government in Cromania	40
Income tax paid to government in Cromania	50

The balance of payments of Namdarb should reflect these entries:

	Credit	Debit
Services-travel		210
Income		
Compensation of employees	500	
Direct investment income	160	
Other investment income	50	
Current transfers-general government		50
Reserve assets (or other appropriate financial account item)		450

376. The salary received by the nonresident worker in Cromania is shown on a gross basis under *compensation of employees*, while the rent received (net of property taxes) from investment in an apartment and interest on bank deposits are classified, respectively, as income under direct investment and other investment. The nonresident worker's expenditures on goods and services in Cromania are recorded under *travel*, while the income tax paid is shown as a ***current transfer***.

377. Individuals who derive labor income from employment in countries where they are not residents can be either border or seasonal workers. Border workers are individuals whose abodes are not located in the economies in which they work. Seasonal workers are individuals who live and work in economies for less than one year. Labor income paid by resident entities to nonresident border and seasonal workers is recorded as *compensation of employees*.

378. The following example clarifies material contained in paragraph 377. A Belgian national (A) lives in Belgium but near the border with France and works for an enterprise in France. Two other Belgian nationals (B and C) work for the same enterprise in France but have homes in France. B has a contract for six months; C's contract is open-ended. In one year, the Belgian nationals receive the following salaries:

A	200
B	300
C	350

The balance of payments of Belgium should show these entries:

	Credit	Debit
Income-compensation of employees	500	
Reserve assets (or other appropriate financial account item)		500

Only the salaries paid to A and B are recorded in the balance of payments of Belgium. From the viewpoint of that country, A is a border worker and B is a seasonal worker, and both are receiving salaries from a nonresident employer. C, however, must be regarded, from the viewpoint of Belgium, as a nonresident, and the income he receives in France should not be recorded in the balance of payments of Belgium.

379. The Belgian nationals spent the following amounts for consumption in Belgium and France:

	Belgium	France
A	150	50
B	100	200
C	60	300

The balance of payments of Belgium should record these expenditures:

	Credit	Debit
Services-travel	60	250
Reserve assets (or other appropriate financial account item)	190	

The entry under travel credits represents the expenditures, which must be treated as travel receipts, made by the nonresident national (C) in Belgium. The entry under travel debits reflects the personal expenditures made in France by A and B, who are employed with private enterprises in that country. The expenditures made in Belgium by A and B are not recorded because these expenditures are related to transactions between residents. The expenditures made by C in France represent transactions between nonresidents and are also excluded from the statement of Belgium. It is acknowledged in the *BPM* that it is often very difficult for the compiler to distinguish between foreign nationals who work and live in a country for less than one year and those who work and live in a country for one year or longer. The *BPM* suggestion is that an effort should nonetheless be made to observe the distinction between foreign workers who should be treated as nonresidents and workers who

are residents. Lack of uniformity in the statistical treatment of the same individuals by the two relevant compiling economies could create significant problems of asymmetry between the BOP statements.

Investment Income

Definition

380. *Investment income* is defined in the *BPM* as the income accruing to an investor from the ownership of financial assets. The most common types of financial assets are bank deposits, loans extended, bonds, bills, shares in the equity capital of an enterprise, and head office claims on branches. Investment income derived from these assets comprises mainly interest, dividends, remittance of branch profits, and direct investor shares of the retained earnings of direct investment enterprises.

381. Interest represents income that is normally paid in accordance with a binding agreement between a creditor and a debtor. Included are all commitment charges in lieu of interest and discounts covered by such agreements. Net interest flows arising from interest rate swaps and similar instruments are also included. Dividends are paid, in contrast, by virtue of discretionary decisions of incorporated enterprises. Dividends represent income payable without a binding agreement between creditor and debtor. Dividends may be paid in cash or in stock.

382. Apart from dividends payable on shares of equity capital in incorporated enterprises, investment income may also result from the ownership or co-ownership of branches and other unincorporated enterprises operating abroad. These enterprises are accorded resident status in the economies in which the enterprises operate. Any income remitted from enterprise operations to nonresident owners is recorded in the balance of payments under *investment income*-direct investment.

383. Another type of investment income recorded in the balance of payments is direct investor shares of the retained earnings or net losses of an incorporated enterprise and the retained earnings or losses of branches and other unincorporated enterprises. Retained earnings increase the value of an investor's financial investment in an enterprise, and losses lessen the value of the financial investment. Therefore, retained earnings represent, from the viewpoint of the direct investor, the counterpart to an increase in the value of investment; losses represent the counterpart to a decrease in the value of investment. In accordance with *BPM* conventions, portfolio investor shares of the retained earnings and losses of an enterprise are excluded from the BOP statement.

384. Two examples are presented to illustrate preceding concepts. An investor in Dromesia holds 50 percent of the shares of an enterprise located in Longa. The profits or net earnings are 500 units. The enterprise decides to pay 300 units in cash dividends to shareholders and to retain 200 units to increase enterprise reserves. In this case, the BOP statement of Dromesia should record (1) the direct investor's share of cash dividends, which amounts to 150, as an investment income inflow and (2) 50 percent, which amounts to 100 units, of the retained earnings. Total investment income is therefore 250 units. The investor's 50 percent participation in the equity capital of the enterprise should entitle her to an effective voice in the management of that enterprise; therefore, she is a direct investor. Thus, the decision to retain a part of enterprise earnings must have been made with her concurrence. It can be assumed that, had the direct investor wished, those earnings would have been distributed. Accordingly, the direct investor made a conscious decision to forgo the distribution of income and to reinvest the earnings in the direct investment enterprise. Therefore, offsetting entries are made under *investment income*-direct investment-reinvested earnings in the **current account** and under *direct investment*-reinvested earnings in the ***financial account***. (For further elaboration of the concept of direct investment, see chapter 18 of the *BPM* and chapter 9 of the *Textbook*.)

385. An investor residing in Domestica holds shares of a large international corporation located in Essendonia. The investor's shares represent only l percent of the equity capital of that enterprise. The profit of the corporation is 1000 units. One-half of that amount is paid in dividends to shareholders and the other half is retained by the enterprise. In this case, the investment income flow recorded in the balance of payments of Domestica is 5 units, which represent only the investor's share of the distributed earnings. The retained earnings are not investment income because the investor's minor (1 percent) participation in the enterprise makes it unlikely that he has an effective voice in the management of the corporation. His investment therefore represents portfolio investment rather than direct investment. As

the decision to retain a portion of the corporation's earnings would be made without much consideration of the portfolio investor's views, reinvested earnings are not shown as income in the balance of payments in this case.

386. Under certain circumstances, investment income may also result from the operation of mobile equipment in an economy other than the economy in which the operator is actually resident. (See paragraph 106 of chapter 2.) According to *BPM* conventions on residency, a change of ownership is imputed for mobile equipment that is operated abroad for a period of one year, accounted for separately by the operator, and recognized by the authorities of the host economy as part of that economy's capital stock. Therefore, a resident of Coonawarra who operates an aircraft in Hughesavia is regarded as having a direct investment in a notional enterprise in Hughesavia if the preceding criteria are satisfied. Earnings from the aircraft therefore represent part of the gross earnings of the notional enterprise in Hughesavia. After depreciation costs are deducted, the net earnings are recorded under *direct investment* as income of the enterprise in Coonawarra. These earnings are construed as resulting from the financial investment in the notional enterprise in Hughesavia. An example of this type of transaction is provided in paragraphs 552–554 of chapter 9.

387. If goods are leased under a financial lease arrangement, a change of ownership from the lessor to the lessee is imputed. The portion of the lease fees representing interest on the loan that is construed as being extended in connection with the change of ownership of the equipment is recorded under *investment income*. (See paragraphs 109–111 of chapter 2 for elaboration of the treatment of financial leases.)

388. Another case in which investment income is derived from a type of lease arrangement is the lease or rental of land. For example, a resident of Nostaw owns land in Daniherland and leases the land to a resident of Daniherland for a fee of 100 units. According to the *BPM* convention, land—except when owned by extraterritorial bodies such as foreign embassies—is always owned by a resident of the economy in which the land is located. Therefore, it is necessary to create a notional enterprise to which ownership of the land in Daniherland can be attributed. The lease payment is now considered a domestic transaction. In Nostaw where the legal owner resides, the imputed withdrawal of entrepreneurial income from the notional enterprise is shown in the balance of payments as:

	Credit	Debit
Direct investment		
Income on equity		
Dividends and distributed branch profits	100	
Reserve assets (or other appropriate financial account item)		100

389. Capital gains and losses are excluded from *investment income*. Capital gains and losses do not represent income at all but are part of the value of the financial assets. When realized, capital gains and losses are recorded in the ***financial account***.[14] All unrealized valuation changes are excluded from the BOP statement. Valuation changes are, however, reflected in stock positions shown in the IIP statement and in changes in the values of these positions over time.

390. If, however, debt securities (such as bonds, notes, and bills) are issued by the debtor at values that differ from amounts paid to the holders when the securities mature, the premiums or discounts are not regarded as capital losses or gains but as portions of the interest paid on those securities. The premiums and discounts on securities are therefore classified in the *investment income* category.

Classification

391. For the purpose of BOP recording, *investment income* is divided into income from direct investment, portfolio investment, and other investment.

Income from Direct Investment

392. Income from direct investment is income that accrues to a direct investor from ownership of direct investment capital. A direct investor is an investor who makes a long-term investment in an enterprise with the intention of having an effective voice in the management of that enterprise. Accoding to the *BPM*, ownership of 10 percent or more of the shares of an enterprise is considered a

[14]Realized valuation changes are reflected as part of the financial transactions giving rise to the realization of gains or losses, but such valuation changes remain excluded from income.

direct investment. Direct investment capital is primarily comprised of:

the share of the direct investor in the equity capital of an enterprise;

the share of the direct investor in accumulated profits not remitted by the enterprise;

other net claims of the direct investor on the direct investment enterprise.

Direct investment enterprises can be incorporated enterprises (privately or publicly owned), branches, unincorporated enterprises, or notional enterprises delineated in accordance with the principles of residence presented in the *BPM*.

393. The *BPM* divides income from direct investment into (1) income on equity (which includes dividends, distributed branch profits, and reinvested earnings) and (2) income on debt (interest). The following example illustrates this classification scheme. Enterprise X in Clintonstan holds 50 percent of the equity of enterprise Y in Bushland. These transactions take place in the reporting period. The profits of Y are 200 units, of which 100 units are paid in dividends to shareholders and 100 units are reinvested in the enterprise. Enterprise X extends a long-term loan of 500 units to enterprise Y, and the interest rate on this loan is 10 percent. Concurrently, enterprise Y has a claim of 100 units on enterprise X in the form of a short-term trade credit on which the interest rate is 15 percent. Enterprise X issues bonds at an interest rate of 8 percent, and enterprise Y acquires 100 of these bonds.

The balance of payments of Clintonstan should reflect these entries:

	Credit	**Debit**
Direct investment income		
Income on equity		
Dividends	50	
Reinvested earnings	50	
Income on debt (interest)	27	
Direct investment-abroad (Bushland)		
Reinvested earnings		50
Reserve assets (or other appropriate financial account item)		77

The credit entries under direct investment income-income on equity reflect the share of enterprise X in distributed and undistributed earnings of enterprise Y. The entry for direct investment income-income on debt reflects the interest (50 units) received on the loan extended to enterprise Y *minus* the interest (15+8=23 units) payable by X to Y. The interest payable by X to Y is recorded, in accordance with recommendations contained in the *BPM*, as negative direct investment income. Any income derived by enterprise X from investments in enterprise Y is netted against income paid by X to Y. If enterprise Y held a small number of shares in enterprise X, this investment would represent negative direct investment rather than portfolio investment. Dividends payable by enterprise X to enterprise Y on such shares would be netted against dividends payable by direct investment enterprise Y to direct investor X.[15] The rationale for these negative direct investment flows is explained in paragraph 529 of chapter 9.

Income from Portfolio Investment and Other Investment

394. Income from portfolio investment and from other investment is income accruing to an investor from investment (other than direct investment) in financial assets. The most typical forms of income from portfolio investment are interest earned on debt securities and dividends earned on equity securities (shares) issued by companies in which the investor has no effective voice in the management. Payments made under interest rate swaps and similar arrangements also represent income from portfolio investment. The BPM shows that income from portfolio investment is divided into two categories: (1) income on equity and (2) income on debt. Income on debt is further divided into (1) income earned from bonds and notes and (2) income earned from money market instruments and financial derivatives (such as interest rate swaps).

395. The most common forms of income from other investment are interest earned from deposits, loans, and trade credits. Lease fees from financial lease arrangements represent, in part, interest on loans construed to be extended in connection with imputed changes of ownership for the goods. This interest also constitutes income from other investment.

396. The following example illustrates the classification scheme for *investment income*. In a specific period, residents of Urangastan derive certain income from their financial investments abroad.

[15] An exception to the netting of income flows between a direct investor and a direct investment enterprise occurs when each enterprise is considered a direct investor in the other. In these cases, income flows between the two enterprises should be recorded on a full gross basis.

Central Bank of Urangastan

(1) Interest of 70 units on bank deposits
(2) Interest of 80 units on securities issued by a foreign public enterprise
(3) Interest of 30 units on a loan extended to a foreign central bank

Government of Urangastan

(4) Dividends of 40 units on a 50 percent share in the equity of enterprise X located in Central Paradiso
(5) Share of 50 units in the undistributed earnings of enterprise X located in Central Paradiso
(6) Dividends of 20 units on a 5 percent share in enterprise Y located in Central Paradiso

National Airline of Urangastan

(7) Interest of 10 units from bank deposits abroad
(8) The airline receives a charter fee of 25 units for an aircraft chartered for two years to Central Paradiso for operations in Central Paradiso. The aircraft is separately accounted for by the airline and is recognized by the authorities of Central Paradiso as part of that country's capital stock. The charter fee includes depreciation costs of 10 units and the remainder of the fee (15 units) represents direct investment income.
(9) The airline receives a lease fee of 35 units for equipment (other than mobile equipment), which is leased for six years to Jaymaranda. As the cumulative lease payments will cover 80 percent of the value of the equipment and the carrying charges, the lease is a financial one. The compilers estimate that the lease fee covers depreciation costs of 20 units and interest payments of 15 units.

Car Manufacturer in Urangastan

(10) Interest of 15 units on debt securities issued by a foreign government
(11) Interest of 55 units on trade credits extended to a dealer in Central Paradiso
(12) Net receipts of 12 units from an interest swap contract with a bank in Central Paradiso

(For simplicity, it is assumed that all foreign currency receipts were sold to the central bank for local currency.)

In the BOP statement of Urangastan, these transactions should be classified thus:

	Credit	Debit	Transaction No.
Investment income			
Direct investment			
Income on equity			
Dividends and distributed branch profits	55		(4)+ part (8)
Reinvested earnings	50		(5)
Portfolio investment			
Income on equity	20		(6)
Income on debt			
Bonds and notes	95		(2)+(10)
Financial derivatives	12		(12)
Other investment	180		(1)+(3)+(7)+ part(9)+(11)
Direct investment-abroad (Central Paradiso)			
Equity capital	10		part (8)
Reinvested earnings		50	(5)
Other investment-assets			
Loans			
Other sectors-long-term	20		part (9)
Reserve assets (or other appropriate financial account item)		392	(1)+(2)+(3)+ (4)+(6)+(7)+ (8)+(9)+(10)+ (11)+(12)

Time of Recording

397. In principle, all investment income flows are recorded at the time of accrual. If interest payments relate to a period of time equal to, or shorter than, the period covered by the BOP statement, interest is also recorded when due rather than when actually paid. On the other hand, if interest payments relate to a period longer than that for which the BOP statement is prepared, the interest is apportioned to each of the relevant BOP accounting periods. For example, if a country that compiles annual BOP statements issues a discounted bond that matures in three years, the discount, which represents interest, is apportioned into three amounts representing income for each of the years for which BOP statistics are prepared. (In addition to the examples provided subsequently, further information on recording interest on an accrual basis may be found in paragraphs 614–624 of the *Balance of Payments Compilation Guide*.) Dividends are recorded when declared payable and not when actually paid. Remitted profits of unincorporated enterprises are recorded at the time of remittance. Reinvested earnings are recorded in the period in which the related profits are earned.

398. Recording income on a full accrual basis requires an entry in the ***financial account*** to offset any income (which is recorded in the **current account**) that is earned but not paid during the accounting period. These financial account entries are extinguished when the interest in actually paid. (In the case of securities issued at discount, such entries are extinguished when the securities are redeemed or sold.)

Interest

399. The following examples illustrate time of recording for interest income. According to the

binding agreement between the creditor and the debtor, interest due on a long-term loan extended by the government of Clintonstan to the government of Bushland amounts to 100 units at the end of 1990 and 120 units at the end of 1991. Bushland compiles BOP statistics on an annual basis. As the frequency with which interest payments are due is the same as the periodicity of Bushland's BOP statements, the statement should reflect interest payments due in each year—whether or not the interest is actually paid. If the debtor is not able to pay the interest on the loan at the end of 1990 but makes up for the payment in the following year, these entries would be shown:

Bushland Balance of Payments Statement for 1990

	Credit	Debit
Investment income-other investment		100
Other investment-liabilities		
General government-short-term*	100	

Bushland Balance of Payments Statement for 1991

	Credit	Debit
Investment income-other investment		120
Other investment-liabilities		
General government short-term*		100
Reserve assets (or other appropriate financial account item)	220	

*In analytical presentations of the balance of payments, these entries would be recorded below the line as transactions involving arrears.

Thus interest is recorded for 1990 although it was not actually paid. The contra entry to this debit is shown as an increase in short-term liabilities. In 1991, when the interest due in 1990 is paid, the BOP statement shows a decrease in short-term liabilities.

400. The next example illustrates the recording of interest income when interest payments are due less frequently than BOP statistics are prepared. Madornia issues a 20-year, zero coupon bond with a face value of 10,000 units to a resident of Pokolbin. (A zero coupon bond is one that has no discrete interest payments. Instead, at the time of redemption, the holder of the bond receives the interest in the form of the difference between the bond's redemption, or face, value and issue or acquisition price. Zero coupon bonds are issued at discounts that reflect underlying interest rates; otherwise no investor would purchase such bonds.) The interest rate is 10 percent when the bond is issued. Therefore, the value of the zero coupon bond at the time it is issued can be determined by discounting 10,000 units by 10 percent each year for 20 years. This value is 1,486 units.

401. One year after issue, the accrued interest on the bond is 10 percent of 1,486 units (149 units). At this time, if there are no changes in interest rates, the bond is valued at issue value plus accrued interest (1,635 units). In the second year, the accrued interest on the bond is 10 percent of the bond's value at the end of the first year (164 units). The value of the bond at the end of the second year, if there are no changes in interest rates, is equal to its value at the end of the first year plus the interest accrued in the second year (1,799 units). This process continues for 18 years until the bond matures. At maturity, the value of the bond is 10,000 units, and the sum of accrued interest for all periods equals the difference between the redemption value and issue price (8,514 units). The accrual of interest is therefore reflected in "reinvestment" of the interest in the bond. Madornia's BOP statement reflects, for years 1, 2, and 20, the following entries in respect of the zero coupon bond:

Year 1	**Credit**	**Debit**
Investment income-portfolio investment		
Income on debt-bonds		149
Portfolio investment-liabilities		
Debt securities-bonds	1,486	
	149	
Reserve assets (or other appropriate financial account item)		1,486

Year 2	**Credit**	**Debit**
Investment income-portfolio investment		
Income on debt-bonds		164
Portfolio investment-liabilities		
Debt securities-bonds	164	

Year 20	**Credit**	**Debit**
Investment income-portfolio investment		
Income on debt-bonds		909
Portfolio investment-liabilities		
Debt securities-bonds	909	10,000
Reserve assets (or other appropriate financial account item)	10,000	

In this example, it was assumed that interest rates remained unaltered during the life of the bond. In many instances, this would be an unrealistic assumption. How should the accrual of interest on securities be calculated when interest rates change during the life of the security?

402. A possible approach would be to ignore changes in interest rates and calculate the accrual of

interest for all periods by using the interest rate prevailing at the time the security was issued. Such a method of recording would probably be consistent with the way the issuing enterprise accrues interest in its accounts. However, there are two disadvantages with this method. The first is that, if the security is traded, the new holder of the security is unlikely to know, or care, what the interest rate was at the time the security was issued. The purchaser's concerns will relate to the prevailing interest rate and the effect of that rate on the return that he or she will receive on his or her investment. The second disadvantage with using the interest rate prevailing at time of issue to accrue interest over the life of the security is that this method does not reconcile well with the use of market values for measuring levels of investment. The change in the market value of a security in a particular period reflects (among other things) the prevailing rate of interest and not the rate of interest prevailing when the security was issued. If the latter rate were used in the calculation of accrued interest, there would be distortions between levels of investment and financial transactions and in the apparent rates of return on the securities.

403. To overcome these difficulties, the *BPM* recommendation is that, if securities are traded, prevailing rates should be used to determine accrued interest. This method will not always be consistent with those used by issuers of securities to accrue interest. However, unless there are significant movements in interest rates over time, any differences are unlikely to be significant.

404. The next example illustrates the calculation of interest accrued but not paid on securities that are issued at discounts and that have coupon payments of interest as well. In these cases, interest accrued but not paid is equal to interest that would be accrued if the security were a zero coupon security minus the coupon interest. For example, if the market value of a security at the beginning of a period is 90 units, the prevailing interest rate is 10 percent, and the coupon return is 7 units, the interest accrued but not paid would be [(0.1 ˇ 90) – 7] or 2 units. In this example, the security must be trading at a discount from face value as the prevailing interest rate is higher than the rate implied by the coupon payment (7/90 or 7.77 percent). If the security were trading at a premium, the calculated interest accrued but not paid would be negative. In this case, there would be a downward adjustment to the coupon payment to calculate the overall interest to be recorded on the security.

405. The treatment of interest on index-linked securities, the principal amounts of which are based on indexes derived from—for example—commodity prices or exchange rates, also warrants attention. Like securities issued at discounts, the value of an index-linked security at maturity generally differs from the value of the security at the time of issue. The difference represents investment income accrued during the life of the security. The accrued interest in each period is calculated by applying the percentage movement in the index underlying the security to the market value of the security. For example, a resident of Dromesia issues a security, the principal of which is based on the consumer price index (CPI) of Dromesia. The security is purchased by a nonresident for 50 units of domestic currency. Dromesia's CPI is 100 at the time of purchase. At the end of the first period, Dromesia's CPI has increased by 10 percent to 110. The accrued interest income is therefore 10 percent of 50 units or 5 units. In parallel with the increase in the underlying index, the value of the security has increased to 55 units at the end of the period.

These entries would be shown in Dromesia's balance of payments in the first period:

	Credit	**Debit**
Investment income-portfolio investment		
Income on debt-bonds		5
Portfolio investment-liabilities		
Debt securities-bonds		
Issue of security	50	
Accrual of interest	5	
Other investment-assets		
Currency and deposits		50

Income on Equity

406. It is suggested in the *BPM* that remitted earnings of branches and other unincorporated enterprises be recorded at times of remittance. This treatment is recommended because these payments are the result of discretionary decisions that can occur at any time and because no agreement between legally independent partners is involved in determining when the investment income is paid. The *BPM* recommendation for reinvested earnings is that such earnings be recorded in the periods in which the underlying profits are earned. Dividends

should be recorded in the periods in which the dividends are declared payable.

407. This example illustrates principles for the time of recording of equity income from direct investment. A legally independent, wholly owned subsidiary of an enterprise resident in Longa is operating in Urangastan and earns profits of 1,000 units in 1989. The direct investment enterprise in Urangastan pays 600 units to shareholders and retains 400 units to strengthen reserves. The decision about distribution of dividends is made in 1990 after the usual accounting and auditing procedures have been completed. The dividends are actually paid in January 1991.

The following entries would be shown:

Longa's Balance of Payments Statement for 1989

	Credit	Debit
Investment income-direct investment		
Income on equity		
Reinvested earnings	1,000	
Direct investment-abroad (Urangastan)		
Reinvested earnings		1,000

Longa's Balance of Payments Statement for 1990

	Credit	Debit
Investment income-direct investment		
Income on equity		
Dividends	600	
Reinvested earnings	–600	
Direct investment-abroad (Urangastan)		
Reinvested earnings	600	
Other capital		600

Longa's Balance of Payments Statement for 1991

	Credit	Debit
Direct investment-abroad (Urangastan)		
Other capital	600	
Reserve assets (or other		
appropriate financial account item)		600

Thus, total earnings attributable to the direct investor are recorded as reinvested earnings in the statement for 1989. Dividends declared in 1990 are recorded in that year. This entry is offset by an increase in *direct investment*-other capital; the increase reflects Longa's claim on Urangastan for the amount outstanding. Actual remittance of the dividends in 1991 reduces this short-term claim; the reduction is recorded in the ***financial account*** under *direct investment*-other capital. In the case of portfolio investments, dividends declared but not paid in a period are recorded as an increase in *other investment*-other assets/liabilities.

Measurement of Earnings

408. Previous paragraphs have referred to *earnings* from direct investment. In the context of the balance of payments and the *SNA*, earnings are the net income—positive or negative—resulting from production and property (including ownership of other enterprises) of an enterprise. Net income is calculated by deducting from gross income (sales, interest, dividends, and current transfer receipts) all costs incurred by the enterprise in connection with operations. Deductions include taxes owed by the enterprise and due for payment, other current transfer payments, and depreciation costs for fixed capital assets. Depreciation costs are recorded at current replacement values, although data on depreciation costs are often available only on a historical cost basis.

409. Capital gains and losses do not constitute income and therefore are not included in the calculation of enterprise earnings. Examples of capital gains are the sudden discovery of natural resources; the revaluation of fixed assets; and increases, which are due to changes in exchange rates or to higher stock exchange quotations for these assets, in the market values of financial assets. Examples of capital losses are losses occurring as a result of catastrophes, the unforeseen obsolescence of equipment, and the depletion of natural resources. Bad debt write-offs and expropriations without compensation that are the result of confiscation or nationalization also represent capital losses.

410. A wholly owned subsidiary of a nonresident enterprise provides, for a year, the following information on income and expenses:

Sales of goods	1,000
minus operating expenses	
purchase of raw materials	200
wages	500
depreciation	200
Operating profit	100
plus	
dividends receivable on shares in resident enterprises	120
interest receivable on domestic bank deposits	50
interest receivable on trade credits extended to resident enterprises	30
minus	
interest payable on loans received from residents	20
Net earnings before tax	280
minus tax due for payment	100
Net earnings after tax	180

The company decides to pay 120 units in dividends to nonresident shareholders and to retain 60 units to increase reserves. The company must pay, on behalf of the nonresident shareholders, withholding taxes of 50 units for the remitted earnings. The BOP statement of the economy in which the enterprise operates would show the following entries:

	Credit	Debit
Investment income-direct investment		
Income on equity		
Dividends		120
Reinvested earnings		60
Current transfers-general government	50	
Direct investment-in reporting economy		
Reinvested earnings	60	
Reserve assets (or other appropriate financial account item)	70	

The remitted earnings (dividends) are recorded on a gross basis as if accrued in full to nonresident shareholders. Withholding taxes are recorded as a current transfer made by nonresident shareholders to tax authorities of the economy in which the enterprise operates.

411. The reinvested earnings of an enterprise may be formally stated as:

Operating profit (operating revenue minus operating expenses)
- plus
  - current transfers receivable
  - interest receivable
  - dividends receivable
  - enterprise's share of reinvested earnings of any subsidiary or associated enterprises
- minus
  - taxes due for payment
  - other current transfers payable
  - interest payable
  - dividends payable
- equals reinvested earnings.

A direct investor's share of the reinvested earnings of an enterprise is determined by the proportion of total voting equity held by the direct investor in the enterprise.

412. Losses other than capital losses are occasionally incurred by enterprises. These losses must be recorded in the balance of payments as negative investment income if nonresidents are direct investors in the enterprise. For example, company X in Hughesavia holds 50 percent of the shares of enterprise Y in Nostaw, and company Z in Hughesavia holds 5 percent of the shares of enterprise Y. Enterprise Y has losses of 200 units in 1991. In this case, the BOP statement of Hughesavia would reflect the following entries:

	Credit	Debit
Investment income		
Direct investment-income on equity		
Reinvested earnings	–100	
Direct investment-abroad (Nostaw)		
Reinvested earnings	100	

The entries of 100 units for direct investment income and capital reflect company X's share of the losses of enterprise Y. Company Z's share of the losses is excluded from the statement because the investment is classified as *portfolio investment* rather than *direct investment*.

Stock Dividends and Bonus Shares

413. Stock dividends are paid in shares (stock) rather than in cash. Stock dividends should be recorded in the balance of payments the same way that other dividends are if such dividends are received by nonresident direct or portfolio investors. Bonus shares reflect the transformation of reserves (which usually consist of accumulated, unremitted earnings) into voting equity capital. As bonus shares are simply a reclassification of equity from one form to another, bonus shares should not be recorded in the balance of payments.

414. This example illustrates the recording of stock dividends. Two Algornian investors, X and Z, have respective interests of 50 percent and 5 percent in enterprise Y in Coonawarra. Enterprise Y reports earnings of 1,000 units for the year. Of the earnings, 200 units are retained; 200 units are paid in cash dividends; and 600 units are paid in stock dividends.

The BOP statement of Algornia would reflect these entries:

	Credit	Debit
Investment income-direct investment		
Income on equity		
Dividends	400	
Reinvested earnings	100	
Investment income-portfolio investment		
Income on equity	40	
Direct investment-abroad (Coonawarra)		
Equity capital		300
Reinvested earnings		100
Portfolio investment		
Assets		
Equities		30
Reserve assets (or other appropriate financial account item)		110

The credit of 100 units shown under *investment income*-direct investment-income on equity-reinvested earnings reflects the direct investor's 50 percent share in the 200 units of retained earnings of enterprise Y. A contra entry is made in the ***financial account*** under *direct investment*-reinvested earnings. Credit entries shown under *investment income*-direct investment-income on equity-dividends and *investment income*-portfolio investment-income on equity account for the direct and portfolio investors' shares in cash and stock dividends. Entries to offset the income entries are made under *direct investment*-abroad-equity capital (direct investor's stock dividends); *portfolio investment*-assets-equities (portfolio investor's stock dividends); and *reserve assets* or other appropriate financial account item (dividends paid in cash).

VII. Current Transfers and the Capital Account

415. Chapters 4, 5, and 6 have dealt with three components of the current account: ***goods***, ***services***, and ***income***. Chapter 7 focuses on transactions recorded under ***current transfers***, which constitute the remaining component of the **current account**. Components of the ***capital account*** (part of the **capital and financial account**) are also examined. Recorded in the ***capital account*** are *capital transfers*, which are closely related in concept to ***current transfers***, and transactions concerning the *acquisition or disposal of non-produced, nonfinancial assets* (such as patents and copyrights). However, before these items are discussed in detail, consideration will be given to topics relevant to the recording, in the balance of payments, of both current and capital transfers.

General Information on Transfers

Definition

416. Transfers are defined in the *BPM* as offsetting entries for real resources or financial items provided, without a quid pro quo, by one economy to another. Whenever an economy does not receive or supply recompense—in the form of real resources or financial items—for goods, services, income, or financial items supplied to or received from another economy, a transfer is recorded in the BOP statement. For example, if Domestica provides, as a gift, goods valued at 100 units to Longa, the BOP statements of the two countries should reflect the following transactions:

	Domestica		**Longa**	
	Credit	**Debit**	**Credit**	**Debit**
Goods	100			100
Current transfers		100	100	

417. In addition to reflecting transfers for economic values provided by one economy to another without a quid pro quo, the BOP statement also reflects increases or decreases that occur in a country's real and financial resources as a result of migration.

418. If a country's real resources or financial assets and liabilities increase or decrease because of a change in economic territory, the increases or decreases are not recorded in the BOP statement. For example, if Bushland cedes some territory to Clintonstan, the transfer of real resources and financial items owned by the inhabitants of the ceded territory are not recorded as BOP transactions between the two countries. This convention is based on the recognition that changes in the territories of countries occur infrequently and that attendant changes represent coverage changes for the reporting economies rather than transactions.

419. For purposes of BOP recording, it is important to determine whether a transfer is current or capital. ***Current transfers*** are recorded in the **current account**; *capital transfers* are recorded in the ***capital account***, which is a component of the **capital and financial account**. This distinction, which was first presented in the fifth edition of the *BPM* (see paragraph 294), is necessary to harmonize the balance of payments with the national accounts. (Previous editions of the *BPM* made no such distinction.) A *capital transfer* is transference of the ownership of a fixed asset or the forgiveness of a liability. A cash transfer (for example, an investment grant) is a *capital transfer* when the cash transfer is linked to, or conditional upon, the acquisition or disposal of a fixed asset by one or both parties to the transaction. According to BOP convention, migrants' transfers are also *capital transfers*. While *capital transfers* are generally large and irregular, such transfers cannot always be defined in terms of size or frequency. All transfers not considered to be capital are current.

420. Some cash transfers may be regarded as capital by one party to the transaction and as current by the other. To prevent different treatments of the same transaction by the donor and the recipient, the *BPM* recommendation is that cash transfers be classified as capital by both parties even if a transfer is linked to the acquisition or disposal of a fixed asset by only one party. If serious doubt exists as to whether a transaction should be classified as capital or current, the *BPM* recommendation is that the transfer be classified as current.

Valuation

421. Transfers are offsetting entries for real resources or financial items provided without a quid quo pro. The values recorded in the transfer entries are the same as those of the real and financial resources to which the transfers are offsets. Real resources involved in transfers are valued by reference to the prevailing market price for the resource being transferred. In the absence of a prevailing market price, real resources being transferred are valued according to the donor's cost of production or acquisition. For example, the government of Cromania purchases, for 90 units per ton, 100 tons of surplus wheat from Cromanian farmers. The prevailing world market price of wheat is 100 units per ton. The surplus wheat is donated to drought-stricken Madornia. The transfer would be valued—in the BOP statements of both Cromania and Madornia—at 10,000, rather than 9,000, units.

Time of Recording

422. In principle, transfers are recorded when the resources to which the transfers are offsets change ownership. Taxes, fines, and other ***current transfers*** imposed by one party on another are recorded upon the occurrence of underlying transactions or other events that give rise to the liabilities. A deferred tax payment is recorded on the basis noted in the preceding sentence rather than on the actual payment date, and an offsetting entry is made in the ***financial account***. For example, in 1989, a resident of Urangastan must pay, to the government of Coonawarra, a tax of 50 units on income earned in that year. The resident of Urangastan defers the payment until 1990. The BOP statement of Urangastan would show these entries:

1989	**Credit**	**Debit**
Current transfers		50
Other investment-liabilities-other liabilities	50	
1990	**Credit**	**Debit**
Other investment-liabilities-other liabilities		50
Reserve assets (or other appropriate financial account item)	50	

Thus, the actual payment, in 1990, of the tax related to 1989 is treated as a repayment of the liability to the Coonawarra government.

Current Transfers

423. In the standard components of the balance of payments, ***current transfers*** are divided into two sub-components: *general government* and *other sectors*. The ***current transfers*** of *other sectors* are further divided into workers' remittances and other transfers.

General Government

424. The *general government* sub-component consists of current transfers made between the government sector (as defined in paragraphs 127–140 of chapter 2) of the compiling country and nonresidents. This item includes current transfers between the government of the compiling country and foreign governments and current transfers between the resident government sector and nonresident, nongovernment entities. This component does not, however, include, current transfers between resident nongovernment entities of the compiling economy and foreign governments. Such transfers are classified as ***current transfers****-other sectors*-other transfers.

425. The ***current transfers****-general government* item includes subsidies or grants to current budgets (except for subsidies or grants relating to additions to the capital stock of the recipient country); gifts of food, clothing, medicine, etc.; gifts of military equipment that has no civilian uses; technical assistance; indemnities imposed under peace treaties (reparations); casualty insurance premiums minus service charges and casualty insurance claims; and government contributions to the administrative budgets of international organizations. However, capital subscriptions to organizations such as the World Bank are not treated as transfers but as increases in financial assets that are recorded in the ***financial account***. Also classified as ***current transfers****-general government* are—on the credit side—taxes other than those (such as inheritance taxes) on the transfer of assets, contributions to social security schemes, fines, licenses to fish, and fees for carrier registration, and—on the debit side—scholarships and similar grants given to nonresident individuals for on-the-job training or to finance education or training in the donor's country or abroad, refunds on taxes, membership fees paid to nongovernmental organizations, grants to nongovernmental entities, and noncontractual pensions and other

benefits. Taxes and subsidies implicit under a multiple official exchange rate scheme are also recorded, when it is appropriate, as ***current transfers****-general government.* (See paragraph 37 of chapter 1.)

426. Grants exchanged, in a specific period, between the government sectors of two economies are recorded on a gross, rather than a net, basis.

427. Taxes levied by the government of a compiling economy on property located in the compiling economy and owned by a nonresident are not transfers and are not recorded in the balance of payments. Such taxes are payable by the notional resident enterprise construed to be the owner of the property in the compiling economy. These taxes represent resident-resident transactions, although the taxes do have an impact on the direct investment income attributable to the nonresident owner of the notional enterprise. The taxes most commonly recorded as ***current transfers*** are those on income. Taxes on income can consist of taxes on labor income or taxes (such as withholding taxes) on investment income (such as dividends).

428. The total cost, including costs incurred in the donor country, of technical assistance is recorded as a ***current transfer***. (This method of valuation is, of course, consistent with the general principle of valuing transfers in the balance of payments.) Some elaboration is necessary for the treatment of transactions that are offset by technical assistance transfers. In the *BPM*, production associated with technical assistance is attributed to the recipient economy, not the donor economy. Therefore, resources consumed in the provision of technical assistance are treated as resources acquired by the recipient economy; the acquisition of these resources is financed by the donor economy.

429. The following example illustrates the BOP treatment of technical assistance. Keatingland provides Nostaw's government with technical assistance, which is valued at 1,000 units, during a six-month period. Costs associated with the provision of this technical assistance are:

Salaries paid to residents of Nostaw	150
Salaries paid to residents of Keatingland who are working in Nostaw	700
Goods and services purchased in Nostaw as part of the technical assistance project	50
Administrative costs incurred in Keatingland	100
	1,000

These entries would be made in Nostaw's balance of payments:

	Credit	Debit
Government services n.i.e.		100
Income		
Compensation of employees		700
Current transfers-general government	1,000	
Reserve assets (or other appropriate financial account item)		200

The entry for *government services n.i.e.* reflects administrative costs incurred in the donor country. Keatingland residents working in Nostaw are working for the government of Nostaw, which is considered the producer of output from the provision of technical assistance. The salaries of these staff members, who are not residents of Nostaw, reflect the provision of labor to the Nostaw government and thus are shown in the balance of payments, even though these salaries are actually paid by Keatingland. The labor provided by Nostaw residents and the acquisition of goods and services in Nostaw constitute transactions, which are not included in the balance of payments, between the Nostaw government and Nostaw residents. However, the financing for these transactions is provided by Keatingland, and the impact of this financing is shown as an increase in Nostaw's holdings of foreign exchange.

Other Sectors

Workers' Remittances

430. Workers' remittances consist of goods or financial instruments transferred by migrants living and working in new economies to residents of the economies in which the migrants formerly resided. However, money remitted by a migrant for the purpose of making a deposit in his or her own account with a bank located abroad represents a financial investment, which is recorded in the ***financial account***, rather than a transfer.

431. Workers' remittances include only those transfers made by workers who stay in foreign economies for at least one year (that is, migrants). If workers remain in foreign economies less than one year, they are not regarded as residents of those economies and remittances to their home countries represent distributions of labor income earned from nonresident employers.

432. Workers' remittances are transfers made by migrants who are employed by entities of economies

in which the workers are considered residents. If a migrant operates her or his own business in the new country—that is, if she or he is self-employed—her or his transfers abroad are not classified as workers' remittances but as ***current transfers****-other sectors*-other transfers. This distinction is made because workers' remittances, according to the BOP convention, arise from labor and not from entrepreneurial income.

433. The following example illustrates the BOP treatment of transactions associated with foreign workers. U.S. citizen A migrates to Canada and works for an enterprise in Canada. Citizen A has a contract for three years. His salary is 300 units. U.S. citizen B works for the same enterprise in Canada but retains his abode in the United States. Citizen B's salary is 250 units. Citizens A and B make and receive these payments in Canadian dollars.

Migrant A	
Deposit in a bank in Canada	120
Deposit in a bank in the United States	20
Expenditure for food and clothing in Canada	120
Cash gift sent to a relative in the United States	10
Income tax paid to Canadian government	30

Border worker B	
Deposit in a bank in the United States	180
Deposit in a bank in Canada	35
Consumer loan received from a bank in Canada	40
Expenditure for food and clothing in Canada	50
Income tax paid to Canadian government	25

The balance of payments of the United States would show the following entries:

	Credit	**Debit**
Travel		50
Compensation of employees	250	
Current transfers-other sectors		
Workers' remittances	10	
Other transfers		25
Other investment		
Assets-currency and deposits		
Banks		210
Other sectors		35
Liabilities		
Currency and deposits-banks	20	
Loans-other sectors	40	

From the viewpoint of the United States, citizen A is a nonresident and citizen B is a resident. Expenditures for food and clothing made by citizen A in Canada, taxes paid by citizen A to the Canadian government, and the deposit made by citizen A in a Canadian bank represent transactions between nonresidents and are not recorded in the BOP statement of the United States. The entry for *compensation of employees* reflects the salary received in Canada by citizen B; his personal expenditure in Canada is recorded under *travel*. The entry for workers' remittances covers the cash gift sent to the United States by citizen A. The entry for other transfers covers the tax payment made by citizen B to the Canadian government. The entry for bank liabilities reflects the deposit made by citizen A in the United States. The entry under assets-currency and deposits-other sectors reflects the deposit made by citizen B in Canada. The entry under liabilities-loans-other sectors covers the loan liability incurred by citizen B in Canada. There is no entry for the deposit made by citizen B in a U.S. bank because the transaction occurs between U.S. residents.

Other Transfers

434. ***Current transfers***, other than workers' remittances, may be made (1) between resident, nongovernment entities and foreign governments and (2) between resident, nongovernment entities and nonresident, nongovernment entities. Such transfers include gifts; alimony and other support remittances; lottery ticket sales and prizes won from lotteries; noncontractual pensions from nongovernmental agencies; casualty (nonlife) insurance premiums minus service charges and casualty (nonlife) insurance claims; grants made for purposes other than investment; contributions to religious, scientific, cultural, and charitable organizations; and membership fees paid to nonprofit associations. Also included, on the credit side, are scholarships and similar grants received from foreign governments to finance on-the-job training or education in the donor's country or abroad, tax refunds, and noncontractual pensions and other benefits received from foreign governments. Also included, on the debit side, are taxes, fines, contributions to social security schemes, licenses to fish, and fees payable to foreign governments for carrier registration.

435. Remittances (such as those sent by parents to children who are studying in other countries) sent abroad by residents of an economy for the purpose of financing other residents who are staying abroad for less than one year are excluded from the BOP statements of the donor economies because the parties to these transactions are residents of the same economies. Expenditures incurred abroad by residents staying for less than one year in foreign countries are recorded as travel expenses.

436. The following example illustrates the treatment of transactions related to the ***current transfers-other sectors***-other transfers item. A resident of Hughesavia makes these payments and receives these receipts.

Payments

Contribution to a charitable organization in Longa	50
Cash remittance to a relative staying for six months in Longa	30
Payment of house insurance premium to an enterprise in Longa*	10
Payment of life insurance premiums to an enterprise in Longa*	20
Cash gift to a relative living and working for two years in Longa	40

Receipts

Prize won from a government lottery in Longa	5
Cash remittance from a relative living and working in Longa for three years	25
Claim received from insurance enterprise in Longa for bush fire damage to a home	100

*The insurance service charge is considered to represent 10 percent of gross premiums for both life and nonlife insurance.

The BOP statement for Hughesavia would show the following entries:

	Credit	Debit
Travel		30
Insurance services		3
Current transfers-other sectors		
Workers' remittances	25	
Other transfers	105	99
Other investment-assets		
Other assets-other sectors		
Equity in life insurance policies		18
Reserve assets (or other appropriate financial account item)	20	

The entry for *travel* reflects cash sent to the relative staying abroad for six months; it is assumed that this money is spent on goods and services acquired by the traveler in Longa. The entry for *insurance services* represents 10 percent (the service charge) of premiums. The entry for workers' remittances reflects cash received from the relative living abroad for three years. The credit entry for other transfers consists of the insurance claim (100 units) plus the lottery prize (5 units). The debit entry for this item consists of nonlife insurance premiums minus the service charge (9 units) plus the contribution (50 units) to the charitable organization in Longa plus the cash gift to the relative living abroad for two years. The life insurance premiums minus the service charge are recorded, in the ***financial account***, as an increase in assets.

Capital Transfers

437. Like ***current transfers***, *capital transfers* are divided into two sub-components—general government and other sectors—in the BOP standard components. *Capital transfers* of general government are further disaggregated into debt forgiveness and other; *capital transfers* of other sectors are disaggregated into migrants' transfers, debt forgiveness, and other. Criteria for determining whether a *capital transfer* should be classified under general government or other sectors are similar to criteria for distinguishing ***current transfers-****general government* from ***current transfers-****other sectors*. Therefore, in subsequent paragraphs, *capital transfers* are discussed in terms of type rather than sector.

Debt Forgiveness

438. Unless the cancellation of a debt occurs by mutual agreement of debtor and creditor, the cancellation is not a *capital transfer*; the write-off of debt reflects a capital loss, which is not recorded in the balance of payments. For example, in 1988, the government of Clintonstan extended a long-term loan of 100 units to the government of Algornia and a long-term loan of 200 units to an enterprise in Bushland. In 1989, the Clintonstan government agreed to the request of the Algornian government for forgiveness of one-half of the loan. In Bushland, the deteriorating economic situation led to the bankruptcy of the enterprise that had borrowed from Clintonstan's government. The Clintonstan government subsequently recorded repayment of one-half of the loan made to Algornia and wrote off, as a bad debt, the loan made to Bushland. Clintonstand's BOP statements for 1988 and 1989 would show these entries:

1988	**Credit**	**Debit**
Other investment		
Assets-loans-general government		300
Reserve assets (or other appropriate financial account item)	300	

1988	**Credit**	**Debit**
Capital transfers		
General government		
Debt forgiveness		50
Other investment		
Assets-loans-general government	50	

The forgiveness of one-half of the 100-unit loan in 1989 is shown as a partial repayment of that loan, and an offsetting entry is shown under *capital transfers*. The write-off of the 200-unit loan represents a capital loss that should not be recorded in the BOP statement. However, the capital loss would be reflected in the market value of the stock of loan assets shown in the IIP statement prepared as of December 31, 1989.

Migrants' Transfers

439. In the *BPM,* migrants are defined as individuals (other than students; medical patients; or diplomatic, military, or similar personnel) who move to new countries and are expected to remain in the new countries for at least one year. The term *migrants' transfers* refers to the household and personal effects and the financial claims and liabilities transferred by migrants from former to new countries. In the strictest sense, these are not transfers between two parties but contra entries to flows of goods between economies and changes, which arise from migration, in the financial items of economies. These contra entries are equal to the net worth of migrants.

440. The value of the household and personal effects of migrants and the movable capital goods that they actually transfer to new countries are recorded as transactions in ***goods***, and offsetting entries are made under migrants' transfers. Migrants' financial claims on or liabilities to (for example, bank deposits, shares, bonds, and loans extended or received) countries of former residence are recorded under various components of the ***financial account***; offsetting entries are made under migrants' transfers. Land and structures owned by migrants and located in former countries of residence and movable capital goods not transferred by migrants to their new countries are treated, according to conventions presented in the *BPM*, as financial investments made by migrants in notional enterprises that own these assets. In the BOP statements of the countries to which the migrants have migrated, these financial investments are recorded as increases in *direct investment*-abroad, and offsetting entries are made under migrants' transfers. A migrant's claims on or liabilities to residents of the country to which he or she has moved are treated, in the balance of payments of that country, as if the external claims (liabilities) have been extinguished.

441. A resident of Domestica is migrating to Essendonia. At the time of migration, he has these assets and liabilities.

Assets

Household effects	200
Automobile	100
Jewelry	50
Bank deposit in Domestica	30
Bank deposit in Essendonia	60
Bonds issued by the government of Domestica	110
Real estate in Domestica	300
Real estate in Essendonia	150
5 percent of the shares of an enterprise in Daniherland	70
Total assets	1070

Liabilities

Consumer loan owed to bank in Domestica	40
Net worth	1030

The BOP statement of Domestica* would reflect the following entries:

	Credit	**Debit**
Goods	350	
Capital transfers-other sectors		
Migrants' transfers		1,030
Direct investment		
Abroad (Essendonia)-equity capital	150	
In reporting economy (Domestica)-equity capital	300	
Portfolio investment		
Assets-equity securities-other sectors	70	
Liabilities-debt securities		
Bonds-general government	110	
Other investment		
Assets-currency and deposits-other sectors	60	
Assets-loans-banks		40
Liabilities-currency and deposits-banks	30	

*Essendonia's BOP statement would show reversed entries.

The ***goods*** entry represents the value of the migrant's personal effects. The net worth (assets minus liabilities equals 1,030 units) of the migrant is shown under migrants' transfers. The ***financial account*** entry under *direct investment*-abroad shows a decrease in Domestica's direct investment capital abroad and reflects the fact that the Essendonian real estate is now owned by a resident of Essendonia rather than Domestica. The entry under *direct investment* in Domestica shows an inflow of direct investment capital because the Domestican real estate is now owned by a resident of Essendonia rather than Domestica. The equity securities entry under *portfolio investment* shows a

decrease in external assets consisting of shares in the enterprise in Daniherland. The entry for bond liabilities of the general government indicates that bonds issued by the Domestican government are now owned by a nonresident and therefore represent liabilities of Domestica to Essendonia. The entry under *other investment* for the deposit assets of other sectors reflects a decrease in Domestica's deposits with nonresident banks because these deposits are now owned by a nonresident. The entry for the loan assets of banks shows an increase in external assets and reflects the fact that a loan formerly owned by a resident is now owned by a nonresident. The entry for the deposit liabilities of banks shows an increase in the external liabilities of banks.

Other Capital Transfers

442. Other capital transfers relate mainly to investment grants. Investment grants are used for adding to or financing the gross fixed capital formation of the recipient economy. Such grants can be provided in kind or in cash. For example, an investment grant could comprise financing provided through a foreign aid program for the construction of a dam. Although grants for large capital projects may be paid in installments over extended time periods, each installment is recorded as a *capital transfer*. General grants made to foreign governments and used for purposes other than financing capital investments are recorded as current, rather than capital, transfers. Inheritance taxes, gift taxes, other taxes on the transfer of assets, and compensation payments (other than those resulting from insurance claims) are also recorded as other capital transfers. Transfers of military equipment that also has civilian uses are recorded as other capital transfers.

Transactions in Non-Produced, Nonfinancial Assets

443. *Non-produced, nonfinancial assets* are a component of the ***capital account***. Under this item, are recorded purchases (debit) and sales (credit) of assets such as copyrights, licenses, patents, etc. The essential characteristics of these assets are that (1) such assets are not produced, and (2) such assets do not satisfy the definition of financial assets. By comparison, transactions in produced assets are recorded in the **current account**, and transactions in financial assets (which are generally evidenced by a claim that one party has on another) are recorded in the ***financial account***. Transactions in the fees, royalties, etc. associated with patents, copyrights, etc. must be recorded separately (in the *royalties and license fees* item under ***services***) from transactions in the underlying assets, which are recorded in the ***capital account***.

444. Land satisfies the criteria for non-produced, nonfinancial assets. According to conventions presented in both the *BPM* and the *SNA*, land must be owned by a resident of the economy in which the land is located. Most transactions in land take place between two parties who are considered residents of the economy in which the land is located; therefore, such transactions are not recorded in the balance of payments. However, acquisitions or disposals of extraterritorial land associated with embassies or with other government activities in foreign countries are BOP transactions and, as such, are recorded under *acquisition/disposal of non-produced, nonfinancial assets*.

VIII. Introduction to the Financial Account

445. Previous chapters of the *Textbook* have covered transactions recorded in the BOP **current account** and in the ***capital account*** portion of the **capital and financial account**. This chapter is concerned with concepts pertaining to the ***financial account***. Topics such as the definition of financial account transactions, coverage, time of recording, valuation, and classification are examined. In subsequent chapters, individual components of the ***financial account*** are discussed in greater detail.

Definition and Coverage

446. In the *BPM*, the ***financial account*** is defined as comprising all transactions (actual and imputed) in the external financial assets and liabilities of an economy. In this chapter, use of the term *transactions* is restricted to exchanges involving changes of ownership, including the creation and liquidation of claims. For convenience, the *BPM* practice of referring to external financial assets and liabilities as "external assets" or "assets," and "external liabilities" or "liabilities" is continued in this and subsequent *Textbook* chapters.

447. Three criteria must be met for a transaction to be included in the ***financial account***. These criteria are:

A transaction involves a change of ownership, including the creation or liquidation of an asset or liability. The pledging, authorization, commitment, or setting aside of funds for the purchase of an asset or repayment of an obligation does not alter the ownership of an asset or liquidate a claim.

An asset or liability must represent actual claims that are legally in existence. Therefore, the authorization of a loan or the incurrence of a contingent liability is not sufficient to establish, respectively, a claim or liability.

A transaction involves an external financial asset or liability. The external financial assets of an economy are comprised of holdings of monetary gold, special drawing rights (SDRs), and claims on nonresidents. The external liabilities of an economy are comprised of indebtedness to nonresidents. Therefore, with the exception of SDRs and monetary gold, each external financial asset of one economy is matched by an external liability of another economy, and vice versa. The important determinants for classifying financial items (assets or liabilities) as *external* are the identities of the creditor and debtor. The creditor and debtor must be residents of two different economies. The denomination of a financial item—whether in national currency, foreign currency, or any other unit of account (such as the SDR)—is not relevant for classification of the item as an external asset or liability. For example, a resident bank purchases a security that is denominated in national currency and issued by a nonresident. The security constitutes a claim on a nonresident, and the purchase of the security is therefore included in the BOP statement as a financial transaction.

448. Transactions are not the only cause of changes in the values of financial items. Changes that do not result from transactions are excluded from the balance of payments, although such changes may be reflected in the IIP statement. These exclusions are discussed in more detail in paragraphs 464–470.

449. Assets can take the form of financial items (such as securities, loans, and trade credits) or nonfinancial assets (such as stocks of grain or machinery held abroad by resident enterprises and real estate consisting of vacation homes located abroad and owned by individual residents) or intangible assets (such as patents and copyrights). Financial assets may be imputed to some nonfinancial assets, such as land, by means of a convention described in the *BPM*. Land, by convention, must be owned by a resident entity. Therefore, if a nonresident legally owns land, the nonresident has a financial claim on a resident entity that owns the land. For example, if a resident of Pokolbin owns land in Cromania, ownership of this land is—for BOP purposes—attributed to an entity resident in Cromania. The resident of Pokolbin has a financial claim equal to his or her equity in the land on the entity resident in Cromania. All receipts and payments attributable to the land are allocated to the

resident entity in Cromania; all profits are remitted to the legal owner residing in Pokolbin or reinvested to increase the value of the financial claim of Pokolbin on Cromania. (See paragraphs 550–551 of chapter 9 for an illustration of the treatment for land owned by nonresidents.)

450. The treatment outlined in the preceding paragraph applies to land owned by nonresident, nongovernment entities. When land located abroad is held abroad by governments for embassies or similar purposes, such land is considered part of the territory of the government holding the land and not part of the territory of the host economy. Therefore, there is no need to attribute ownership of such land to an entity resident in the host economy. Transactions in government land held abroad are recorded in the ***capital account*** under *acquisition/disposal of non-produced, nonfinancial assets*; only the financing associated with these transactions is shown in the ***financial account***.

451. According to the *BPM*, the following types of nonfinancial external assets require the imputation of financial assets:

immovable assets such as land and structures (except when such assets are owned by foreign government entities)

mobile equipment such as ships, aircraft, highway vehicles, rolling stock, fishing vessels, and drilling rigs that operate within an economy for at least one year, have separate records kept in respect of operation, and are recognized by tax and licensing authorities as part of the host economy's capital stock (These assets are considered to be owned by an entity residing in the economy in which the assets are located.)

nonfinancial, as well as financial assets, of an unincorporated enterprise operating in an economy other than the one in which the owner resides (These assets are considered to be the assets of an unincorporated entity residing in the host economy rather than assets of the economy of the entity's owner.)

goods transferred under a financial leasing arrangement and presumed to have undergone a change of ownership (imputation of a financial asset for the lessor and a liability for the lessee)

goods sent abroad for processing and subsequently returned to the original country. Such goods are recorded in the balance of payments as if ownership has changed—both when the goods were originally exported and again when the goods are re-imported. Offsetting the first imputed change of ownership is the creation of an imputed financial claim that is recorded in the ***financial account***. This claim is extinguished as an offset to the second imputed change of ownership.

452. Up to this point, an asset has been described as a resident claim with a counterpart nonresident liability. Certain assets do not have this characteristic but are nevertheless treated, in the *BPM*, as external financial assets. These assets are monetary gold and special drawing rights (SDRs) in the IMF. These assets are treated as external financial assets because such assets are widely accepted as a means of international payment.

Transactions in Financial Assets

Kinds of Transactions

453. Transactions in financial assets can be classified as:

exchanges of real resources for financial items
One side of the transaction is recorded in the current account; the other is recorded in the ***financial account***.

exchanges of non-produced, nonfinancial assets for financial items such as copyrights and patents
One side of the transaction is recorded in the ***capital account***; the other is recorded in the ***financial account***.

exchanges of financial items for other financial items
Both sides of the transaction are recorded in the ***financial account***.

exchanges of financial items without a quid pro quo
In such transactions, cash or other financial items are provided by one party to another party but no economic value is provided in return. Offsetting the financial transactions are transfers classified as current or capital transfers and entered in either the **current account** or the ***capital account*** component of the **capital and financial account**.

Parties to Transactions

454. Information on the identity of both parties to a financial transaction may not be available to BOP compilers. For example, a compiler may not know

whether a resident who purchased a transferable security issued by a nonresident conducted this transaction with another resident or with a nonresident. Similarly, a compiler may not know whether a nonresident who withdrew funds from a domestic bank account used the funds to settle a transaction with another nonresident or with a resident. The *BPM* recommendation for dealing with this problem is that the balance of payments cover all transactions in external assets and liabilities. Coverage includes (1) transactions that take place between two residents of the reporting economy and involve that economy's external assets and (2) transactions that take place between two nonresidents of the reporting economy and involve the external liabilities of that economy.

455. BOP coverage of all transactions in external assets and liabilities is also relevant to economic analysis. For example, if the household or nonfinancial corporate sector sells an external financial asset to the banking sector, the sale has an impact on the money supply of the economy. Any analysis that relates BOP developments to those in money supply must take account of such transactions.

456. According to the *BPM*, credit and debit entries for each component of the ***financial account*** are generally netted in a BOP statement. As a result, most transactions between residents and nearly all transactions between nonresidents will cancel; therefore, such transactions do not appear as entries in the statement. However, transactions that involve assets and take place between resident creditors with different sector classifications will be net only at higher level balances and not at balances for particular items. For transactions involving liabilities, the identity of the nonresident creditor is used in differentiating between *direct investment* and other types of investment, between *liabilities constituting foreign authorities' reserves* and *other transactions* (supplementary financial account classifications), and between liabilities owed to different countries in regional BOP presentations. When transactions in the financial liabilities of an economy involve two nonresidents who are classified in different nonresident creditor categories, the transactions will not be net for each individual item in the ***financial account***.

457. For example, a resident nonbank enterprise of Madornia uses foreign exchange to purchase short-term commercial paper issued by a resident of Nostaw. This transaction is recorded in the BOP statement of Madornia (1) as a debit entry representing an increase in the portfolio debt assets of other sectors and (2) as a credit entry representing a decrease in *reserve assets*-foreign exchange. The commercial paper is then sold by the resident enterprise of Madornia to another resident enterprise of Madornia. If the sector classification for these two transactors is the same, the BOP entries are net, and no entry appears in Madornia's BOP statement for the resident-resident transaction. However, if the commercial paper is sold by the resident nonbank enterprise to a resident bank, the transaction is reflected in the BOP statement (1) as a credit entry representing a reduction in the portfolio debt assets of other sectors and (2) as a debit entry representing an increase in portfolio debt assets of banks.

Reinvested Earnings

458. One type of asset or liability shown in the ***financial account*** is reinvested direct investment income. Related transactions are discussed in chapters 6 and 7. If the reinvested earnings of a direct investment enterprise accrue to a nonresident direct investor, these earnings are treated as a BOP transaction. The reinvested earnings are viewed as income paid to the nonresident direct investor by the direct investment enterprise and simultaneously reinvested by the investor.

Migrants' Financial Transfers

459. Migrants' financial assets and liabilities are recorded in the ***financial account*** of the balance of payments when migrants change their countries of residence. For example, land owned by migrants in their former countries, enterprises owned by migrants and located in the former countries, and migrants' deposits with banks in their former countries become, at the time of migration, financial assets of the countries to which the migrants are moving. Migrants' liabilities to their new countries become, at the time of migration, claims between residents of the same country. From the point of view of the new country, the recording of migrants' financial transfers is achieved by creating or extinguishing assets and liabilities. The offset to a change, which results from the migration, in an economy's financial items is entered as a *capital transfer* in the ***capital account***. Chapter 7 contains additional information on the treatment of migrants' transfers.

Borderline Cases

460. Changes in maturities or terms of contracts for existing assets or liabilities may or may not constitute transactions that should be recorded in the balance of payments. The *BPM* states that changes in the original terms of a contract normally require formal agreement between the parties involved in the contract. The agreement reflecting the changes constitutes a transaction that is recorded in the balance of payments. For example, a resident private enterprise borrows 200 units from a nonresident bank. In the period in which the loan becomes due for repayment, the resident enterprise negotiates with the bank to extend the loan for another six months. As the contractual terms of the loan are altered, the following transaction would be recorded in the balance of payments:

	Credit	**Debit**
Other investment-liabilities-loans-other sectors-long-term		200
Other investment-liabilities-loans-other sectors-short-term	200	

However, if a loan contract originally provides the borrower with an option to extend the loan, the extension does not represent a change in the contractual agreement between the creditor and debtor. In such cases, the extension is not recorded as a transaction in the balance of payments.

461. Changes that occur in contractual terms when the government negotiates to take over liabilities incurred by the private sector may or may not constitute transactions that should be recorded in the balance of payments. For example, the central bank of Hughesavia encourages resident companies to borrow funds, on a short-term basis, from nonresident banks. The resident companies are scheduled to pay interest and repay principal in national currency, which is not convertible, but the central bank has agreed to transfer to nonresident creditors the equivalent amount in foreign exchange. However, the country subsequently experiences BOP problems and the central bank does not allocate the necessary foreign exchange for these payments. The outstanding principal (before scheduled repayments) is 700 units. Scheduled repayments of principal and interest due amount to 100 units and 18 units, respectively. After lengthy negotiation with the creditors, the outstanding balances on these short-term loans are converted to seven-year loans, and the central bank replaces the resident companies as the debtor. The following entries would be recorded in the BOP statement of Hughesavia:

Before loan conversion agreement

	Credit	**Debit**
Interest		18
Short-term loan repayment by other sectors		100
Payments arrears of other sectors	118	

After loan conversion agreement

	Credit	**Debit**
Payment arrears of other sectors		118
Short-term loan repayment-other sectors		600
Long-term loan drawing-resident monetary authorities	718	

If, however, the monetary authorities simply assume responsibility for the arrears and do not renegotiate the contract, no BOP transactions are recorded. In such cases, the changed sector of the liability would be reflected only in the IIP statement.

462. Another type of borderline case occurs when a transactor intends to dispose of a certain asset at virtually the same moment that ownership of the asset is nominally acquired. The most common examples of such closely linked pairs of transactions are arbitrage and certain other dealings, such as forward contracts, in foreign exchange. Arbitrage seeks to exploit price differentials that may exist in different markets; forward contracts are concluded to exploit price differentials that exist over time in the same markets. It is recommended in the *BPM* that two changes of ownership be recorded—no matter how briefly an asset is owned—when pairs of transactions are closely linked. The rationale for this recommendation is the recognition that a profit or loss in an arbitrage transaction or a forward contract reflects the realization of a capital gain or loss that should be entered in the ***financial account***.

463. Yet another kind of borderline case occurs with the redefinition, at a later period, of a country's transactions with the International Monetary Fund. For example, if a member country makes a reserve tranche drawing from the IMF, the country's reserve position in the IMF decreases (credit) by the same amount that its reserve of foreign exchange assets increases (debit). At a later period, the IMF may determine, on the basis of more up-to-date information, that the member country qualified for use of Fund credit for compensatory financing of export fluctuations at the time of its reserve tranche

drawing. In such instances, it is recommended that entries showing an increase in the use of Fund credit (credit) and an increase of an equal amount in the reserve position in the Fund (debit) be recorded in the period in which the redefinition took place. For example, a country makes a reserve tranche purchase of 200 units from the Fund. This purchase is subsequently redefined as the use of Fund credit. The following entries would be recorded in the country's balance of payments:

Period 1	**Credit**	**Debit**
Reserve position in the Fund	200	
Reserve assets (or other appropriate financial account item)		200
Period 2	**Credit**	**Debit**
Reserve position in the Fund		200
Use of Fund credit	200	

This treatment, which relates to transactions that rarely occur in practice, is recommended in order to align BOP entries with statistics published by the IMF on its own activities. Because the exchange of instruments imposes different obligations on the debtor, the transaction is more akin to the renegotiation of a loan than to a reclassification.

Financial Item Changes to Be Excluded from the Balance of Payments

Allocation or Cancellation of SDRs

464. The holding of special drawing rights (SDRs) is discussed in detail in chapter 12, although allocations and cancellations of SDRs are no longer recorded in the balance of payments. In the fourth edition of the *BPM*, such changes were regarded as transactions offset by counterpart entries to the allocations or cancellations. The impact of allocations or cancellations of SDRs on a country's reserves can be determined from an analysis of the reserve assets component of the IIP statement rather than from the balance of payments.

Monetization or Demonetization of Gold

465. The same stock of gold held by monetary authorities may, at different times, be classified as a commodity (nonmonetary gold) or as a financial asset (monetary gold). Changes, which result from reclassification of gold stocks, in holdings of monetary gold are not recorded in the balance of payments. Instead, the impact of these changes is reflected in the reserve assets component of the IIP statement. The treatment of monetization or demonetization of gold recommended in the fifth edition of the *BPM* is different from that recommended in the previous edition.

Valuation Changes

466. The *BPM* recommendation is to omit from the balance of payments all unrealized valuation changes in the external financial assets and liabilities of an economy. Valuation changes can occur for a number of reasons. One is a change in the price of the unit in which an asset is denominated. For example, a resident of Namdarb purchases, in Clintonstan currency, a security issued by Clintonstan at a price of 500 units. The exchange rate at the time of the purchase is l unit of Namdarb currency for 5 units of Clintonstan currency, so the resident of Namdarb pays 100 units to purchase this security. When the value of the security subsequently increases to 550 units in Clintonstan currency, the price—expressed in Namdarb currency—is 110 units. The increase of 10 units—in Namdarb currency—in the value of the security represents one type of valuation change.

467. Another type of valuation change occurs when the monetary unit in which an asset is denominated changes in terms of the unit of account used for recording BOP statistics. For example, Clintonstan currency depreciates (in terms of Namdarb currency) from an exchange rate of l unit of Namdarb currency for 5 units of Clintonstan currency to a rate of l unit of Namdarb currency for 6 units of Clintonstan currency. The value, in terms of Namdarb currency, of a security worth 500 units of Clintonstan currency decreases from 100 units to 83.3 units.

468. Valuation changes like those described in the foregoing paragraphs are omitted from the balance of payments as such changes do not represent transactions. (However, transactions may take place for which valuation changes are realized. Resulting capital gains or losses are reflected implicitly in the balance of payments as part of the value of the transactions that gave rise to realization of the capital gains or losses.) In the previous edition of the *BPM*, valuation changes in reserves—as well as counterpart entries to these valuation changes—were reflected in the balance of payments. However, as the IIP statement provides a framework for analyzing changes, there is no longer a need to show the total change in the level of reserves in the balance of payments.

Write-offs

469. A valuation change occurs as a result of a write-off if a debtor is unable or unwilling to make partial or full repayment of a claim. In such cases, the creditor may choose to regard a part or the full amount of the claim as canceled. As opposed to the contractual rescheduling of debts discussed previously, write-offs do not involve contractual agreements and thus are unrealized capital losses that should not be recorded in the balance of payments. However, forgiveness by a creditor of all or part of the debt owed by the debtor does constitute a transaction that should be recorded in the balance of payments. In such cases, the reduction in debt recorded in the ***financial account*** is offset by an entry in the debt forgiveness item in the *capital transfers* component of the ***capital account***.

Classification Changes

470. Classification changes in an economy's external assets or liabilities are not recorded in the balance of payments. Classification changes arising from territorial changes (other than those associated with government purchases of foreign land for embassy and similar uses); reclassifications between *portfolio investment* and *direct investment*; and reclassifications related to assumption or relinquishment of control, by monetary authorities, of the foreign exchange assets of banks are examples of reclassification changes that are not shown in the balance of payments.

Net Recording

471. In general, financial movements are recorded on a net basis. That is, each item in the ***financial account*** is presented—depending on whether total debits exceed total credits or vice versa—as a net debit or net credit entry. The net change in claims on nonresidents by residents and the net change in claims on residents by nonresidents during a period is considered to be of more interest than the total value of financial claims that changed hands during the period. Therefore, most categories in the ***financial account*** are shown on a net basis.[16] The only exception specified in the *BPM* to net recording in the ***financial account*** is for drawings and repayments on long-term loans and trade credits, which are shown as supplementary classifications.

Valuation and Timing

472. Transactions in financial items are recorded in the ***financial account*** at market values when changes of ownership occur. The concepts of market value and time of recording are discussed in detail in chapters 5 and 6 of the *BPM*. These concepts and the application thereof to financial transactions are further elaborated in chapters 9, 10, 11, and 12 (which deal with the various items in the ***financial account***) of the *Textbook*. Financial items are recorded in the balance of payments when the creditor and debtor enter, respectively, the claim and the liability in their books.

Classification

473. In the development of a BOP classification scheme for financial items, emphasis was given to distinguishing categories of transactions that exhibit different patterns of behavior. On this basis, five main approaches are used to classify financial items.

Functional Types of Investment

474. In the *BPM*, three broad categories of investment exhibiting different behaviors and a fourth residual category are distinguished. The following discussion focuses on the salient features of these categories. A more detailed discussion on each of the categories is provided in chapters 9–12.

Reserve Assets

475. *Reserve assets* are instruments available to governmental authorities for financing or regulating payment imbalances. *Reserve assets* are comprised of monetary gold, special drawing rights (SDRs) in the IMF, reserve positions in the IMF, and claims on nonresidents (such as foreign exchange) available to the central authorities. Under a fixed exchange rate system, changes in holdings of reserves usually reflect a response to an aggregate surplus or deficit resulting from transactions undertaken for their own sake. These transactions are called *autonomous transactions*. For example, if the sum of all autonomous transactions between residents and nonresidents of an economy produces an overall

[16]Even on the net basis used for recording in the balance of payments, transactions in financial assets are shown separately from transactions in liabilities.

deficit, this deficit may be financed by drawing down on reserves.

476. In flexible exchange rate systems, changes in reserves may also reflect actions (such as intervention in the foreign exchange market to affect the exchange rate for the national currency) taken by the authorities to influence autonomous transactions. For instance, if the currency of a country is under pressure in foreign exchange markets, the authorities may decide to prevent depreciation in their country's currency by selling foreign exchange assets in support of the currency. This policy would result in a reduction of the country's reserves.

Direct Investment

477. The direct investor is usually different from other investors because the direct investor seeks to have, on a lasting basis, an effective voice in the management of an enterprise (the direct investment enterprise) in which the direct investor's investment is made. To achieve this purpose, the investor normally owns a significant percentage of the equity capital invested in the direct investment enterprise. In addition, the direct investor may provide other types of capital (such as loans and trade credits) and technical expertise to the direct investment enterprise. Because of this special relationship between the direct investor and the direct investment enterprise, direct investment capital flows often show characteristic behavior that differs from the flows of *portfolio investment* and *other investment*. For this reason, direct investment flows are recorded separately in the balance of payments.

Portfolio Investment

478. The portfolio investment category covers investment—other than investment classified as *reserve assets* or *direct investment*—in equities, other securities, and financial derivatives. Nonequity securities include bonds, bills, negotiable certificates of deposit, preference shares (except participating preference shares), bankers' acceptances, and marketable promissory notes. Stocks and shares are examples of equities. Financial derivatives are secondary market instruments that give the holder a qualified right to receive an economic benefit in the form of cash or another primary financial instrument at some future point in time.

479. Portfolio investors are primarily concerned with the safety of their investment, the likelihood of an appreciation in the value of that investment, and the return they will obtain from their investment. If circumstances change, the portfolio investor—unlike the direct investor—can often easily shift the investment to another area.

Other Investment

480. *Other investment* is a residual category comprising all other kinds of financial transactions, including loans, trade credits, and bank deposits. The transactions included here are diverse and, for this reason, it is difficult to make further meaningful distinctions along functional lines.

Assets and Liabilities

481. There is no doubt that a distinction between assets and liabilities is important for analyzing a country's international investment position. This distinction is important even for financial intermediaries that borrow and re-lend abroad the same funds because conditions (such as rates of interest and maturity) for the borrowing and lending are usually different. Therefore, these ostensibly offsetting flows may have different implications for the BOP. A strict distinction between assets and liabilities is less important for direct investment capital because of the related nature of the transactors. However, even within *direct investment*, the standard BOP classification allows for a distinction between assets and liabilities.

Type of Instrument

482. The method by which an investor chooses to make an investment—that is, the instrument of investment—is often important in BOP analysis. The many instruments available for investment may be divided into two broad categories: equity and debt. Equity instruments are those that entitle the holder to a share in the profits of the issuing enterprise or a claim on the residual value of the enterprise after all of the other liabilities of the enterprise have been met. Debt instruments, on the other hand, entitle the holder to a return that is not related to the profitability or net worth of the issuing enterprise.

483. The three main equity instruments are shares in incorporated enterprises, equity in unincorporated enterprises, and direct investors' shares of the reinvested earnings of direct investment enterprises.

Within debt instruments, the major subcategories are loans (including use of Fund credit), trade credits, currency and deposits, bonds and notes, money market instruments, and financial derivatives. While not debt instruments in the strictest sense (because there is no debtor associated with these instruments), monetary gold and SDRs are generally grouped with debt instruments in presentations of BOP and other related statistics.

Domestic Sector

484. The institutional sector of the domestic (resident) creditor is often a factor that influences financial transactions in assets. Likewise, the institutional sector of the debtor often influences financial transactions in liabilities. Accordingly, for *portfolio investment* and *other investment*, four sectors are distinguished in the BOP standard components: general government, monetary authorities, banks, and other. For *direct investment*, however, the domestic institutional sector is not particularly important for explaining the behavior of investments. Accordingly, *direct investment* transactions are not classified by sector in the standard components of the balance of payments. Monetary authorities can be presumed to be either directly or indirectly responsible for *reserve asset* transactions; therefore, sectoral classification is not required for these transactions.

485. The classification of BOP transactions by sector also plays a significant role in linking BOP statistics with other statistical systems, such as the system of national accounts, money and banking statistics, and government finance statistics.

486. The principle of classification by sector, which is specified in the *BPM*, is to identify the domestic creditor for assets and the domestic debtor for liabilities. The identification of assets by domestic creditor does not present any problems because the creditor is always the owner of an asset and thus one of the parties to transactions involving the asset. Therefore, for assets, sector attribution by creditor and by transactor coincides. However, this coincidence does not always apply in the case of liabilities. For example, a resident of Coonawarra purchases 40 units worth of 90-day government notes in the financial market of Hughesavia. Subsequently, a resident of Hughesavia purchases these notes from the resident of Coonawarra. The following transactions would be recorded in the balance of payments of Hughesavia:

Initial transaction	**Credit**	**Debit**
Portfolio investment-liabilities		
Money market instruments-general government	40	
Reserve assets (or other appropriate financial account item)		40
Subsequent transaction	**Credit**	**Debit**
Portfolio investment-liabilities		
Money market instruments-general government		40
Reserve assets (or other appropriate financial account item)	40	

487. Entries appearing in the previous example show that a claim on a domestic debtor (the Hughesavian government) changes ownership from a nonresident creditor to a domestic creditor. The domestic debtor (the Hughesavian government) is not a party to the subsequent transaction between the nonresident investor and the resident of Hughesavia who acquires the claim. Nevertheless, according to the *BPM*, the sector of the debtor determines the classification of the transaction. The original nature of the liability is generally considered more significant than the identity of the present claim-holder. The second transaction in the example is attributed to the debtor in Hughesavia who issues the notes and not to the resident who acquires these securities from the nonresident investor.

488. Sectoral attribution of transactions in financial items should be interpreted quite strictly. Guarantees and financial intermediation (when the intermediary is not actually the legal creditor or debtor) undoutedly have an influence on investors. However, such factors do not constitute the primary motivation of those engaging in the transactions. A government guarantee for repayment of a loan to an enterprise may have a favorable impact on a lender. Nonetheless, the basic motivation for the transaction is the decision of the enterprise to borrow.

Long- and Short-Term Investments

489. The criterion used in the *BPM* for distinguishing between long- and short-term investments is the original contractual maturity. Long-term investment is defined as investment with an original contractual maturity of more than one year or an investment with no stated maturity (such

as corporate equities). Short-term investment is defined as investment payable on demand or with an original contractual maturity of one year or less; short-term investment includes currency. The definitions of long- and short-term investments are not sufficient or satisfactory for distinguishing between long- and short-term movements. Often, the original maturity does not have much influence on the length of time a financial asset will be held. Nevertheless, it appears to be one of the factors that investors take into account with regard to certain instruments.

490. While a number of the innovations in financial markets have somewhat diminished the usefulness of classifying many of the BOP financial transactions by maturity, it is still seen as an important classification for the trade credit, loans, and other assets and liabilities components of *other investment*. Accordingly, it is recommended in the *BPM* that transactions in these instruments be classified in this way. However, for investment in other instruments, the maturity classification is not viewed as particularly useful and is not recommended.

Supplementary Classifications

491. In addition to the five primary classifications of financial transactions, there are—according to the *BPM*—two other classifications that can be used to analyze financial account transactions: *liabilities constituting foreign authorities' reserves* (LCFAR) and *exceptional financing transactions*. However, as the BOP analysis that uses these classifications tends to be more specialized than analysis undertaken on the basis of other classifications, LCFAR and exceptional financing are not included in the BOP standard components. Instead, these classifications are shown as supplementary classifications.

Liabilities Constituting Foreign Authorities' Reserves

492. A BOP analyst may wish to group certain liabilities with *reserve assets* if he or she considers these liabilities to perform a function similar to that of *reserve assets*. The relationship between most liabilities and *reserve assets* is, however, not always straightforward. *Reserve assets* may be used to perform more than one function, and the liabilities related to each of the functions may be different. It may also be difficult to identify the underlying causes of changes in certain liabilities. Therefore, the *BPM* recommendation is to identify any liability that constitutes a *reserve asset* from the point of view of the nonresident creditor. In certain cases, it may be very difficult—from the debtor's point of view—to determine whether a creditor will classify a claim as part of *reserve assets*. For example, the central bank of Nostaw could purchase, through a broker, securities issued by a resident of Namdarb and place these securities in the *reserve assets* of Nostaw. It would be difficult for the BOP compiler of Namdarb to determine whether these securities are held as *reserve assets* by Nostaw. As a practical matter, BOP compilers in debtor countries can follow a rule of thumb to identify liabilities that constitute foreign authorities' reserves.

493. The rule of thumb is based on the assumption that a nonresident creditor will probably classify as *reserve assets* any liability of the compiling economy that is:

repayable on demand or in the short-term (i.e., marketable) or that the debtor is prepared to redeem on short notice;

repayable in a form that the debtor regards as a *reserve asset*;

owed to a central bank, central government, or other agency (except a public nonmonetary enterprise) of the central authority.

All of these conditions need not be met or be simultaneously applicable. One of the following two rules is sometimes applied. The overwhelming majority of monetary assets (that is, assets that can be used to make payments) owned by governmental authorities will be *reserve assets*. Therefore, in the absence of information to the contrary, the debtor economy could consider any liabilities to foreign central authorities to be classified as *liabilities constituting foreign authorities' reserves*. Alternatively, the debtor economy could decide to classify as LCFAR only its liabilities to foreign monetary authorities. This decision could be made if the the available evidence suggests that a significant portion of the debtor economy's liabilities to other foreign central authorities is comprised of types of assets that are not likely to constitute part of the *reserve assets* of the creditor economies.[17]

[17]That is, central authorities other than monetary authorities

494. According to the *BPM*, liabilities that constitute *reserve assets* of the creditor economy are shown as a supplementary classification, even though the compiling country itself (the debtor) may not, in fact, regard some or any of the liabilities as an additional means of financing its BOP deficit or as an offset to its *reserve assets*.

Exceptional Financing

495. *Exceptional financing transactions* consist of any arrangements (other than the use of *reserve assets*, Fund credit and loans from the Fund, and LCFARs) made by the authorities of an economy to finance BOP imbalances. The category of *exceptional financing transactions* therefore covers BOP financing items not included in categories for *reserve assets* and *liabilities constituting foreign authorities' reserves*. There are three main forms of exceptional financing: external borrowing, repayment of arrears, and forgiveness of debt.

External Borrowing

496. Instead of using *reserve assets* to finance a BOP deficit, authorities may engage in external borrowing for that purpose. For example, to bolster foreign exchange reserves, the central bank of a country borrows 100 units on a short-term basis. The BOP entries would be:

	Credit	**Debit**
Exceptional financing		
Other investment-liabilities-drawings on new loans-general government*	100	
Reserve assets		100

*In this and other examples of the recording of exceptional financing transactions, the exceptional financing element of the transaction is classified according to the supplementary exceptional financing classification rather than the BOP standard components classification.

Both entries are shown "below the line" because the borrowing is not an autonomous transaction affecting the BOP deficit of the country but a means of financing the deficit.

497. The main practical problem in classifying official borrowing is the necessity of distinguishing between BOP financing and project financing. (The latter is always shown "above the line" as a factor contributing to the overall BOP position of the country.) No objective criterion, such as original maturity or sector of transactor, can be depended upon to provide the desired distinction. Rather, the purpose of the borrowing must be determined on the basis of available information.

498. Some borrowings that are encouraged or inspired by governmental authorities but do not constitute official liabilities may nonetheless be regarded as *exceptional financing transactions*. For example, authorities may use commercial banks to conduct external borrowing operations. When the proceeds of commercial bank borrowings are effectively subject to the control of the authorities, the borrowings should be categorized as exceptional financing. (Such proceeds are analogous to *reserve assets* legally owned by commercial banks but under the effective control of authorities and therefore considered part of official reserves.) Compilers must determine whether authorities are exercising control over proceeds and whether the borrowings were undertaken for the purpose of BOP financing. The determination may be very difficult to make and, in some situations, quite important because of the large movements that sometimes occur in commercial banking funds.

499. Without becoming the legal debtors, governmental authorities may also encourage borrowing abroad by offering exchange rate guarantees or other inducements to public enterprises, local governments, or the private sector. The authorities may even state that their purpose is the improvement of the country's BOP position. The existence of such a policy is certainly a relevant fact to be noted in appraising a country's position. Nevertheless, official inducement is rarely the only reason that such borrowing takes place. Therefore, treating this debt as official financing exaggerates the influence that authorities can exert in an indirect manner. Moreover, most financial flows are likely to be affected by actions of the authorities, and those actions are no doubt taken with the BOP impact in mind. However, the indirect BOP effects cannot be quantified, and cases do arise in which an inducement offered by authorities seems the most reasonable explanation for a certain financial inflow. In that circumstance, the borrowing should undoubtedly be shown "below the line" in measuring the balance of payments.

500. The repayment of a loan is not usually a discretionary act on the part of the debtor. Therefore, with one exception, only original drawings on loans constitute *exceptional financing transactions*. The exception occurs when, for balance of payments reasons, loan repayments are made on schedules that differ from predetermined

schedules. If authorities choose, with or without the consent of the creditor, not to make a loan repayment on schedule, the obligation is treated as if it had in fact been satisfied and a new, replacement obligation is created. Specifically, a debit entry for reduction of the liability is made "above the line," and an offsetting credit entry for an increase in official borrowing is made in exceptional financing. Similarly, a loan repayment made by authorities in advance of the due date is sometimes shown as exceptional financing. If the loan prepayment is made for other than BOP purposes (to improve the debtor's standing in the credit market, for example), the prepayment is not included in *exceptional financing transactions*.

501. If the short-term borrowing described in paragraph 496 were repaid on time and if interest of 10 units were charged, entries for the repayment would be:

	Credit	Debit
Interest		10
Other investment-liabilities-loans-short-term-general government		100
Reserve assets	110	

Thus, even though the drawing of the loan was shown "below the line" as an exceptional financing transaction, repayment of the loan is shown "above the line."

Payments in Arrears

502. Payments in arrears are simply payments that are not made when due. According to the *BPM*, such payments are recorded as if the payments were made, and new liabilities are created for the outstanding debts. Payments in arrears are included in *exceptional financing transactions* if monetary authorities fail to provide the necessary foreign exchange but not if the payments are in arrears because a debtor refuses or is unable to pay in national currency.

503. For example, in period 1, a manufacturer imports some materials on credit. In period 2, when the debt falls due, the manufacturer tries to convert his national currency into foreign exchange to make the payment. The country is experiencing BOP difficulties, and the central bank cannot allocate the necessary foreign exchange. The payment, therefore, is not made. Principal and interest due amount to 150 units and 10 units, respectively. Entries in the balance of payments would be:

Period 1	**Credit**	**Debit**
Goods		150
Other investment-liabilities-trade credit-other sectors	150	

Period 2	**Credit**	**Debit**
Interest		10
Other investment-liabilities-trade credit-other sectors		150
Exceptional financing		
Other investment-liabilities-other sectors-accumulation of arrears-		
principal on short-term debt	150	
original interest	10	

504. As with external borrowing, debt repayments are included in *exceptional financing transactions* only if the repayments are unscheduled. Such is usually the case for payments in arrears. To extend the previous example—in period 3, the exchange restrictions are lifted and the repayment is made. The entries would be:

Period 3	**Credit**	**Debit**
Exceptional financing		
Other investment-liabilities-other sectors-repayments of arrears-		
principal		150
interest		10
Reserve assets	160	

505. When payments are in arrears, debts are often renegotiated and new contracts arranged. Under such circumstances, changes in the nature of the exceptional financing are recorded as repayments of the payments in arrears and drawings of new loans. If the debt were rescheduled for payment over two years, the entries would be:

	Credit	Debit
Exceptional financing		
Other investment-liabilities-other sectors-repayments of arrears-		
principal		150
interest		10
rescheduling of existing debt	160	

New loan repayments, if made according to schedule, are shown "above the line" in the periods in which the repayments are made.

506. If repayments other than those scheduled for the current period are rescheduled, only the rescheduling of the repayment for the current period is shown as exceptional financing. The remainder of

the rescheduled repayments are shown "above the line" as the repayment of the old liability and the creation of a new one.

Debt Forgiveness

507. Occasionally, a creditor will forgive all, or part, of the debt of a debtor in a country experiencing BOP problems. This debt forgiveness will also affect the exceptional financing category. The liability is reduced "above the line" for the amount forgiven. That part of the offsetting *capital transfer* relating to the scheduled repayment for the current period is shown as part of *exceptional financing transactions*. The remainder of the transfer is shown "above the line."

Other Exceptional Financing Transactions

508. In addition to the three types discussed in previous paragraphs, there are other types of transactions (such as debt-equity swaps and grants received from Fund subsidy accounts) that could be considered *exceptional financing transactions*. Additional details on these transactions may be found in chapter 22 of the *BPM*.

IX. Direct Investment

The Concept of Direct Investment

509. *Direct investment* is a category of international investment in which a resident entity in one economy (the direct investor) acquires a lasting interest in an enterprise resident in another economy (the direct investment enterprise). Direct investment implies a long-term relationship between the direct investor and the direct investment enterprise and a significant degree of influence by the direct investor on the management of the direct investment enterprise. Direct investment comprises the initial transaction between the two entities—that is, the transaction that establishes the direct investment relationship—and all subsequent transactions between the entities and among affiliated enterprises, both incorporated and unincorporated.

510. The Organisation for Economic Cooperation and Development (OECD) presents the same concept of direct investment in the *Detailed Benchmark Definition of Foreign Direct Investment* (*BMD*). The *BMD* is complementary to the *Balance of Payments Manual*. The purpose of the *BMD* is to provide a detailed operational definition of direct investment to serve as a reference, or standard, against which each country can compare its statistical system by using the concept and definition of *direct investment* contained in the *Balance of Payments Manual*. The *BMD* supplements the information provided in the *Balance of Payments Manual*.

511. The concept of direct investment differs from the concept of control. To be classified as a direct investor, an investor need not have the controlling share, or even the largest share, of ownership in an enterprise.

Motivation for Direct Investment

512. Direct investors expect to derive benefits from having a voice in the management of an enterprise. Portfolio investors, who do not exercise significant influence over the enterprises in which they invest, expect to obtain different benefits. From a direct investment perspective, enterprises often represent units in a multinational operation, the overall profitability of which depends on advantages gained by deploying resources available to each unit in a way that best enhances the synergy of the group. For example, the direct investor may be able to obtain resources or access to markets that might otherwise be unavailable to the enterprise. Direct investors may also be able to increase enterprise profitability and value through management skills and other expertise. Direct investment may also allow the direct investor to diversify and manage risk more effectively.

513. Therefore, direct investors may receive benefits in addition to income that would otherwise accrue on invested capital. In contrast, portfolio investors are primarily concerned about return on investment and the likelihood of appreciation in value. Portfolio investors generally evaluate prospective investment units separately and often shift their investments according to changes in prospects.

Defining the Direct Investment Relationship

514. The direct investor may be an individual, an incorporated or unincorporated private or public enterprise, an associated group of individuals or enterprises, or a government or government agency that owns a direct investment enterprise (as described subsequently) in an economy other than that in which the direct investor resides. A direct investment enterprise is an incorporated or unincorporated enterprise in which a direct investor owns 10 percent or more of the ordinary shares or voting power (for an incorporated enterprise) or the equivalent (for an unincorporated enterprise). The direct investment relationship extends to direct investment enterprise subsidiaries, direct investment enterprise associates, and branches directly or indirectly owned by the direct investor.

515. Enterprise X is a *subsidiary* of enterprise N only if:

(1) enterprise N owns more than half of the shareholders' or members' voting power in X

or

(2) enterprise X is a subsidiary of any other enterprise that is a subsidiary of N.

Enterprise K is an *associate* of enterprise N only if:

(1) enterprise N and its subsidiaries own 10 percent or more of the shareholders' voting power in enterprise K and enterprise K is not a subsidiary of N

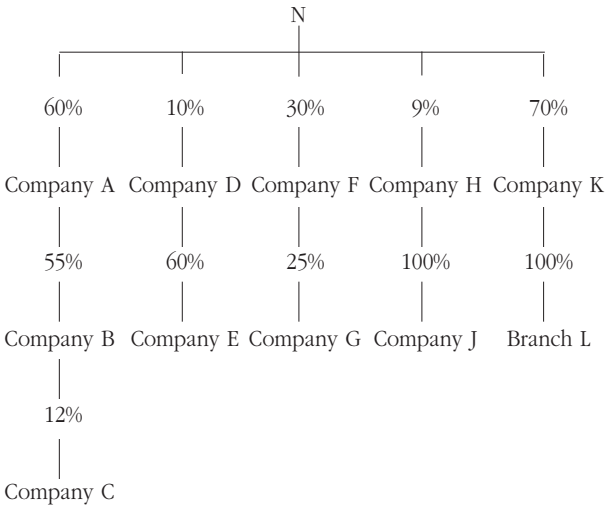
or

(2) enterprise K is a subsidiary of any other enterprise that is an associate of N.

Therefore, an investor need not control or be the largest shareholder in an enterprise for a direct investment relationship to exist between them. The concept of direct investment is fundamentally different from the concept of foreign-controlled enterprises. While all foreign-controlled enterprises are direct investment enterprises, enterprises not considered foreign controlled may also be in direct investment relationships with nonresident direct investors.

516. The rule of 10 percent is used to ensure consistent classification of investor/investee relationships for all countries' statistics. In many countries, regulatory and other authorities consider 10 percent ownership to constitute a relationship implying a degree of influence by the investor. Sometimes, investors who own 10 percent or more of an enterprise have little or no influence on enterprise management (e.g., pension funds not involved in the management of enterprises in which the funds have substantial investments). On the other hand, investors who own less than 10 percent may have an effective voice in enterprise management (for example, by being able to appoint managing directors). In the interest of comparability, however, use of the 10 percent rule is preferable to subjective judgment. Furthermore, as most direct investment enterprises are branches or subsidiaries that are wholly or majority owned by nonresidents, borderline cases are relatively insignificant.

517. Illustrated below are **subsidiary** and **associate** relationships. Enterprise N has these investments:



According to the definition of direct investment:

A is a subsidiary of N.

B is a subsidiary of A and therefore a subsidiary of N, even though only 33 percent of B is indirectly attributable to N.

C is an associate of B and therefore an associate of N through N's subsidiary B, even though only 4 percent of C's capital is indirectly attributable to N.

D is an associate of N.

E is a subsidiary of D and therefore an associate of N, even though only 6 percent of E is indirectly attributable to N.

F is an associate of N.

G is an associate of F but not of N as F is only an associate of N.

H is neither a subsidiary nor an associate of N.

J is a subsidiary of H but neither a subsidiary nor an associate of N.

K is a subsidiary of N.

L is a branch of K and thus a branch of N.

Therefore, enterprises A, B, C, D, E, F, K, and L are involved in a direct investment relationship with N and in direct investment relationships with each other. Transactions between company E and company K, for example, represent direct investment transactions.

518. For purposes of the balance of payments and the national accounts, enterprises that have significant long-term (that is, more than one year) operations in more than one economy are divided into separate entities in each economy. These entities are always in a direct investment relationship; the head office constitutes the direct investor and the branches constitute the direct investment enterprises. Land and structures directly owned by nonresidents (other than foreign governments) are, in the balance of payments and the national accounts, considered to be owned by notional resident units that are in direct investment relationships with the legal owners of the land. Also considered to be owned by enterprises that are resident in the host country and in direct investment relationships with the actual operators of equipment (such as ships, aircraft, gas and oil drilling rigs) is mobile equipment that operates in an economy for at least one year, is accounted for separately by the operator, and is recognized by taxation and similar authorities of the host country as part of the country's capital stock.

Direct Investment Capital

519. Direct investment capital is (1) capital provided by the direct investor—either directly or through other enterprises related to that investor—to the direct investment enterprise or (2) capital received by the direct investor from the direct investment enterprise. Direct investment capital includes equity capital, reinvested earnings, and other capital involved in various intercompany debt transactions. Direct investment capital includes only actual amounts provided; for example, funds for which the direct investor merely makes the arrangements or guarantees repayment are not considered direct investment capital.

520. Equity capital covers equity in branches, all shares (whether voting or nonvoting) in subsidiaries and associates, and other capital contributions (for example, the provision of machinery—which constitutes part of the capital of the direct investment enterprise—by a direct investor to a direct investment enterprise). Equity capital also covers the acquisition by a direct investment enterprise of shares in its direct investor. Reinvested earnings are the direct investors' shares (in proportion to equity held) of the undistributed earnings of the direct investment enterprise. These reinvested earnings are recorded as income with an offsetting capital transaction. The rationale for including reinvested earnings in the balance of payments is discussed in chapter 6.

521. Other capital (or intercompany debt transactions) covers the borrowing and lending of funds, including debt securities and trade credits, between direct investors and direct investment enterprises and between two direct investment enterprises that share the same direct investor. Debt claims on the direct investor by the direct investment enterprise are also recorded as direct investment capital.

522. However, in regards to investments between affiliated banks and other financial intermediaries, only those investments associated with equity and permanent debt (that is, loan capital) are considered to be *direct investment*. Other debt investment (such as deposits and other claims and liabilities related to normal banking activity) between affiliated banks and other financial intermediaries is considered to be *portfolio investment* or *other investment*.

523. In practice, it is sometimes difficult to distinguish between the equity capital and the other capital of direct investment enterprises. Differentiation is particularly difficult when an enterprise is 100 percent owned by a direct investor. In these situations, the classification of capital for the balance of payments could be the same as that used in the direct investor's (or direct investment enterprise's) accounting records. That is, when a claim of the direct investor on the direct investment enterprise is considered—in the accounting records of the direct investor or the enterprise—to be equity capital or shareholder funds, this claim is also considered equity capital in the balance of payments.

524. Capital provided to a direct investment enterprise by economic units other than the direct investor and enterprises related to the direct investor is not direct investment capital. For example, if a direct investment enterprise borrows money from an enterprise that is not affiliated with the direct investor, this borrowing is classified in the balance of payments as *other investment*.

525. The following example illustrates the concept of direct investment capital. Enterprise X in Namdarb is 50 percent owned by enterprise Z in Coonawarra. Forty-five percent of enterprise X's shares are owned

by residents of Namdarb, and 5 percent are owned by a resident in Cromania. In a particular year, enterprise X undertakes the following transactions:

(1) One hundred shares of new equity are issued, and these are purchased by shareholders of enterprise X in proportions equal to their existing shareholdings.

(2) Enterprise Z provides enterprise X with 20 units' worth of machinery, which is entered in the accounting records of enterprise X as non-voting equity.

(3) Enterprise Z sells goods worth 40 units to enterprise X. Enterprise X pays 20 units, and the remaining 20 units are entered, in the accounting records of enterprise X, as a trade credit payable.

(4) Acting as a guarantor for the loan, enterprise Z arranges for an unrelated bank in Dromesia to lend enterprise X 75 units.

(5) Enterprise X's operating profit, after tax and interest expenses, for the year is 10 units. Enterprise X does not pay any dividends during the year.

526. These entries would be made in Namdarb's balance of payments:

	Credit	Debit
Goods		20 (2) 40 (3)
Income-investment income-direct investment-earnings on equity-reinvested earnings		5 (5)
Direct investment in Namdarb		
Equity capital	50 (1) 20 (2)	
Reinvested earnings	5 (5)	
Other capital	20 (3)	
Portfolio investment-liabilities-equity	5 (1)	
Other investment-liabilities-loans-other sectors	75 (4)	
Reserve assets (or other appropriate financial account item)	20 (3)	55 (1) 75 (4)

A direct investment relationship is created when an investor (or group of related investors) obtains 10 percent or more of the shares in an enterprise. If an investor does not own any shares in an enterprise prior to becoming a direct investor, the entire acquisition of shares is recorded as a *direct investment* transaction. Conversely, if an investor has enterprise shareholdings of less than 10 percent prior to becoming the direct investor, only the shares acquired in the transaction that makes the investor a direct investor are classified as a *direct investment* transaction. In other words, the reclassification of shares previously classified as *portfolio investment* to *direct investment* is not recorded in the balance of payments but is reflected instead in the international investment position.

527. For example, enterprise P in Pokolbin purchases, for 8,000 units, 8 percent of the shares in enterprise M in Madornia. One month later, enterprise P acquires, for 6,000 units, another 5 percent of the shares of enterprise M. The following transactions would be shown in Madornia's balance of payments:

	Credit	Debit
Portfolio investment-liabilities-equity	8,000	
Reserve assets (or other appropriate financial account item)		8,000
Direct investment in Madornia		
Equity capital	6,000	
Reserve assets (or other appropriate financial account item)		6,000

528. If enterprise P's investment in Madornia is valued at 15,000 units at the end of the period, the following entries would be shown in Madornia's IIP statement:

	Level at Start of Period	Trans-actions	Other Changes	Level at End of Period
Liabilities				
Direct Investment				
Equity	0	6,000	9,000	15,000
Portfolio Investment				
Equity	0	8,000	−8,000	0
Total	0	14,000	1,000	15,000

Direction of Investment

529. Unlike other financial investments, *direct investment* is not recorded in the balance of payments on a strict asset/liability basis. Instead, *direct investment* is recorded on a directional basis—resident direct investment abroad and nonresident direct investment in the reporting economy. Capital invested by the direct investment enterprise in its direct investor (reverse investment) is regarded as an offset to capital invested in the direct investment enterprises by a direct investor and its related enterprises. That is, such capital is regarded as *disinvestment* by the direct investor rather than as an asset of the direct investment enterprise. For purposes of analysis, these investments are recorded separately in the BOP standard components. When a direct investment enterprise invests in an enterprise related to its

direct investor, this investment is recorded, by the economy providing the investment, as resident *direct investment*-abroad and, by the economy of the enterprise receiving the investment, as *direct investment*-reporting economy.

530. In some instances, two enterprises or groups of related enterprises hold 10 percent or more of each other's voting shares. Thus, two direct investment relationships are established, and investments between the two enterprises or groups of enterprises are recorded on a full asset and liability basis—that is, as *direct investment*-reporting economy and as *direct investment*-abroad.

531. The following two examples illustrate the directional basis for recording direct investment transactions. In the first example, enterprise A in Algornia is 100 percent owned by enterprise N in Nostaw. Enterprise N owns 100 percent of enterprise E in Essendonia. In a particular period, enterprise A is involved in the following transactions:

Enterprise N provides machinery worth 50 units to enterprise A. The machinery is recorded as an equity investment in the accounting records of enterprise A.

Enterprise A lends enterprise E 100 units. The loan is repayable in five years. Enterprise E pays interest of 5 units on the loan during the year.

Enterprise E sells to enterprise A goods worth 50 units. Enterprise A provides payment in the form of trade credit, which remains outstanding at the end of the year. Enterprise A pays interest of 4 units on the trade credit.

Enterprise A purchases 80 units of bonds issued by enterprise N and receives 8 units in interest income.

Enterprise A's operating profit, after taxes and interest, is 25 units; dividends equal to this amount are paid.

The following entries would be recorded in Algornia's balance of payments:

	Credit	Debit
Goods		100
Income		
Direct investment		
Income on equity-dividends		25
Income on debt	15	–4
Direct investment in Algornia		
Equity capital		
Liabilities to direct investor	50	
Other capital		
Liabilities to direct investor	50	
Claims on direct investor		80
Direct investment abroad		
Other capital		100
Reserve assets (or other appropriate financial account item)	196	

532. In the second example, enterprise H operating in Hughesavia is 50 percent owned by enterprise L in Longa. In a particular year, these transactions occur in the order of presentation:

Enterprise H lends enterprise L 45 units.

Enterprise H purchases 20 percent of the shares of enterprise L for 1,200 units.

Enterprise H lends another 15 units to enterprise L.

Enterprise H receives interest of 6 units on funds lent to enterprise L.

Enterprise H's operating profit, after taxes and interest, is 50 units. No dividends are paid.

Enterprise L's operating profit, after taxes and interest, is 80 units. Dividends of 40 units are paid to shareholders.

533. The following entries would be made in Hughesavia's balance of payments:

	Credit	Debit
Investment income		
Direct investment		
Income on equity		
Dividends	8	
Reinvested earnings	8	25
Income on debt	6	
Direct investment in Hughesavia		
Reinvested earnings		
Liabilities to direct investor	25	
Other capital		
Claims on direct investor	45	
Direct investment abroad		
Equity capital		1,200
Reinvested earnings		8
Other capital		15
Reserve assets (or other appropriate financial account item)	1,246	

Enterprise H's first loan to enterprise L is shown as reverse investment because, at the time the loan is made, enterprise H does not have a direct investment interest in enterprise L. The second loan, which is made after enterprise H becomes a direct investor in enterprise L, is treated as *direct investment*-abroad. As all of the interest is paid after enterprise H becomes a direct investor in enterprise L, this amount

is shown as a direct investment credit rather than as a negative direct investment income debit. The value of enterprise H's stock of direct investment abroad would be shown in Hughesavia's statement of international investment position at the end of the period as the entire amount that enterprise H has lent to enterprise L. The reclassification of the first loan would be shown as a non-transaction change in levels.

Valuation

534. The recommendation of the *BPM* is that market values be used to value direct investment financial flows, income transactions, and stock positions. Use of market values is consistent with valuation principles recommended for recording other entries in the balance of payments and the international investment position. The recommendation to use market values for the valuation of *direct investment* is made for two primary reasons. First, comparisons of *direct investment* and other financial investment recorded in the balance of payments and international investment position would be invalid if inconsistent valuation bases were used. Second, market valuation provides the most meaningful measure of the economic value of resources available to, or transferred between, economies.

535. Unfortunately, because of the nature of the direct investment relationship, the criterion used for establishing market values is generally not satisfied as a key aspect of this criterion is that the parties to transactions must be independent. With regard to transactions, values shown in the accounting records of the direct investor and direct investment enterprise often serve as acceptable proxies for market valuations. However, in some instances, transactions occur between enterprises in a direct investment relationship, and the values shown in the accounting records of the transactors are significantly distorted from market values. For example, an enterprise may use prices that are unrelated to costs of production or acquisition in selling goods to a related enterprise. Such pricing might be employed as a means of transferring profits from one country to another for tax reasons or because the country of the direct investment enterprise imposes restrictions on repatriation of income by more straightforward means. In other instances, transfer prices may be used as a means by which a direct investor makes a capital investment in a direct investment enterprise.

536. The recommendation of the *BPM* is that, when the actual transaction price of a transfer of real resources between enterprises in a direct investment relationship differs from the value that could have been expected if the enterprises had been independent, the BOP compiler should make an adjustment to these values as shown in the balance of payments. The *BPM* also contains the caution that such adjustments should be made only when significant distortions are encountered.

537. When adjustments are made to one side of a BOP transaction, similar adjustments must be made to the other side of the exchange to preserve equality between credit and debit entries. Offsetting adjustments are always made to investment income or to direct investment financial transactions.

538. The following two examples illustrate the adjustment process. In the first example, direct investment enterprise U in Urangastan produces copper. Were this copper sold to an unrelated enterprise, direct investment enterprise U could expect, on the basis of the production cost of the copper, to earn 50 units per ton. However, the government of Urangastan has imposed restrictions on the repatriation of income to nonresidents. Therefore, enterprise U sells—to direct investor C in Clintonstan—1,000 tons of copper at only 10 units per ton. In this case, direct investment enterprise U and direct investor C are using transfer pricing to achieve a repatriation, which would otherwise not be permitted, of income to Clintonstan. These entries would be made:

Balance of Payments of Urangastan

	Credit	**Debit**
Goods		
As shown in transactors' accounting records	10,000	
Adjustment to market valuation	40,000	
Direct investment income		
Income on equity		40,000
Reserve assets (or other appropriate financial account item)		10,000

539. In the second example, direct investor D in Daniherland wishes to increase his investment in wholly owned subsidiary B in Bushland. However, Bushland's foreign investment policy restricts further explicit financial investment. To circumvent this policy, direct investor D sells machinery to subsidiary B for 2,000 units. Direct investor D could have sold this machinery to an unrelated

enterprise for 5,000 units. The following entries would be shown in Daniherland's balance of payments:

	Credit	Debit
Goods		
As shown in transactors' books	2,000	
Adjustment to market valuation	3,000	
	Credit	**Debit**
Direct investment abroad		
Equity capital		3,000
Reserve assets (or other appropriate financial account item)		2,000

540. The concept of market valuation can also be difficult to apply to direct investment relationships for valuations of equity positions in the IIP statement. Stock positions for equities and other securities are generally valued by using prices prevailing in an independent market on the date for which the IIP statement is prepared. As an independent market often does not exist for equity investment in direct investment enterprises, the *BPM* recommendation is that market value proxies be used. In the absence of regular market trading, the value of equity investment could be calculated as the net worth of an enterprise; one would apply current market values to the assets (including intangibles) and liabilities of the enterprise and determine the difference. See chapter 13 for valuation of direct investment equity stocks.

Special Cases

541. Four types of *direct investment* require elaboration: (1) special purpose entities, (2) construction enterprises, (3) investment in land, and (4) mobile equipment stationed in an economy for more than one year.

Special Purpose Entities (SPEs)

542. Special purpose entities (SPEs) are (1) generally organized or established in economies other than those in which the parent companies are resident and (2) engage primarily in international transactions but in few or no local operations. SPEs meeting the criteria presented in paragraphs 514–518 are included, with one exception, as direct investment enterprises. Excepted are SPEs with the sole purpose of serving as financial intermediaries; for these, investments recorded under *direct investment* are limited to equity capital and permanent debt.

543. Two examples illustrate the BOP treatment of SPEs. An Australian enterprise sets up an enterprise in Bermuda with share capital of $2. The enterprise is (1) to purchase and hold $2 million of portfolio equity investment in the United States; (2) to purchase and hold $1 million of bonds issued by a German company; and (3) to purchase, for $5 million, and hold a 50 percent interest in a United Kingdom company. Half of the $8 million required for the investments is provided by the Australian direct investor and half is provided by a bank in the Netherlands Antilles. Bermuda's balance of payments would show the following transactions:

	Credit	Debit
Direct investment in Bermuda		
Equity capital	2	
Other capital	4,000,000	
Direct investment abroad		
Equity capital		5,000,000
Portfolio investment-assets		
Equities		2,000,000
Bonds		1,000,000
Other investment-liabilities		
Loans-other sectors	4,000,000	
Reserve assets (or other appropriate financial account item)		2

As the enterprise in Bermuda is not purely a financial intermediary, BOP transactions with related enterprises are recorded on the same basis as other direct investment transactions are—although the enterprise has no operations in Bermuda.

544. A New Zealand company wishes to borrow funds on the U.S. capital market by issuing bonds valued at $3 million. Under U.S. regulations, only resident companies are allowed to issue such securities on the U.S. market. So the New Zealand company establishes "a $2 subsidiary" in Delaware (a U.S. state) and the subsidiary issues the bonds and lends the proceeds to its parent. As this SPE acts purely as a financial intermediary, only equity capital and any permanent debt provided by the direct investor are classified as *direct investment*. The following transactions would be recorded in New Zealand's balance of payments:

	Credit	Debit
Direct investment abroad		
Equity capital		2
Portfolio investment-liabilities		
Bonds	3,000,000	
Reserve assets (or other appropriate financial account item)		2,999,998

Construction Enterprises

545. The treatment of international construction activity has been described in chapters 2 and 5. However, some reiteration is justified because of the relative complexity, from a BOP perspective, of this activity and its impact on direct investment statistics for some countries.

546. Work undertaken in one economy by a construction enterprise resident in another economy can be treated (1) as work performed by a notional enterprise that is resident in the host economy and engaged in a direct investment relationship with the parent enterprise or (2) as a service imported by the host economy. The important issue is determination of the economy to which production is attributed. If an enterprise maintains, or expects to maintain, a presence in the host economy for more than a year, and if separate and appropriate records are kept in respect of the enterprise's work in the host economy, production should be attributed to the host economy. In such a case, a direct investment enterprise is created in the economy. Otherwise, no direct investment relationship is established and an import, by the host economy, would be shown in the balance of payments.

547. An example illustrates the recording of construction activity in the balance of payments if the creation of a direct investment enterprise is necessary. Enterprise J in Jaymaranda wins a construction contract that is valued at 100,000 units and is to be fulfilled in Central Paradiso. The project takes two years to complete. At commencement, enterprise J deposits 60,000 units in local currency with banks in Central Paradiso. Enterprise J also sends a machine worth 8,000 units to Central Paradiso. A payment of 40,000 units is received at the end of the first year and one of 60,000 units at the end of the second year. These payments are immediately repatriated to Jaymaranda. These costs are incurred in association with the project:

	Year 1	Year 2
Material purchased in Central Paradiso	20,000	15,000
Salaries paid to residents of Central Paradiso	10,000	15,000
Depreciation on machinery	1,000	1,000
Total costs	31,000	31,000

548. The first item to be calculated is the year-by-year profit on the project. If a constant ratio of cost to profit is assumed, the profit for each of year 1 and year 2 is half of the total profit on the project because half the total cost of the project is incurred in each year.[18] As project remittances are greater than profits in both years, a portion of the total remittance is considered a remittance of profit and the remainder is considered a withdrawal of direct investment capital.[19]

549. As the project is a long-term one and separate project records are kept, a notional direct investment enterprise that is resident in Central Paradiso is created to account for the construction activity. The following BOP entries would therefore be recorded for Jaymaranda:

Year 1	Credit	Debit
(1)Goods	8,000	
Direct investment abroad		
Equity capital		68,000
Reserve assets (or other appropriate financial account item)	60,000	
(2)Investment income		
Direct investment		
Income on equity-remitted profits	19,000	
Direct investment abroad		
Equity capital	21,000	
Reserve assets (or other appropriate financial account item)		40,000

Transaction (1) reflects the initial capital provided to the direct investment enterprise in the form of machinery and working capital. Transaction (2) shows repatriation of the first year's progress payment, a portion of which is allocated to *investment income* and the remainder of which is considered a withdrawal of direct investment capital.

Year 2	Credit	Debit
Goods		6,000
Investment income		
Direct investment		
Income on equity-remitted profits	19,000	
Direct investment abroad	47,000	
Reserve assets (or other appropriate financial account item)		60,000

In entries for year 2, return of the machinery (recorded at written-down value) and repatriation of

[18]The total profit from the project is equal to the value of output (100,000 units) less costs incurred in producing the output (62,000 units). As costs are equally incurred in both years, the 38,000–unit profit is equally attributable to both years. Were two-thirds of the cost incurred in year 1 and one-third in year 2, two-thirds and one-third—respectively—of the profit would be attributable to year 1 and year 2.

[19]Direct investment income can only relate to operating profits (described in chapter 6) earned in either the current or the previous period. When remittances exceed earnings, a withdrawal of capital should be recorded in the balance of payments.

the progress payment beyond the amount covering second-year profits are both shown as withdrawals of *direct investment*- abroad.

Foreign Ownership of Land

550. According to conventions presented in the *BPM* and the *SNA*, land, structures and other immovable objects can only be owned by resident entities.[20] When a nonresident acquires legal ownership of land, a notional resident entity owned by the nonresident is, for BOP purposes, created to own the land. The relationship between the nonresident legal owner of the land and the notional entity is a direct investment relationship. The initial investment by the direct investor is equal to the purchase price of the land. The net rent from the land—that is, gross rent minus expenses incurred in the host country—is considered income earned by the direct investor from the direct investment enterprise. If the land is subsequently sold, the sale is considered a withdrawal of direct investment, which is recorded on the basis of the sale price. This treatment applies to all types of immovable assets, whether or not the assets are used for productive purposes. For example, a household's ownership of a holiday house in a foreign country is treated in this manner.

551. An example illustrates the treatment of nonresident ownership of land. A resident of Japan purchases land and buildings located in Hawaii and valued at US$ 250 million. In the first year, gross rent receivable is $20 million, and property taxes and other costs incurred in the United States are $5 million. The net rent, $15 million, is repatriated to Japan. In the second year, the same amount of net rent is received. At the end of the second year, the Japanese resident sells the land and buildings to a U.S. investor for $280 million. The following entries would be recorded (in millions of US$) in Japan's balance of payments:

Year 1	**Credit**	**Debit**
Direct investment income		
Income on equity-remitted profits	15	
Direct investment in the United States		
Equity capital		250
Reserve assets (or other appropriate financial account item)	235	

Year 2	**Credit**	**Debit**
Direct investment income		
Income on equity-remitted profits	15	
Direct investment in the United States		
Equity capital	280	
Reserve assets (or other appropriate financial account item)		295

Mobile Equipment

552. As noted in chapter 2, mobile equipment that operates in an economy for more than one year, is accounted for separately, and is recognized by taxation and other authorities as part of the capital stock of the host economy is regarded as being operated by a resident enterprise. If such an enterprise does not actually exist, the BOP compiler should create a notional enterprise. This notional enterprise is a direct investment enterprise and the direct investor is the actual operator of the equipment.

553. In these cases, the initial investment in the notional enterprise is equal to the value of the mobile equipment at the time the equipment enters the host economy. Net profits from mobile equipment operations in the host economy are considered direct investment income. In calculating net profit, it is important to include, as a cost, depreciation on the equipment. However, as depreciation typically involves no actual payment of money, the money received by the direct investor will generally exceed the net operating profit after allowance for depreciation. Receipts in excess of direct investment income represent a withdrawal of capital by the direct investor. If the mobile equipment eventually leaves the host economy, then its departure also represents a withdrawal of investment, which is recorded as an amount equal to the value of the equipment at that time. Because of depreciation, the value of repatriated equipment will generally be less than the value of that equipment when it entered the host economy.

554. An example illustrates previous points. An oil rig operated by a Pokolbin resident is chartered by a Namdarb oil company to drill for oil in waters just off the Namdarb coast. The oil rig is valued at 500 units when it enters Namdarb's territorial waters. In the first year, net operating profit (before depreciation) from the oil rig is 55 units and depreciation is recorded as 10 units; the amounts of net operating profit before depreciation and depreciation for the second year are the same as

[20]It is useful to recall the treatment of embassy land, etc. According to conventions presented in the *BPM*, such land is considered part of the territory of the government using the land rather than part of the territory of the host country.

those for the first year. At the end of the second year, the oil rig leaves Namdarb's waters and returns to Pokolbin. The following entries would be made in Pokolbin's balance of payments:

Year 1	**Credit**	**Debit**
Goods	500	
Direct investment income		
Income on equity-remitted profits	45	
Direct investment in Namdarb		
Equity capital*	10	500
Reserve assets (or other appropriate financial account item)		55

*In the presentation of BOP statistics, this item is shown on a net basis. Gross entries are shown here for illustrative purposes.

Year 2	**Credit**	**Debit**
Goods		480
Direct investment income		
Income on equity-remitted profits	45	
Direct investment in Namdarb		
Equity capital	490	
Reserve assets (or other appropriate financial account item)		55

In the foregoing example, income on equity is shown net of depreciation, which is shown as a withdrawal of capital. Furthermore, the value of the oil rig when returned to Pokolbin is recorded at the written-down value of 480 units—that is, 500 units minus two years of depreciation at 10 units per year.

X. Portfolio Investment

555. The *portfolio investment* component of the ***financial account*** covers transactions in equities, other securities, and financial derivatives—except when these transactions relate to the *direct investment* or *reserve assets* components of the ***financial account***. Both short- and long-term instruments are covered under *portfolio investment.* The essential characteristic of instruments classified as *portfolio investment* is that such instruments are traded or tradable. That is, the instruments offer investors the flexibility to shift, regardless of the underlying maturity of the instrument, invested capital from one instrument to another. Portfolio investors are more concerned than direct investors about rates of return that are independent of any influence investors may have and about being able to move funds quickly if circumstances so dictate.

556. Portfolio investment transactions are classified as those involving an economy's financial assets and those involving an economy's financial liabilities. Within these asset and liability classifications, portfolio investment transactions are classified by type of instrument. Four types of instruments are included in the BOP standard components: (1) equities, (2) bonds and notes, (3) money market instruments, and (4) financial derivatives. Transactions recorded in these categories are subsequently discussed in more detail. Within each instrument category, classification of transactions by resident sector is recommended in the *BPM.*

Equity

557. Equity securities are instruments acknowledging the holder's claim to the residual value or residual income of the issuing enterprise after the claims of all other creditors have been met. Shares or similar documents (such as American Depositary Receipts) usually denote ownership of equity. Preferred stock or shares that provide for participation in the distribution of residual earnings or in the residual value upon liquidation are included as equity. However, preference shares are not considered equity when the specified return and fixed value at maturity to which the holder is entitled are both independent of the underlying profitability of the issuing enterprise. Instead, transactions in these instruments should be classified as bonds and notes.[21]

558. Regardless of the types of investment made by the trust or fund, the ownership of trusts, mutual funds, and other similar investments also represents equity investment. For example, if a resident of Clintonstan invests in a cash management trust in Coonawarra, which in turn invests only in debt securities issued by the government of Nostaw, Clintonstan's balance of payments would reflect an equity investment. Coonawarra's balance of payments would reflect an equity liability and a debt asset, while Nostaw's balance of payments would show a debt liability.

559. The ownership of life insurance policies or similar claims on commercially operated pension funds is also considered equity investment as these claims generally entitle the holder to the residual income of the life insurance or pension fund. However, as these insurance policies are typically not tradable, such policies are not considered portfolio investments. Instead, transactions in these instruments are classified as other assets or other liabilities under *other investment.*

Bonds and Notes

560. In the BOP standard components, the category for bonds and notes includes debt securities with original contractual maturities of more than one year (long-term). Generally, the portfolio investment instruments classified in this category are debt securities that give the holder the unconditional right to a fixed money income or to a contractually determined variable money income that is not dependent on the earnings of the issuer. However,

[21]When these types of nonparticipating preference shares are issued with maturities of less than one year, such shares are recorded as money market instruments.

some securities with this characteristic should be classified as money market instruments if the securities are issued with maturities of one year or less (short-term). Similarly, some debt securities with characteristics similar to money market instruments (which are discussed subsequently) should be classified as bonds and notes if the securities are issued with long-term maturities.

561. Apart from bonds and notes, other securities—if issued with maturities of more than one year—recorded in this classification are debentures; nonparticipating preference shares; convertible bonds; perpetual bonds; negotiable certificates of deposit; collateralized mortgage obligations; dual currency, zero coupon, and other deep discounted bonds; floating rate bonds; and index-linked bonds.

562. Perpetual bonds are bonds that never mature. That is, such a bond theoretically provides the holder with an infinite stream of income payments. In a number of countries, perpetual bonds are classified as *second-tier equity* in the balance sheets of the issuing enterprises. Nevertheless, as the income payable on these bonds is typically independent of the earnings of the issuing enterprise, perpetual bonds are classified as bonds and notes, rather than equity, in the balance of payments.

563. Collateralized mortgage obligations and other asset-backed securities are instruments that specifically relate to an asset or group of assets held by the issuing enterprise. For example, a bank might issue securities based on mortgage loans made by the bank to households. The income that the bank earns from lending activities is used to pay interest on the securities and the mortgages are used as collateral for the securities. The holder of the asset-backed security does not own the asset backing the security; the collateral provided with the security is contingent. Securities based on mortgage obligations are favored by lending institutions as it is possible with such securities to match the maturity of an enterprise's assets (its mortgages) with the maturity of its liabilities (the securities). There are other types of asset-backed securities that enable the issuing enterprise to have access to cash before the related assets mature.

564. Index-linked securities are instruments for which coupon payments or principal amounts payable at maturity are linked to a commodity price index, an exchange rate index, or some other index. Such securities are often used to conserve the purchasing power of an investment during periods of inflation.

565. Transactions recorded in the balance of payments for bonds and notes are those relating to issues, redemptions, purchases, sales, and the offset to interest accrued but not due for payment. With regard to the accrual of interest, the financial transaction represents the offset to the income entry recorded in the **current account**. This accrual of interest is likely to be most significant for zero coupon and other deep discounted bonds and for index-linked securities for which repayments of principal at maturity are linked to specific indexes. For discounted bonds, the amount of interest accrued in a particular period is based on prevailing interest rates and adjusted for any coupon payments made during the period. (However, the issuer of the security will often accrue interest on the basis of the interest rate prevailing at the time the security was issued.) For index-linked securities, the interest accrued in a particular period is based on the movement that occurs in the underlying index during that period. Chapter 6 provides further elaboration, including examples of the recording of accrued interest on securities. The issue price is recorded as the value of a transaction at the time the security is issued and the redemption price is recorded as the value of a transaction at the time of maturity.

566. Bonds, notes, and similar instruments—with the exception of perpetual bonds—entitle the holder to the right to a specified amount at redemption. This amount is generally, but not necessarily, paid in cash. Some bonds convert to other instruments, such as equity, upon redemption. Until such a conversion occurs, these instruments are treated as bonds, not equity, in the balance of payments. At conversion, the withdrawal of investment in bonds and the offsetting increased investment in equity are recorded in the balance of payments. The withdrawal in bonds is valued at the current market value of the equity acquired.

Money Market Instruments

567. Money market instruments are debt securities issued with maturities of one year or less. These short-term instruments generally give holders the unconditional rights to receive stated amounts on maturity. Money market instruments are usually issued and traded in organized markets at discounts

to redemption values. It is the discounts, rather than coupon payments of interest, that provide holders of these instruments with income on their investments. However, instruments that share the characteristics of money market instruments but are issued with maturities of more than one year are classified as bonds and notes. Short-term tradable instruments that provide investors with returns by means of coupon payments, rather than discounts, are treated as money market instruments.

568. Types of instruments generally classified as money market instruments include treasury bills, commercial paper, bankers' acceptances, short-term negotiable certificates of deposit, and short-term notes issued under note issuance facilities (NIFs)—even though these facilities are typically long-term in nature. Entries are recorded in the BOP ***financial account*** for (1) transactions relating to the issue, purchase and sale, and redemption of money market instruments and (2) offsets to interest income accrued but not due for payment on these instruments.[22] However, "purchases" and "sales" of money market instruments under repurchase (repo) agreements should not be recorded as transactions in money market instruments. These agreements represent collateralized borrowing and are recorded as part of *other investment*-loans in the ***financial account***. Repurchase agreements are discussed in paragraph 597 of chapter 11.

569. A note issuance facility (NIF) is a form of revolving credit consisting of the periodic issuance of paper by an enterprise when the enterprise requires funds.[23] NIFs are usually long-term agreements in which an enterprise (generally a bank) or a group of enterprises underwrites notes issued by another enterprise. The notes are generally short-term instruments. The underwriters purchase any of the notes that cannot be sold in the market-place. For their services, the underwriters receive fees and, on any notes that they are required to purchase, the underwriters receive interest.

570. For BOP recording, the NIF itself is a contingent facility that does not generate any entries in the ***financial account***. (However, any fees paid to the underwriters are recorded in the **current account** as *financial services.*) Only the actual issuance of notes and any subsequent trading and redemption of these notes are recorded as financial transactions in the balance of payments. Any notes purchased by underwriters are treated by underwriters as investments.

571. The following example illustrates the treatment of NIFs in the balance of payments. A bank in Coonawarra provides a three-year NIF for an enterprise resident in Clintonstan. The enterprise in Clintonstan pays the bank 100 units each year for providing the facility. In the first year, no notes are issued under the facility. At the beginning of the second year, 1000 three-month notes with face values of 100 units each are issued. Of these, 700 notes are sold to residents of Algornia, and the underwriting bank purchases the other 300 notes. The notes are issued for 95 units each and there are no coupon payments. At the end of the three months, the notes are rolled over. This time, all 1000 notes are sold, with the issue price remaining at 95 units, to residents of Algornia. After the end of the second three months, the notes are redeemed and no further notes are issued under the facility. The following entries are shown in Clintonstan's balance of payments:

Year 1	**Credit**	**Debit**
Financial services (Coonawarra)		100
Reserve assets (or other appropriate financial account item)	100	
Year 2	**Credit**	**Debit**
Financial services (Coonawarra)		100
Portfolio investment income-interest		
First set of notes (Coonawarra)		1,500
(Algornia)		3,500
Second set of notes (Algornia)		5,000
Portfolio investment-money market instruments*		
First set of notes (issue)		
Coonawarra	28,500	
Algornia	66,500	
First set of notes (accrual of interest)		
Coonawarra	1,500	
Algornia	3,500	
First set of notes (redemption)		
Coonawarra		30,000
Algornia		70,000
Second set of notes (issue)		
Algornia	95,000	
Second set of notes (accrual of interest)		
Algornia	5,000	

*Entries for this item would normally be shown on a net basis in the balance of payments. Gross entries are shown in this example for illustrative purposes only.

[22]For many of these short-term securities, interest income will be accrued and paid—whether by way of the difference between redemption and issue price or by way of coupon—in the same accounting period. In practice, therefore, the recording of interest on money market instruments closely approximates the due-for-payment basis on which investment income is recorded.

[23]Note issuance facilities (NIFs) are also referred to by other names, such as revolving underwriting facilities (RUFs).

Year 2 (continued)	**Credit**	**Debit**
Second set of notes (redemption) Algornia		100,000
Reserve assets (or other appropriate financial account item)		
Fee	100	
First set of notes (net)	5,000	
Second set of notes (net)	5,000	

Year 3	**Credit**	**Debit**
Financial services (Coonawarra)		100
Reserve assets (or other appropriate financial account item)	100	

The only entries in the first and third years relate to the fee payable to the bank in Coonawarra for arranging and underwriting the NIF facility. In the second year, the Coonawarra bank's acquisition of notes that could not be sold to Algornia is shown as an investment by Coonawarra in Clintonstan. The interest income payable on the notes represents the difference between the issue price (95 units) and the amount payable on redemption (100 units). This accrued interest, which is part of the amount paid at redemption, is "reinvested" in the notes.

Table 10.1 Option Terminology

Call option—an option that gives the holder the right, but not the obligation, to ***buy*** an underlying asset
Put option—an option that gives the holder the right, but not the obligation, to ***sell*** an underlying asset
Strike price—the price, stated in the option contract, at which transactions, if any, in the underlying asset take place
Expiration date—the final date for exercise of an option
European option—an option that can be exercised only on the expiration date
American option—an option that can be exercised at any time up to and including the expiration date
Writer—the party that issues the option; that is, the debtor
Premium—the initial cash paid
Margin—an amount paid by the writer to a broker or some other financial intermediary as security against the writer's future obligations
In-the-money—an option that has a strike price that is ***less than*** the prevailing market price for the underlying asset
Out-of-the-money—an option that has a strike price that is ***greater than*** the prevailing market price for the underlying asset
Black-Scholes model—a mathematical formula used to value options

Financial Derivatives

Options and Warrants

572. Options are financial instruments that provide one party (the holder) with the right, but not the obligation, to buy (call option) or sell (put option) a specified financial or real asset for a predetermined price (the strike price) from another party (the option writer).[24] If the option holder exercises his or her right, then he or she is said to exercise the option. Exercise can take either of two forms: (1) actual delivery of the underlying asset for the strike price or (2) a cash settlement based on the difference between the prevailing market price of the underlying asset and the strike price. Table 10.1 provides an overview of the terminology associated with options, and table 10.2 shows factors that determine the values of options.

Table 10.2 Factors Determining the Values of Options

Factor 1—*the difference between the strike price (A) and the value of the underlying asset (B)*
For call options, if A > B, the bigger the difference, the less an option is worth. (An option can never have a negative value.) If B > A, the bigger the difference, the more an option is worth. For put options, the reverse is true.

Factor 2—*the current interest rate*
The higher the interest rate, the less an option is worth.

Factor 3—*the price volatility of the underlying asset*
The more volatile the price, the more an option is worth.

Factor 4—*the time remaining to expiration*
The closer an option is to expiration, the less it is worth.

573. If the option holder and option writer are residents of different countries, the creation and exercise of option contracts constitute transactions that are recorded in the BOP statements of the relevant countries. Also, the trading of options between residents of different countries results in BOP transactions for the countries concerned.

574. The following example illustrates the treatment of options in the balance of payments. A resident of Pokolbin writes a three-month call option on

[24] Warrants are options written by an enterprise on its own shares. In the balance of payments, warrants are treated in the same manner as other types of options.

10 shares in an enterprise located in Cromania; the strike price is $15 per share. The option is purchased from the writer by a resident of Coonawarra for $20. The following transactions would be recorded in the balance of payments of Pokolbin:

	Credit	Debit
Portfolio investment—liabilities		
Financial derivatives	20	
Reserve assets (or other appropriate financial account item)		20

575. After three months, the price of shares in the enterprise in Cromania rises to $18 per share, and the option holder in Coonawarra decides to exercise the option. The resident of Coonawarra acquires ownership of 10 shares, with a market value of $180, in the enterprise located in Cromania. However, only $150 (10 x $15) is actually paid. The remaining $30 represents the extinguishment of the option contract at the time of exercise. The following transactions would be recorded in the balance of payments of Pokolbin:[25]

	Credit	Debit
Portfolio investment—assets		
Equities	180	
Portfolio investment—liabilities		
Financial derivatives		30
Reserve assets (or other appropriate financial account item)		150

In this example, the underlying asset is delivered when the option is exercised. However, the option holder in Coonawarra could, instead, have accepted a cash settlement of $30, in which case the following entries would be recorded in the balance of payments of Pokolbin:

	Credit	Debit
Portfolio investment—liabilities		
Financial derivatives		30
Reserve assets (or other appropriate financial account item)	30	

576. Table 10.3 shows the common transactions and how such transactions are recorded, in association with options, in the balance of payments.

577. An international transactions reporting system (ITRS) or enterprise surveys (ES) could be used to collect, for the balance of payments, information on transactions involving options. However, if an ITRS is used, particular care should be taken to ensure

[25]Pokolbin owned the shares in the Cromanian enterprise prior to the exercise of the option contract. Otherwise, Pokolbin would have to purchase these shares (at market value) in order to deliver the shares to Coonawarra. Such a purchase could result in the recording of additional transactions in Pokolbin's balance of payments.

Table 10.3 Common Transactions Associated with Options

Issue of an option—In the balance of payments of the option writer's country, credit *portfolio investment*-liabilities-options and debit the financial instrument (e.g., currency) acquired in exchange. In the balance of payments of the option holder's country, debit *portfolio investment*-assets-options and credit the financial instrument (e.g., currency) provided in exchange.

Sale of option from one holder to another—In the balance of payments of the option seller's country, credit *portfolio investment*-assets-options and debit the financial instrument (e.g., currency) acquired in exchange. In the balance of payments of the option buyer's country, debit *portfolio investment*-assets-options and credit the financial instrument (e.g., currency) provided in exchange.

Exercise of a call option; delivery of underlying asset—In the balance of payments of the option writer's country, debit (1) *portfolio investment*-liabilities-options (at a value representing the difference between the strike price and the prevailing market price of the underlying asset) and (2) the financial instrument (e.g., currency) acquired; credit the underlying asset that is given up (at a value representing the prevailing market price for that asset). In the balance of payments of the option holder's country, credit (1) *portfolio investment*-assets-options (at a value representing the difference between the strike price and the prevailing market price of the underlying asset) and (2) the financial instrument (e.g., currency) provided; debit the underlying asset received (at a value representing the prevailing market price for that asset).

Exercise of a put option; delivery of underlying asset—In the balance of payments of the option writer's country, debit (1) *portfolio investment*-liabilities-options (at a value representing the difference between the strike price and the prevailing market price of the underlying asset) and (2) the underlying asset received (at a value representing the prevailing market price for that asset); credit the financial instrument provided in exchange. In the balance of payments of the option holder's country, credit (1) *portfolio investment*-assets-options (valued as the difference between the strike price and the prevailing market price of the underlying asset) and the underlying asset sold (valued at the prevailing market price for that asset); debit the financial instrument received in exchange.

Exercise of an option; settlement in cash—In the balance of payments of the option writer's country, debit *portfolio investment*-liabilities-options and credit the financial instrument (e.g., currency) paid to the holder. In the balance of payments of the option holder's country, credit *portfolio investment*-assets-options and debit the financial instrument (e.g., currency) received from the option writer.

Option expires without being exercised—No BOP transactions are recorded.

correct recording of transactions that result in delivery of the underlying asset. Unless supplementary information is sought, an ITRS respondent would probably (1) record the transaction in the underlying asset at the option strike price rather than at the market value at the time of transaction and (2) fail to record the extinguishment of the option contract.

Other Derivatives

578. Derivatives other than options typically involve contracts in which two parties agree to exchange specified assets, either real or financial, at some future point or points in time. Such contracts are either (1) tradable or (2) settled, on a net basis, for cash rather than an actual exchange of the underlying assets. Such derivatives are considered financial instruments and include forward foreign exchange contracts, futures, and currency swaps. If transactions in these instruments involve residents of different countries, the transactions are recorded in the BOP ***financial account***.[26] Transactions that are recorded in relation to derivative instruments include any trading in the contracts and the net value of settlements made. It may also be necessary to record transactions associated with the establishment of derivative contracts. Frequently, however, two parties will enter into a derivative contract but neither will make any payment to the other. In these cases, the value of the transaction establishing the contract is nil, and no entry is actually required in the balance of payments.

579. Fees paid to financial intermediaries (such as banks and brokers) to establish derivative contracts do not represent transactions in derivatives per se. These fees are classified as *financial services* and recorded in the ***services*** component of the **current account**. Likewise, margin payments provided by one party to another as security against future obligations do not represent transactions in derivatives. These margin payments are reflected in the currency and deposits item in the *other investment* component of the ***financial account***.

580. Two more examples provide illustration of the treatment of derivatives in the balance of payments. A resident of Namdarb purchases a tradable futures contract from a broker in Clintonstan for 100 units and pays brokerage fees of 12 units. The resident of Namdarb is also asked to make a margin payment of 250 units to the broker as security against adverse market movements. The following transactions are recorded in the balance of payments of Namdarb:

	Credit	**Debit**
Current account		
Financial services		12
Financial account		
Portfolio investment—assets		
Financial derivatives		100
Other investment—assets		
Currency and deposits	362	250

581. When the futures contract expires after three months, the market has moved against the resident of Namdarb, and he is required to pay 180 units as settlement. This settlement is deducted from the margin payment previously made, and the balance of 70 units is returned to the resident of Namdarb. The following transactions are recorded in the balance of payments of Namdarb:

	Credit	**Debit**
Financial account		
Portfolio investment—liabilities		
Financial derivatives		180
Other investment—assets		
Currency and deposits	250	70

In this example, the financial derivative contract has "flipped"—as a result of adverse market movements—from being an asset to being a liability for the resident of Namdarb. Such "flipping" can occur with derivative contracts other than options. Movements in prices of underlying assets cause such movements in value and are reflected in the price change component of the reconciliation statement between stocks and flows.

582. In the second example, an enterprise in Daniherland enters into a currency swap with an enterprise in Hughesavia. No money changes hands at the start of the contract. In six months, because of favorable movements in exchange rates, the enterprise in Daniherland receives a net settlement of 80 units from the swap partner in Hughesavia. The following transactions are recorded in the balance of payments of Daniherland:

	Credit	**Debit**
Financial account		
Portfolio investment—assets		
Financial derivatives	80	
Other investment—assets		
Currency and deposits		80

[26] An exception is derivatives (such as interest rate swaps and forward rate agreements) associated with interest rates. Transactions in these instruments are recorded in the *investment income* component of the **current accoun**t.

583. One or both parties to a derivative contract may enter into the contract to hedge against adverse movements in some other position. For example, an enterprise borrowing in U.S. dollars but preferring liabilities in Japanese yen may enter into a currency swap in which the enterprise receives U.S. dollars for Japanese yen. In BOP recording, transactions in derivative contracts are recorded separately from any transactions involving the position being hedged. Otherwise, asymmetries could arise in the recording of BOP transactions, and distortions could occur in the analysis of BOP items. If compilers wish to provide users with information on the impact of hedges, such data could be shown in satellite tables.

XI. Other Investment

584. *Other investment* is a residual category that includes all financial transactions not considered *direct investment*, *portfolio investment*, or *reserve assets*. Like *portfolio investment*, *other investment* is primarily divided into investments that represent the financial assets and liabilities of an economy. Within these asset and liability classifications, *other investment* transactions are further divided by instrument and resident institutional sector. Five types of instruments are identified in the BOP standard components: (1) trade credits, (2) use of at Fund credit and loans from the Fund, (3) other loans, (4) currency and deposits, and (5) other assets and liabilities. Each type of instrument is discussed in more detail in subsequent paragraphs.

585. Loans, deposits, and similar transactions between enterprises in a direct investment relationship are generally recorded as direct, rather than other, investment. However, as noted in chapter 9, when banks and other financial intermediaries are in a direct investment relationship, only those transactions relating to permanent debt and equity investment are recorded as *direct investment*. Therefore, the loans and deposits of such institutions are generally recorded as *other investment*, even if a direct investment relationship exists between the creditor and the debtor.

586. *Other investment* transactions include offsets to interest accrued but not paid on other investment.[27] Such interest is reflected as increased investment in the underlying instrument on which the interest has been earned. When an accrued amount becomes due for payment, this amount is reflected as a decrease in investment in the underlying instrument and offset by a transaction in foreign exchange or a similar instrument. If actual payment is not made, the decrease in the underlying instrument is offset by increased investment in the other assets or other liabilities items of *other investment*.

[27]Interest accrued but not paid on direct investment should be offset by an increase in non-equity direct investment, and interest accrued but not paid on portfolio securities should be "reinvested" in the securities.

Trade Credits

587. Trade credits are to assets and liabilities that arise from the direct extension, during the normal course of trading, of credit from a supplier to a buyer—that is, when payment for goods and services is made at a time that differs from the time when ownership of the underlying goods or services changes. Trade credit arrangements usually contain pre-specified limits on the amounts involved and the times at which payments must be made. Trade credits do not involve the issue of securities. Tradable securities (such as import and export bills) used to finance international trade should be classified as *portfolio investment*, rather than *other investment*, in the balance of payments. While the dividing line between trade credits and loans is not always clear, trade credits are ordinarily the result of ongoing or open book arrangements between purchasers and suppliers, whereas loans are specific agreements tailored to particular circumstances. Funding provided by an enterprise other than the supplier for the purpose of purchasing goods or services is generally regarded as a loan and not as trade credit.

588. There are two types of trade credit assets: (1) prepayments on imports and (2) trade credit extended on exports. Assets represented by prepayments on imports are extinguished upon delivery of the goods or services and assets represented by trade credit on exports are extinguished by actual payment (postpayment). Trade credit liabilities arise from the prepayment of exports or trade credit received on imports. Delivery of exports extinguishes the former and actual payment (postpayment) extinguishes the latter.

589. The following example illustrates the treatment of trade credit in the balance of payments. In a particular period, Clintonstan exports goods worth 1,000 units. Of this amount, 100 units were paid last period, 500 units are paid this period, and 400 units will be paid in the next period. Furthermore, payments of 130 units are received

for exports that will be delivered in the next period, and payments of 280 units are received for exports delivered in the previous period. The following entries would be made in Clintonstan's balance of payments:

	Credit	Debit
Goods	1,000	
Other investment		
Assets		
Trade credits	280	400
Liabilities		
Trade credits	130	100
Reserve assets (or other appropriate financial account item)		910

590. Trade credits can be measured directly or indirectly. Direct measurements can be made by approaching enterprises receiving or extending trade credits. Indirect measurement methods include the use of official records if, for example, trade credits are registered with a government organization for the purpose of monitoring foreign exchange. Another way of indirectly measuring trade credits in the balance of payments is to calculate the difference between actual imports and exports (as measured by customs authorities) and payments for imports and exports (as measured through the banking system). The disadvantage with the latter method is that it will not always be clear what part of the calculated trade credit transactions represents transactions in an economy's assets and what part represents transactions in an economy's liabilities.

Use of Fund Credit and Loans from the Fund

591. Membership in the International Monetary Fund provides countries that are experiencing BOP difficulties with opportunities to use credit extended by the IMF or to borrow money from the IMF. Generally, these arrangements with the IMF are conditional in nature; that is, a member country accessing IMF resources agrees to meet a set of conditions that are negotiated with the organization. Both Fund credit and loans from the Fund are denominated in SDRs.

592. Economically, the use of Fund credit and the use of loans from the Fund result in the same outcome—that is, the country entering into these agreements has access to foreign exchange in return for agreeing to meet a set of conditions. However, the two types of arrangements are actually executed in somewhat different ways. A loan from the Fund is simply an agreement by which the member country borrows foreign exchange with a commitment to repay. On the other hand, when a country uses Fund credit, the country "sells" its national currency to the IMF in return for foreign exchange. If the value of the country's national currency changes in relation to the SDR, "maintenance of value payments" are made in the country's national currency to maintain a constant SDR liability. Liabilities under Fund credit arrangements are extinguished when the country uses foreign exchange to "repurchase" its national currency. In the balance of payments, the IMF is not shown as having a claim on a country in the form of that country's national currency. Instead, the requirement for the national authorities to pay back the foreign exchange is recognized by a BOP presentation that shows the economic nature of these transactions. Furthermore, as this requirement is denominated in SDRs, the maintenance of value payments are not entered as transactions in the balance of payments because such payments simply represent the manner in which amounts converted to national currencies are revalued when these currencies depreciate or appreciate in relation to the SDR.

Other Loans

593. Loans are financial assets (1) created through the lending of funds by a creditor (lender) directly to a debtor (borrower); the lender receives no security evidencing the transaction or receives a non-negotiable document or instrument.[28] Included are loans (different from trade credits) to finance trade, mortgages, and other loans and advances. Financial leases and repurchase agreements are also considered loans.

594. Financial leases are included under loans as such leases are, in essence, a method of financing the purchase of goods. (Refer to chapter 4 for elaboration of the nature of financial lease arrangements.) The *BPM* recommendation on financial leases is that a change of ownership of the good being leased be imputed at the inception of the lease. In the BOP of the economy of the lessee, the entry for imports will be matched by an entry under ***financial account***-loans for the increase in

[28]The term *funds* refers to the provision of real and financial assets for which there exists an agreement specifying repayment terms.

financial liabilities. The value of the equipment, which should be the market value, and the value placed on the loan will be the same. The value of the loan will not necessarily equal the discounted value of future lease payments.

595. The lease payments contain two elements: (1) interest on the outstanding liability and (2) repayment of the loan liability. Upon termination of the lease, an entry is recorded for the extinguishment of any remaining liability. This entry is offset by a transaction in goods (if the leased goods are returned to the lessor) or a transaction in some other financial item (if the goods are legally acquired by the lessee).

596. The following example illustrates the treatment, in the balance of payments, of a financial leasing arrangement. At the commencement of a lease, the market value of the equipment being leased is estimated at 1,000 units. Lease payments are to run for nine years at an annual rate of 100 units. Ten percent of the first annual lease payment is estimated to be the interest, which declines as a proportion of total lease payments in subsequent years. The lease contract calls for the lessee to purchase the goods, at written-down value, at the termination of the lease. In the first year, entries for the balance of payments would be:

Lessee's Balance of Payments—first year

	Credit	Debit
Goods		1,000
Investment income-other investment		10
Other investment-liabilities-loans	1,000	90
Reserve assets (or other appropriate financial account item)	100	

In the second year, the entries would be:

Lessee's Balance of Payments—second year

	Credit	Debit
Investment income-other investment		9
Other investment-liabilities-loans		91
Reserve assets (or other appropriate financial account item)	100	

At the end of the lease, the written-down value of the asset is 155 units (the difference between the original 1,000 units and the repayment total of 845 units). The lessee pays this amount in foreign exchange to acquire legal ownership of the asset. Hence, BOP entries for the final period would be:

Lessee's Balance of Payments—final year

	Credit	Debit
Other investment-liabilities-loans		155
Reserve assets (or other appropriate financial account item)	155	

597. A repurchase agreement consists of the sale, made with the intention that the transaction will be reversed at a specified future date, of a security (such as a government bond) by one institution to another. In the balance of payments, repurchase agreements are treated as a form of securitized lending and not as transactions in the underlying securities. The economic nature of the transaction takes precedence over the legal form, and repurchases are classified as part of the loans item under *other investment* in the ***financial account***.

598. Loan repayments are recorded when due. If actual payment is not made upon the due date, the offset to the loan repayment is the creation of a short-term asset (from the creditor's point of view) or liability (from the debtor's point of view) to reflect the payment arrears. This asset or liability is recorded under the other assets or other liabilities items in the *other investment* component of the ***financial account*** and is extinguished when payment is finally made or when alternative arrangements are made between the creditor and the debtor.

Currency and Deposits

599. Currency consists of notes and coins in circulation. In this regard, an economy's external assets consist of notes and coins issued by foreign governments and held by residents. These notes and coins represent claims that holders have on issuing governments. An economy's external liabilities, in respect to notes and coins, consist of notes and coins that are issued by the economy's government and held by nonresidents.

600. For example, a Canadian shopkeeper accepts U.S. notes for purchases, and a U.S. traveler in Canada spends $100 with the shopkeeper. The Canadian resident has a claim on the U.S. government for the notes that she receives in the transaction. This transaction would be recorded in Canada's balance of payments as:

	Credit	Debit
Travel	100	
Other investment-assets		
Currency and deposits-other sectors		100

In the balance of payments of the United States, the following transactions would be recorded:

	Credit	Debit
Travel		100
Other investment-liabilities		
Currency and deposits-monetary authorities	100	

601. In practice, it will be often difficult for a country to determine the extent of nonresident holdings of its notes. This difficulty could lead to net errors and omissions in the balance of payments.

602. Deposits consist of transferable deposits and other deposits; however, negotiable certificates of deposit, which are classified as part of *portfolio investment* because of their tradable nature, are excluded from this item. Transferable deposits (or demand deposits) are exchangeable on demand at par without restriction or penalty and are freely transferable. Checking accounts generally satisfy the criteria for transferable deposits. Other deposits include: nontransferable savings deposits; time deposits; and deposits in savings and loan associations, credit unions, building societies, etc. These deposits are generally redeemable on demand or on short notice but cannot be readily transferred to another party by way of check or similar payment order. "Deposit accounts" that cannot be redeemed on demand or on short notice should be classified in the balance of payments as loans, rather than deposits, as their economic behavior is more akin to the former.

603. Deposits may be denominated in the domestic currency of the compiling country or in foreign currencies. The currency classification is not relevant for determining whether or not the deposits are recorded in the balance of payments. What is relevant is that a nonresident must hold a deposit with a resident financial institution (liability of the compiling economy) or a resident must hold a deposit with a nonresident financial institution (asset of the compiling economy) in order for transactions in deposits to be reflected in the balance of payments.

604. The following example illustrates the treatment of deposits. An importer in Cromania purchases goods worth 500 units from an exporter in Longa. Payment for these imports is made by a check drawn on the importer's bank account with a Cromanian resident bank. When the check is presented by the exporter, the funds are transferred to the exporter's bank account with the same bank. The transfer increases Cromania's deposit liabilities to nonresidents. The transaction would be recorded in Cromania's balance of payments as:

	Credit	Debit
Goods		500
Other investment-liabilities		
Currency and deposits	500	

Other Assets and Liabilities

605. Other assets and other liabilities are residual items that include all external financial assets and liabilities not recorded elsewhere in the ***financial account***. Among the types of assets and liabilities recorded in these items are:

household equity in life insurance and commercial pension funds;

miscellaneous accounts receivable and payable (for example, accounts relating to interest payments in arrears, loan payments in arrears, wages and salaries outstanding, prepayments of insurance premiums, taxes outstanding, etc.);

capital subscriptions to international nonmonetary organizations.

606. With regard to household equity in life insurance and commercial pension funds, premiums payable—minus the estimated service charge—are recorded as increases in policyholder claims on life insurance and pension funds; claims payable are recorded as withdrawal of investment. While most investments of this type are held over long periods, policies may also be "surrendered" prior to maturity. Such "surrendering" of policies is treated as withdrawal of investment as well. Life insurance and pension fund policyholders generally receive income (often referred to as *bonuses*) on their policies, and this income is reflected as an increase in the holder's investment in the fund. In the balance of payments, such bonuses are recorded as income receivable by the policyholder and offset by an increase in the policyholder's claim on the fund.

607. The treatment of life insurance and investment in commercially operated pension funds is discussed in chapter 5. However, another example may serve to elaborate this treatment. During a particular period, Hughesavian residents receive bonuses of 500 units on life insurance policies held with a

fund that is resident in Namdarb, and claims of 200 units became payable on these policies. Entries would be recorded thus in Hughesavia's balance of payments:

	Credit	Debit
Portfolio investment income-equity	500	
Portfolio investment-assets-equity	200	500
Reserve assets (or other appropriate financial account item)		200

608. With regard to payments in arrears, refer to chapter 6 (time of recording) and chapter 8 (exceptional financing) for a discussion of the BOP treatment of these transactions.

609. With regard to capital subscriptions to international nonmonetary organizations, amounts paid to international organizations in the form of grants should be recorded as transfers rather than as assets of the providing economy.

XII. Reserve Assets

610. *Reserve assets* are one of the four functional types of investment distinguished in the balance of payments. Reserve assets consist of financial instruments available to the central authorities for financing or absorbing an imbalance of payments or for regulating the size of such imbalances. (The authorities may regulate the size of imbalances by intervening in the market to influence the exchange rate of the national currency.) *Reserve assets* are distinctly different from other types of investments. The principal function of *reserve assets* is to provide or absorb the liquidity necessary to facilitate, by various means, the adjustment of an imbalance of payments between a country and the rest of the world. In addition, *reserve assets* may be held for other reasons. For example, *reserve assets* may be held to preserve confidence, to satisfy domestic legal requirements, or to serve as collateral for borrowing abroad.

611. *Reserve assets* determine some important aspects of the relationship between the International Monetary Fund and member countries. Reserve holdings are one of the factors on which a member country's quota is based, and such assets also affect a member country's eligibility to draw on its reserve tranche and to use Fund credit. Information on a country's reserve holdings is used by the IMF in the designation of SDRs.

612. Because *reserve assets* play an important role in the adjustment process and in relations between the IMF and member countries, there is considerable interest in fully assessing changes in member countries' stocks of reserves. (Such changes may be the result of transactions, the result of fluctuations in value, or the result of certain other occurrences unrelated to transactions.) Previous editions of the *BPM* addressed this interest through recommendations that supplementary information on total changes and valuation changes in reserve holdings be recorded in the BOP statement. However, in the fifth edition of the *BPM*, the conceptual framework was expanded to provide a means of assessing stocks (and changes in stocks) of reserves and all of an economy's external financial assets and liabilities. Accordingly, information relating to stocks of reserves (as distinct from transactions) can be obtained by analyzing the *reserve assets* component of an economy's international investment position.

Reserve Assets and the Adjustment Process

613. In theory, freely fluctuating exchange rates are sufficient to bring about continuous adjustments in imbalances of payments; it should not be necessary for *reserve assets* to play a significant role in the adjustment process. However, free-floating exchange rates may affect the established patterns of international trade and finance, existing legislation, the outlook for obligations under long-term international contracts, and similar circumstances of a structural nature. For many countries, the introduction of totally free-floating exchange rates would represent a disruptive and costly means of adjustment. Therefore, a broader range of adjustment measures, including a prominent role for reserves, is generally employed by these countries.

614. The monetary authorities of a country may adjust an imbalance of payments by a variety of means. In addition to expending or accumulating reserves, the authorities may finance imbalances directly through increases or reductions in net borrowing from official entities of other countries or from private financial markets. They may finance imbalances indirectly by encouraging other sectors of the economy to engage in financial transactions that are expected to offset imbalances. Moreover, a country's authorities may take recourse to regulatory measures (such as controls on capital flows) or intervene in exchange markets to move the exchange rate of the national currency towards a level consistent with their adjustment objective. The monetary authorities of a country can also adjust domestic interest rates to influence the exchange rate. When confronted with a serious imbalance of payments, monetary authorities usually do not confine themselves to a single adjustment option.

615. However, factors such as limited access to financial markets, domestic political and economic

considerations, or regard for other countries' concerns may constrain monetary authorities from exercising some options. Certain constraints (including those of exchange rate arrangements) arise directly from the obligations that member countries have under the Articles of Agreement of the International Monetary Fund.

616. The authorities of many countries cooperate with each other in numerous ways to facilitate adjustment of imbalances of payments. Cooperation may include exchanges of information, intervention in exchange markets as an agent of a partner country, ad hoc arrangements to avert developments of mutual concern, reciprocal swap agreements that can be activated on short notice between central banks, and permanent and formal monetary and exchange rate cooperation agreements between countries of a particular region. The most comprehensive cooperation occurs through IMF consultation procedures, which include input from the Fund's surveillance of exchange rate practices.

617. The options available for dealing with imbalances of payments and the circumstances under which countries must deal with them make the adjustment process a complex one for individual countries and for the world. Because of this complexity, it is often difficult for anyone (other than the monetary authorities themselves) to determine which of the actions taken actually led to the achievement of the desired adjustment during a particular phase.

618. Nonetheless, reserve holdings are prominently and continuously involved in the adjustment process—through financing, or intervention operations, or both. An accumulation of *reserve assets* or a decline in holdings may be interpreted as an early indication of, and response to, the aggregate surplus or deficit resulting from autonomous transactions (those undertaken for their own sake) between residents of an economy and the rest of the world. While reserve assets are not the only resources available to manage aggregate surpluses or deficits, reserves usually finance or absorb a significant portion of the corresponding imbalances in the very short term. Consequently, reserve holdings fluctuate with the evolution of surpluses or deficits. Monetary authorities may or may not consider these fluctuations to be cause for concern.

619. For example, during short periods, surpluses and deficits can be minor enough to offset each other. Small holdings of reserves are usually sufficient for coping with these limited fluctuations. Seasonal fluctuations that exhibit no discernible trend of increasing deficits or surpluses may also occur. In these instances, a country's monetary authorities determine—on the basis of observations concerning the effects, on the country's balance of payments, of seasonality and related factors—the level of reserves necessary to finance or absorb such imbalances in the short to medium term. If there is reasonable expectation of a surplus in the near term, the authorities might consider borrowing from abroad on a short-term basis to augment the country's reserves during deficit periods.

620. In the absence of factors with sufficient impact to effect relatively rapid self-adjustment in a country's imbalance of payments, reserve holdings finance or absorb the initial impact of the imbalance. However, there are limitations on the time and the extent to which reserve assets are employed in this way. Whether reserves are used in financing or in intervention operations, a country's monetary authorities normally do not permit reserve holdings to decrease below the level considered minimally appropriate or adequate for the country. A high priority objective of most adjustment policies is the maintenance of an adequate level of reserves and the restoration, in the course of the adjustment process, of depleted reserves. In view of the financial and psychological implications of permitting reserve holdings to decrease to critical levels, monetary authorities can be expected to implement alternative measures.

621. Monetary authorities often react rather cautiously to deviations, which could become cause for concern, from established BOP patterns. Although evolving imbalances are continuously monitored, decisions regarding the implementation of additional measures—and the determination of which measures are most appropriate—cannot be reached instantly. Time is required to assess the nature of developments, to implement corrective measures, and to permit corrective measures to take effect—especially as such measures are usually designed to avoid disruptive movements in exchange and financial markets and in other international transactions. *Reserve assets* are therefore continuously used (expended or accumulated, as the case may be) to finance or absorb rising imbalances and for intervention in exchange markets during transition

phases in which adjustments to more stable positions take place. When deficits are increasing, substantial reserve holdings allow the authorities to extend adjustment policies over longer periods.

622. The level of *reserve assets* appropriate for a particular country (referred to as the country's *demand for reserves*) depends upon factors such as the openness of the country's economy, the magnitude of fluctuations in its imbalance of payments, and the cost of holding reserves. Each of these factors can be measured or otherwise evaluated to provide the authorities of the country with guidance in developing and implementing reserve policies. The openness of an economy, which is a reflection of a country's interdependency with the world economy, can be determined by measures such as the ratio of the country's exports (or imports) of goods and services to gross domestic product. The volatility of a country's balance of payments can be measured by observations, which are made over time, of deviations from an average, and the cost of holding reserves can be measured by appropriate interest rate differentials.

623. A common measure of the adequacy of reserve holdings is the ratio of *reserve assets* to imports of goods. This ratio is sometimes expressed as the number of days' or weeks' or months' worth of imports that could be paid for from a specific stock of *reserve assets*. Such a measure must not, of course, be taken as a rigid standard; ratios can vary considerably from country to country. For example, although U.S. participation in international trade is extremely significant, the United States requires only a limited level of nongold *reserve assets* because of the dominant role of the U.S. dollar as a reserve currency. However, in many cases, the ratio of *reserve assets* to imports is useful for analyzing the adequacy of reserve holdings because the ratio relates *reserve assets* to the predominant component in many countries' external transactions. Moreover, trade statistics on goods are usually available sooner (and at more frequent intervals) than those for other current transactions.

624. In summary form, the principal attributes of *reserve assets* are:

(1) *Reserve assets*—the external assets available to the monetary authorities of an economy—are internationally recognized financial instruments that constitute the basis of a country's ability to deal with continuous imbalances (surpluses or deficits) arising from the economy's autonomous international transactions.

(2) *Reserve assets* are used to finance or absorb imbalances and to regulate the size of such imbalances through intervention, by a country's monetary authorities, in exchange markets to influence the exchange rate of the national currency.

(3) Excessive use of reserves—that is, to an extent that reduces or increases reserve holdings beyond an appropriate range—does not usually occur. In the event of persisting imbalances, monetary authorities generally engage in alternative or additional policies of adjustment.

(4) The principal function of reserves is to provide or absorb liquidity during a limited period while decisions are made and alternative measures of adjustment aimed at correcting imbalances arising from international transactions are implemented.

(5) The use of *reserve assets* thereby permits countries to avoid recourse to totally free-floating exchange rates or to restrictive regulatory measures. Either of these two responses to an imbalance of payments could adversely affect the international transactions of other countries, and the latter action could well be inconsistent with provisions of the IMF Articles of Agreement.

The Relationship Between Reserve Assets and Liabilities

625. In the *BPM*, *reserve assets* are defined as monetary gold held by the authorities of a country, the authorities' claims on nonresidents, holdings of IMF special drawing rights (SDRs), and a country's reserve position in the Fund. These four components are commonly referred to as the *gross external assets of the central authorities*.

626. To conceive of reserve assets solely as external assets is to concentrate on limited aspects of international liquidity. A concept of reserve assets that includes selected liabilities (usually some or all of the external liabilities of a country's monetary authorities) permits a more comprehensive view of BOP financing. ***Net reserves*** can, in fact, be considered a corollary of the analytic measure of an overall balance, which distinguishes autonomous transactions recorded "above the line" from accommodating transactions recorded "below the

line." According to this measure, reserve assets and selected official liabilities are the financing (or accommodating) items of the net surplus or deficit resulting from above-the-line (or autonomous) transactions.

627. Official liabilities included in net reserves are generally those incurred to finance deficits or extinguished to absorb surpluses. For example, in the event a country experiences an overall surplus, the monetary authorities may, with the concurrence of the creditor, elect to reduce outstanding liabilities—sometimes before the due dates—instead of accumulating reserves. Conversely, in the event of a deficit, the authorities may incur liabilities instead of expending *reserve assets*, or they may borrow *reserve assets* outright from the authorities of another country. Transactions in such reserve-related liabilities can be netted against transactions in *reserve assets*, and outstanding liabilities can be netted against holdings of *reserve assets* because such liabilities can be regarded as direct claims on the *reserve assets* of a country. By defining ***net reserves*** as those that include liabilities substituting for *reserve assets*, it is possible to measure reserves that are actually available.

628. To the extent that all such reserve-related liabilities are considered liabilities to foreign monetary authorities and to the extent that holders of corresponding claims regard such claims as *reserve assets*, there is symmetry in the relationship between official reserve-related liabilities and *reserve assets*. Such symmetry permits meaningful comparisons—between countries—of official settlements or overall balances and net reserve positions between countries, and regional or world aggregates of net reserve positions can be calculated in a consistent way.

629. In practice, however, there will be divergence from country to country regarding the types of claims that are considered reserves and the types of liabilities that are considered reserve-related liabilities. Indeed, there is no compelling reason to consider the notional border of the official monetary sector as the essential factor for determining which claims are regarded as reserve assets and which liabilities as reserve liabilities.

630. The most obvious case is that of claims on countries (especially the United States) with currencies typically held as *reserve assets*. In 1971, the United States officially declared that gold (its principal reserve asset) would no longer be exchanged for U.S. dollars held by foreign authorities. Even before 1971, *reserve assets* consisting of U.S. dollar claims of monetary authorities of other countries were regarded as reserve-related liabilities by the United States only if such claims were held in official U.S. securities. However, a large portion of such claims were and are held in the form of liquid claims on private banks in the United States.

631. Likewise, *reserve assets* held in the form of claims denominated in other major currencies are not necessarily claims on the monetary authorities of the countries issuing those currencies or direct claims against the *reserve assets* of those countries. To a large extent, *reserve assets* denominated in major currencies represent claims on private banks in countries issuing such currencies. Some claims may be officially guaranteed, or the exchange values of the claims may be guaranteed by the authorities of the debtor countries. The existence of such guarantees can be a factor in determinations of whether or not certain financial instruments are considered *reserve assets*. The fact that some claims held as *reserve assets* are claims against international financial institutions (such as the World Bank) also adds to asymmetries because corresponding official liabilities are not incurred by any country. Fortunately, such claims are relatively small and easily identifiable and thus do not pose practical problems for analyses based on the ***net reserves*** concept.

632. Another source of asymmetry is use of the degree of liquidity as a criterion to determine whether or not a claim is considered a *reserve asset*. Although application of this standard normally involves little variation in judgment, the authorities of one country may apply the standard in an extremely rigid way and the authorities of another may apply it more leniently. On the basis of liquidity considerations, some claims of one country may be regarded as reserve assets but the corresponding liabilities of another may not be considered reserve-related liabilities—and vice versa. Consequently, there may be asymmetrical recordings of the same types of claims under equally defensible positions.

633. On the other hand, not all reserve-related liabilities are owed to foreign monetary authorities. To supplement *reserve assets*, a country may, for example, borrow from private banks located abroad.

634. For the foregoing reasons, items shown under *reserve assets* in the standard components of the

balance of payments are restricted to gross reserves. Liabilities related to an economy's reserve assets are recorded under other BOP items.

635. Another type of liability related to *reserve assets* may be incurred through the use of Fund credit by member countries. In a sense, the availability of such resources makes them an extension of the *reserve assets* of these countries. If BOP problems arise, a member country may—after making a formal declaration of need—obtain the use of IMF resources through reserve tranche purchases or through various IMF facilities. In the case of reserve tranche drawings, conditionality is not an issue. To use Fund credit, however, the member country must propose and agree to implement reforms, which are reviewed and approved by the executive board, to ensure that the member's BOP problem will be solved in a manner consistent with provisions of the IMF Articles of Agreement and that there are adequate safeguards for the return of IMF resources. This conditionality is an important factor for classification of a country's transactions with the IMF. Transactions relating to a country's reserve position in the Fund are treated as part of the country's gross reserves. Transactions relating to the conditional use of IMF resources are treated as transactions in a liability related to reserves (rather than as transactions in reserves) and recorded as *other investment*-liabilities-use of Fund credit and loans from the Fund in the BOP ***financial account***.

636. An analysis of overall balances and net reserves may be undertaken on the basis of items classified according to the BOP standard components. All of the liabilities identified as liabilities of the monetary authorities, or liabilities of the resident official sector, or some of these liabilities (such as short-term loan liabilities of the resident official sector) may—with some degree of flexibility—be selected as financing items for constructing official settlements or an overall balance suitable for a particular country.

637. To provide further assistance for analyzing the financing of imbalances of payments, a special category of *exceptional financing transactions* is included in the Selected Supplementary Information table that accompanies the listing of BOP standard components contained in chapter 3. (Transactions in this category are also published in the *Balance of Payments Statistics Yearbook*.) The exceptional financing category highlights transactions undertaken with the recognizable intent of financing an imbalance of payments by means other than gross reserves. The financial flows shown in this category reflect a wide variety of alternatives to the use of *reserve assets* for financing imbalances. The alternatives range from long-term borrowing through bond issues, certain grants received, and temporary accumulations of payments in arrears. Nevertheless, this category emphasizes the exceptional nature of such financing. Exceptional financing transactions, including grants received from IMF-administered subsidy accounts and loans from the Fund, are discussed in detail in chapter 8.

638. Liabilities constituting foreign authorities' reserves (LCFAR) are also closely related to a country's reserves. LCFARs may or may not be included in the liabilities of the official sector. For example, a portion of the reserves of an economy may be held in the form of deposits with nonresident commercial banks. In this case, the bank liabilities represent LCFARs of the economies in which the banks are residents.

639. It is difficult to develop criteria for identifying LCFARs, and the nature of their relationship to *reserve assets* is not always clear. Nevertheless, it is useful (for example, for bilateral and international comparisons of reserve asset data) for the compiling (debtor) economy to attempt identification of liabilities considered by other countries to be part of their *reserve assets*. LCFARs, which are not reflected in the listing of BOP standard components, are shown in the accompanying Selected Supplementary Information table on pages 34–35.

640. In certain analytic presentations (including those of the IMF) of the balance of payments, LCFARs are grouped together with *reserve assets* and exceptional financing as below-the-line items, that is, as a means of financing imbalances of payments. Interpretation of the behavior of LCFARs depends on the purpose of the analysis and the factors that brought about the changes recorded in the balance of payments. Moreover, interpretations are sometimes uncertain. For example, an increase in a central bank's claims on a commercial bank may or may not indicate strength in the BOP position of the economy of the commercial bank. Nevertheless, changes in liabilities that are counterparts of another country's *reserve assets* can be relevant in understanding the global process of reserve creation and neutralization.

Coverage of Reserve Assets

641. According to the *BPM*, *reserve assets* cannot be unambiguously identified through the application of objective criteria. The readily observable characteristics—legal ownership, original contractual maturity of a claim, marketability, currency of denomination, and the like—are not sufficient to establish whether an asset is actually available to central authorities to use for financing imbalances or for intervention operations in exchange markets. *Reserve assets* must actually exist; foreign exchange that could be obtained through swap agreements, other lines of credit, or credit from IMF stand-by arrangements does not constitute an existing claim. Conversely, assets that are pledged, committed, earmarked, set aside in sinking funds, blocked, sold forward or otherwise encumbered by the holders are nonetheless existing assets and are not precluded on those grounds alone from constituting part of *reserve assets*.

642. What assets, in addition to those actually owned by the central authorities, can be considered effectively at their disposal? Which of the assets controlled by the central authorities are available for use if the need arises? The test inherent in the first question is an entirely domestic one. The authorities may achieve effective control (which is tantamount to having the assets at their disposal) over external assets by holding legal title to such assets or by exercising their statutory powers. The test inherent in the second question concerns requirements determined outside the reporting economy. If a country's central authorities consider specific external assets to be available for their use, such assets are usually considered by other countries to be at the disposal of the relevant central authorities.

Effective Control

643. As ownership of external assets is sufficient to establish control, the test of effective control can be confined to institutional arrangements that confer some measure of control on the central authorities when they do not legally hold title to the assets. Such arrangements exist in a number of countries. However, such arrangements often are not made for the exclusive purpose of placing external assets not owned by the central authorities at their disposal for use as reserves. Some countries maintain exchange controls primarily to forestall undesirable outflows of capital and thereby subject all dealings in external assets to explicit authorization. In many such countries, only official financial institutions and selected private banks may be authorized to hold and/or legally own external assets. In addition, effective control over these assets is maintained through terms specified by the authorities or through other forms of authorization under which such institutions are permitted to deal in external assets.

644. Controls of this type must actually be in force if the external assets are to be considered at the disposal of central authorities. For example, a statutory provision permitting the authorities of a country to introduce or to tighten (even on very short notice) regulations endowing them with control over external assets is not a sufficient indication that the relevant external assets are effectively controlled by the country's authorities.

645. However, control of the authorities over external assets owned by the private sector should not be interpreted as extending beyond the assets of depository institutions. It is unlikely that a country's authorities could obtain accurate and complete information about foreign exchange that is privately held outside the country's depository institutions. As information is a prerequisite to effective control, the exercise of control cannot meaningfully be extended into areas for which information cannot be obtained.

646. There are some countries where arrangements unrelated to exchange regulations provide the central authorities with effective control over external assets that they do not legally own. By comparison with the size of the economies, the official sectors of some countries are very large, and external assets may be held and owned by a variety of agencies that are part of the general government or closely associated with it. External assets may be held by state governments, various public financial or nonfinancial institutions, marketing boards, and similar organizations. Some of these institutions may be rather independent from the central authorities. Although they are part of the public sector, it cannot be assumed that their external assets are effectively controlled by the central authorities. Arrangements existing between the central authorities and these agencies should be examined to determine which of the external assets are at the disposal of the central authorities.

647. Arrangements subjecting external assets not owned by the central authorities of a country to their effective control must be definite in intent as well as actually in force. Arrangements that merely provide incentives to the owners of foreign exchange to

transfer their holdings to the central authorities are not a form of effective control.

648. Temporary transfers made on the basis of repurchase agreements or swaps often take place between central banks and private deposit banks. Those transfers of foreign exchange assets from private banks to the central bank are frequently implemented as "window dressing," and domestic liquidity is often the motive for transfers in the opposite direction. Effective control over such foreign exchange assets is, according to the *BPM*, exercised by a country's authorities for the period during which they hold the foreign exchange transferred to them by the private banks. Control of foreign exchange temporarily transferred to private banks remains in the hands of the authorities.

649. For external assets to be considered *reserve assets*, arrangements conferring control of them to the authorities of a country must be definite and in force. In addition, the assets must actually exist. Many countries prepare for contingencies by making arrangements (often reciprocal) to obtain additional foreign exchange reserves through lines of credit or reciprocal swap agreements between central authorities and also through stand-by arrangements with the IMF. Such arrangements are an important component of an adjustment strategy, but available lines of credit do not constitute reserves at the disposal of a country's authorities—unless, and to the extent that, drawings have actually been made on these facilities and *reserve assets* have thereby been created.

650. The issue of effective control pertains to all *reserve assets*, but only foreign exchange assets are actually subject to the procedures and criteria discussed in the preceding paragraphs. Unlike foreign exchange claims, monetary gold is, by definition, a *reserve asset*. While virtually all gold held as monetary gold is actually owned by various authorities, arrangements may sometimes exist under which gold is owned by others but effectively controlled by the central authorities. However, as monetary gold unambiguously constitutes reserves, it must be at the disposal of the authorities as it otherwise could not be classified as monetary gold.

651. The issue of effective control does not apply to reserve positions in the Fund. According to the terms of the Articles of Agreement of the International Monetary Fund, only the central authorities of member countries may hold reserve positions in the Fund. The articles, which constitute an international agreement, may be signed by sovereign countries only.

652. SDRs may be held only by the central authorities of IMF member countries and other holders designated by the IMF.[29] SDRs owned by other holders are not subject to the effective control of national authorities, even if the national authorities are members of international and regional bodies consisting of other holders.

Availability for Use

653. *BPM* references to the availability of *reserve assets* for use in the event of need pertain to a variety of situations and do not specifically address a particular one. For most countries, the need to use *reserve assets* can arise in the course of any business day. To be available for use in daily market transactions, assets must be free of conditions restricting subsequent use by those who accept these assets. Therefore, two elements constitute the acceptability (or the availability for use) of external assets:

(1) the universal use, which is determined by convertibility, that can be made of a specific asset;

(2) the immediate usability, which is determined by liquidity, that a specific asset affords.

654. References to the liquidity of external assets, especially in a context of international or world liquidity, almost automatically imply the notion of convertibility. Any asset that is immediately available but not freely convertible is not, in an international context, regarded as liquid.

Foreign Exchange, SDRs, and Reserve Position in the Fund

655. Liquid balances in convertible currencies are commonly held to meet immediate needs (usually in relation to requirements determined by the volume of day-to-day transactions but often in excess of actual requirements) and to provide a margin for unforeseeable fluctuations. Such deposits are now

[29]Other holders include the Bank for International Settlements, the International Bank for Reconstruction and Development, the International Development Association, the Andean Reserve Fund, the Arab Monetary Fund, the Central Bank of West African States, the Bank of Central African States, the Eastern Caribbean Currency Authority, the International Fund for Agricultural Development, the Nordic Investment Bank, the Swiss National Bank, the Asian Development Bank, the East African Development Bank, and the Islamic Development Bank.

held in a number of currencies—usually some or all of the major trading currencies such as the U.S. dollar, deutsche mark, Swiss franc, Japanese yen, pound sterling, French franc, and Netherlands guilder—and in other currencies in which significant settlements are regularly made. The medium for intervention in virtually all major exchange markets is the U.S. dollar—the currency in which a major portion of the foreign exchange holdings of other countries is often maintained. The composition of a country's foreign exchange reserves is determined by considerations of a practical nature and, in more recent years, by the objective of protecting the value of foreign exchange reserves from changes in the values of individual currencies.

656. SDRs, which are *reserve assets* created by the IMF, are equivalent to liquid balances in convertible currencies in nearly every respect. SDRs are as liquid as demand deposits and, within the limits set by the IMF's Articles of Agreement and By-Laws, unconditional in their convertibility. SDRs (the unit of account for all Fund accounting) can be used to settle financial obligations, to extend loans or make donations, and to obtain foreign exchange from other participants in the Fund's Special Drawing Rights Department or from other holders designated by the IMF. While the amounts and most of the terms associated with SDRs are determined by agreement between the transactors, SDRs cannot be exchanged for gold. The exchange rate calculated by the IMF is binding for all settlements.

657. Reserve positions in the Fund can also be considered liquid. While a member country must present a declaration of BOP-related need to make a purchase in the reserve tranche (reduction in reserve position), the IMF does not challenge a member's statement of need. Convertible currencies from a reserve tranche purchase may be made available within days. Paragraphs 674–679 include a discussion of the transactions associated with a member country's reserve position in the Fund.

658. In addition to liquid balances of foreign exchange, SDRs, and reserve positions in the Fund, most countries hold reserves in monetary gold and in the form of medium- or long-term claims. To minimize the costs of holding reserves, countries may invest assets in financial instruments that offer higher yields but less liquidity. In addition to holding external assets for reserve-related purposes, a country may also hold external assets (for example, investments in World Bank bonds, which provide development aid) for other reasons or purposes.

659. Although the presence of additional motives for holding external assets does not preclude such assets from qualifying as reserves, the test of availability for use in the event of need must, nonetheless, be passed. A judgment as to an asset's potential availability for use would have to follow an assessment of constraints that might be encountered were it necessary to transform such an asset into immediately usable liquid foreign exchange.

660. Objective criteria alone are often insufficient for determining the availability of external assets to be used as reserves. The degree of marketability of an asset that has a relatively distant maturity or conditionalities attached to an asset considered for classification as a *reserve asset* must be evaluated in the context of a specific situation to determine the impact that these factors have on the transformation of such an asset into a liquid one. Usually, it will be possible to express the degree of marketability of an asset in terms of the cost that arises from liquidation prior to maturity. The amount that an asset represents, as well as other conditions such as yield and time remaining to maturity, may require that the price be negotiated if the asset cannot be absorbed by readily acceptable bids from the market. The cost and time involved in the liquidation of an asset may vary with changing market conditions, but a realistic assessment of the asset's marketability in these terms is the only basis for judging the availability of an asset for use in the event of need.

661. Assets designated for specific uses cannot be excluded from reserves for this reason alone. On the other hand, assets redeemable only in inconvertible currencies or assets with uses restricted or blocked by the issuers are affected by conditions that the holders did not unilaterally impose and do not have the power to change. External assets held in the form of long-term loans extended to provide development assistance or to promote exports, deposits held in inconvertible currencies accumulated from export contracts at concessional terms, or repayments of loans extended under similar terms are among the more obvious examples of assets that could not, in virtually all conceivable circumstances, qualify as reserves.

Payments Agreements

662. In evaluations of the reserve character of foreign exchange assets, asset balances arising from

payments agreements are particularly difficult to categorize. Such agreements have commonly been used to facilitate exchanges of goods and services between countries when one or both of the relevant countries lack sufficient resources of convertible currencies to sustain such exchanges under regular market conditions. The terms of such agreements vary. Settlements of outstanding balances may take place at periodic intervals; or balances may be permitted to increase (swing) to certain ceilings, and amounts in excess of such ceilings must be settled when due.

663. Limited convertibility is the primary factor that leads to the exclusion (from *reserve assets*) of asset balances held in connection with arrangements of this kind. The very existence of payments agreement arrangements appears to be sufficient proof that assets (particularly those constrained by bilateral arrangements) in this form are not available for use in the event of imbalances of payments. However, some multilateral arrangements that are wider in scope may permit related asset balances to be available for use in the event of need. Moreover, the primary motivation for some of these arrangements is not the absence of sufficient resources in the form of convertible assets. Such agreements may even require the settlement of balances in convertible assets. The agreements contained in the framework of the Latin American Integration Association, for example, were primarily motivated by the desire to provide a stronger incentive for intra-regional exchange and an institutional mechanism for corresponding settlements. In presentations in the *Balance of Payments Statistics Yearbook*, asset balances arising from these agreements have therefore been recognized as part of the reserves of participating countries.

Monetary Gold

664. After a prolonged period of rapid growth in the market price of gold and the development of a significant gap between that price and the official price (based on the Bretton Woods system) of monetary gold, the official price of gold was abolished, as of April 1978, by the second amendment to the IMF Articles of Agreement. During the period of increasing disparities between official and market prices of gold, use of monetary gold as a reserve asset was severely curtailed because of the absence of a commonly accepted price.

665. Lack of common acceptance does not necessarily imply that the price of gold should have been a stable one; the prices of assets denominated in major trading currencies and even those denominated in SDRs also began to fluctuate as a result of floating exchange rates. However, changes in the value of this latter group of assets were commonly accepted because the prices of such foreign exchange assets were regarded as representative. This acceptance reflects the fact that the trading volume of such assets in relation to holdings of them was far greater than the trading volume of gold in relation to holdings of monetary gold.

666. The volatility, which resulted in part from the thin market, of the price of gold in turn imposed a constraint on the potential availability of monetary gold for use as a *reserve asset*. (Lack of availability is not characteristic of liquid *reserve assets*.) The price at which monetary gold was acceptable to the parties of a potential settlement had to be negotiated or otherwise determined before monetary gold could be deemed available for use.

667. The long-range objective, which is stated in the second amendment to the IMF Articles of Agreement, of making the SDR the principal *reserve asset* in the international monetary system also affected the use of monetary gold. Although price determination for monetary gold remains an open issue, the continued inclusion of monetary gold in the *reserve assets* category is unequivocal. Therefore, monetary gold should unambiguously be treated as part of *reserve assets*.

Other Claims

668. The other claims component of *reserve assets* includes any claims—other than holdings of monetary gold by monetary authorities, SDRs, reserve position in the Fund, and foreign exchange—that constitute *reserve assets*. For example, the foreign exchange component may not cover working balances of government nonmonetary agencies or external financial assets held by private banks and subject to control by a country's authorities.

669. In addition to these claims, the other claims component is used to facilitate reconciliation of presentations in the *Balance of Payments Statistics Yearbook*. The series on foreign exchange in the international liquidity section is published in

International Financial Statistics (*IFS*). As a publication presenting monthly data, *IFS* may not—for practical reasons—include minor asset positions for which it is sometimes difficult to obtain information on a current basis or at monthly intervals. Also, the data in *IFS* may occasionally pertain to the last workday—rather than the last calendar day—of a month, quarter, or year.

Transactions with the International Monetary Fund

Determination of Quotas

670. On joining the IMF, a country is assigned a quota. Quotas, which are stated in SDRs, are assessed on the basis of comparisons between the new member country's economic characteristics and those of other member countries similar in size. A member country's voting power, the quantity of IMF resources to which a country has potential access, and a country's share in allocations of SDRs are determined by quota size.

671. Each member country is required to pay 25 percent of its quota in SDRs or in currencies that are issued by other IMF members and are acceptable to the Fund. (In all cases, the currencies must be fully convertible.) This 25 percent portion of the quota determines the initial value of the member's reserve position in the Fund, which is a component of the member's *reserve assets*. In the balance of payments, a transaction involving a reduction in foreign exchange reserves (credit) would be offset by an increase in the reserve position in the Fund (debit). The 25 percent portion of the quota (minus the Fund's net use—if any—of the member's currency; see paragraph 674) also comprises a member country's reserve tranche. The other 75 percent of the quota is payable in the member's own currency. However, no payments are actually made at the commencement of membership. Rather, the member agrees that the IMF may have access to this amount if and when it is required. The country therefore opens an account for the Fund (typically called the Number 1 Account) in its central bank or issues to the IMF a non-negotiable security that can be cashed at any time. In economic terms, the 75 percent portion of quota represents a contingent liability of the member country to the IMF. Consequently, no transaction is recorded in the member's balance of payments. No interest is payable on either the deposit account or the security.

Change in Quotas

672. For two primary reasons, the IMF periodically reviews the size of member quotas. First, a general increase in quotas may be necessary so that the IMF can obtain additional capital to carry out operations. Second, it may be desirable to make adjustments in the relative sizes of quotas to reflect developments that take place in member countries' economies after quotas are initially assigned. If, as a result of such reviews, it appears that changes in quotas are necessary or desirable, the membership votes on the proposed changes. When sufficient votes are received in favor, quota changes take effect.

673. Transactions reflecting a change in a member's quota are similar to those that take place when the quota is initially paid. That is, 25 percent of the quota increase is normally paid in a currency acceptable to the IMF; the remaining 75 percent is payable in the member country's currency and made available to the IMF if and when the amount is required. Only the 25 percent paid in foreign exchange is recorded in the balance of payments as an increase in the member country's reserve position in the Fund (debit) and offset by a reduction in foreign exchange reserves (credit).

Other Transactions

674. A member country's reserve position in the Fund constitutes part of that country's *reserve assets*. Therefore, such reserves are available for use by member countries experiencing an imbalance of payments. To use its reserve position in the Fund to alleviate an imbalance, a country purchases foreign exchange from the IMF by "selling" its own currency to the Fund. In essence, there is an increase in the amount of the member country's currency available to the IMF. The "sale" occurs through an increase in the Fund's Number 1 Account with the member country's central bank or through the country's issuance, to the IMF, of a security with a value equal to the amount of currency "sold" to the IMF by the member country. The economic outcome of this transaction is a reduction in the member country's reserve position in the Fund. The reduction is offset by an increase in the member country's foreign exchange reserves. Both the reduction and the offset are recorded in the balance of payments.[30]

[30]In formal terms, a country's reserve position in the Fund equals the country's quota, minus the holdings in the Fund's Number 1 Account, of the country's national currency (or equivalent in securities), minus any outstanding purchases of Fund credit made by the country.

675. When a member country purchases foreign exchange from the IMF, the Fund often provides this foreign exchange from funds made available by another member country as part of that country's contribution to its quota. In these cases, the first country's reduction in its reserve position in the Fund is matched by an increase in the second country's reserve position in the Fund. For the second country, this transaction is offset by an increase in liabilities, which are denominated in the country's currency, to nonresidents.

676. A country that experiences BOP difficulties can "repurchase" its own currency with foreign currencies or SDRs when the situation improves. In such a case, the member country's foreign exchange holdings decrease (credit), and the decrease is offset by an increase (debit) in the country's reserve position in the Fund.

677. When a country exhausts its reserve tranche, it generally must make use of Fund credit to acquire additional foreign exchange from the IMF. As is required for use a of country's reserve position in the Fund, the country must demonstrate that it is experiencing an imbalance of payments. However, when a country uses Fund credit, it must also agree to adopt and adhere to IMF-approved policies. There is, in addition, a formal agreement for the country to repurchase its own currency during a specified period. These conditions make the use of Fund credit a transaction in the user's liabilities rather than in its assets. Accordingly, the use of Fund credit is classified as a loan liability under *other investment* in the ***financial account***. Further discussion on this issue is contained in chapter 11.

678. When a country's reserve position in the Fund exceeds a certain level, which is determined by application of a Fund-calculated ratio to the country's quota, the IMF pays the country "remuneration" on a quarterly basis. This remuneration represents income and is typically recorded in the recipient country's balance of payments as *investment income*-other investment-interest (credit) and offset by an increase in the foreign exchange component of *reserve assets* (debit).

679. As well as maintaining a Number 1 Account with a member country's central banks, the IMF typically maintains a second account. The Number 2 Account is used by the IMF for operational purposes and, unlike the Number 1 Account, is reflected in the balance of payments of a member country as an explicit liability. Transactions involving the Number 2 Account are recorded as increases or decreases in this liability and are offset by the source of funds (in the case of an increase) or the use of funds (in the case of a decrease). For example, when the IMF transfers funds from the Number 1 Account to the Number 2 Account in a member country, the member's balance of payments shows an increase in its reserve position in the Fund (debit). The increase reflects the reduction in IMF holdings of the country's currency in the Number 1 Account and is offset by an increase in the country's other investment liabilities relating to currency and deposits (credit). When the IMF uses funds from the Number 2 Account to pay for the acquisition of goods and services in a country in which the Fund maintains an office, the balance of payments of the member country shows a reduction in this account (debit) and an offset (credit) under *government services n.i.e.* in the **current account**.

XIII. The International Investment Position

680. The IIP statement shows, at a particular point, the stock of an economy's external financial assets and liabilities. An economy's external financial assets consist of claims on nonresidents and of monetary gold and SDRs held by the monetary authorities. The difference between an economy's financial assets and liabilities is the economy's net international investment position. When financial liabilities exceed financial assets, an economy has a negative net international investment position.

681. In concept, an IIP statement is similar to a balance sheet, which shows the assets, liabilities, and net worth of an economic unit at a particular point. However, there is an important difference between an economy's net international investment position and an economy's net worth. An economy's holdings of nonfinancial assets, which are not measured in the international investment position, are also included in the calculation of an economy's net worth. For most economies, the value of nonfinancial assets far exceeds the value of claims on nonresidents (plus SDRs and monetary gold).

682. There is a close relationship between the international investment position and the balance of payments. The BOP ***financial account*** measures an economy's transactions in external financial assets and liabilities. Obviously, these transactions have an impact on the stock of external financial assets and liabilities measured in the international investment position. However, over time, there are other factors (such as price changes) that also cause changes in stock values; the impact of these other factors is also reflected in the international investment position.

683. The international investment position is also closely related to the *investment income* component of the BOP **current account**. Investment income consists of income accruing on external financial assets and liabilities. If all other things are equal, the greater the stock of external financial assets and liabilities, the greater the investment income accruing on these financial assets and liabilities.[31]

684. There is also an indirect relationship between the BOP **current account** and the international investment position. Because of the double entry nature of the balance of payments, the current account balance must be offset by an equivalent balance (with opposite sign) in the **capital and financial account**.[32] As the ***financial account*** impacts directly upon the international investment position, to the extent that the ***financial account*** offsets the **current account** balance, the **current account** indirectly affects the international investment position. These aspects of the relationship between the international investment position and the balance of payments are explored in further detail in paragraphs 690–702.

Balance Sheets and the International Investment Position

685. A balance sheet shows, at a particular point, an economic unit's assets, nonequity liabilities, and net worth. Net worth is equal to the difference between assets and nonequity liabilities. The net worth of an enterprise consists of enterprise assets attributable to the owners.

686. In theory, a balance sheet exists for all economic units—that is, the government, enterprises, and households—within an economy. As shown in illustration 13.1, a balance sheet can be divided into components and sub-components. Assets can be split into real and financial assets; the latter can be divided into claims on residents and claims on nonresidents. Nonequity liabilities can be classified as liabilities to residents and liabilities to nonresidents. The net worth (which is also called *equity*) of an enterprise can be divided into net

[31]Income accrued will also depend on other factors, such as the general level of interest rates and the perceived riskiness of investment.

[32]The balances of the two accounts will be equal with opposite signs if there are no net errors and omissions.

Illustration 13.1 Components of a Balance Sheet

Assets	Liabilities
A.1 Real assets (e.g., land, machinery, consumer durables, inventories)	L.1 Nonequity liabilities to residents L.2 Nonequity liabilities to nonresidents
A.2 Financial assets A.21 Claims on residents in the form of equity A.22 Other claims on residents A.23 Claims on nonresidents, SDRs, and monetary gold	Net worth N.1 Net worth of enterprises attributable to resident owners N.2 Net worth of enterprise attributable to nonresident owners N.3 Net worth of households and government

worth attributable to resident owners and net worth attributable to nonresident owners.

687. If balance sheets could be prepared for all economic units within an economy, a balance sheet could be derived for the economy as a whole. Such a derivation would involve two steps: (1) the summation of balance sheet items from all economic units and (2) consolidation. Consolidation results in the cancellation of offsetting assets and liabilities involving two resident counterparts. For example, a household has a deposit account with a resident bank. The account is shown as an asset on the household's balance sheet and as a liability on the bank's balance sheet. However, the assets and liabilities of the economy as a whole are not affected by this position. Therefore, this position can be eliminated from the balance sheet of the economy.

688. Consolidation, on an economy-wide basis, of the balance sheet entries shown in illustration 13.1 would eliminate the entries for A.21, N.1, A.22, and L.1. After consolidation, an economy's balance sheet could contain the entries shown in illustration 13.2.

689. The entries denoted A.23 (financial assets—claims on nonresidents, SDRs, and monetary gold), L.2 (nonequity liabilities to nonresidents), and N.2 (net worth attributable to nonresident owners of enterprises) in illustration 13.2 are recorded in an economy's international investment position. However, calculation of an economy's net worth (entry N.3 in illustration 13.1) requires consideration of an economy's real assets (entry A.1). In other words, an economy's net worth is equal to its net international investment position plus its holdings of real assets.

The Relationship Between the International Investment Position and the Balance of Payments

690. The international investment position measures an economy's stock of external financial assets and liabilities; the BOP ***financial account*** measures transactions in these assets and liabilities. Transactions in assets and liabilities also affect the stock of these assets and liabilities. For example, on January 1, an enterprise has $100 in a bank account and, on January 15, deposits (transaction) another $15. On January 31, the value (stock) of the enterprise bank account has obviously been affected by the transaction. In fact, as there are no other transactions and no other changes, the stock of financial assets at the end of January is equal to the

Illustration 13.2 Consolidated Balance Sheet of an Economy

Assets	Liabilities
A.1 Real assets (e.g., land, machinery, consumer durables, inventories) A.23 Financial assets—claims on nonresidents, SDRs, and monetary gold	L.2 Nonequity liabilities to nonresidents
	Net worth N.2 Net worth of enterprises attributable to nonresident owners

stock of financial assets at the beginning of January plus the deposit transaction.

691. However, an enterprise may own an asset with a market price that changes on a day-to-day basis. For example, on January 1, an enterprise owns 10 shares in another corporation and, on that date, the stock market price of these shares is $10 per share. The value of enterprise holdings is therefore equal to $100 (10 x $10). During January, the enterprise does not purchase or sell any shares and, on January 31, the stock market price of the shares has increased to $12 per share. The value of enterprise holdings on January 31 is therefore $120 (10 x $12). In other words, a change attributable to price changes, which are not recorded in the balance of payments, occurred in the stock of financial assets. Therefore, an international investment position can, over time, change as a result of factors that are not reflected in the balance of payments.

692. Other non-transaction changes also occur. External financial assets or liabilities may be denominated in currencies other than the currency (the unit of account) in which the international investment position is prepared. Changes in the rates at which the other currencies and the unit of account are exchanged consequently affect the values of assets or liabilities. For example, Cromania compiles its international investment position in Cromanian dollars (C$) and on an annual basis. On December 15, 1993, a Cromanian bank borrows US$ 1,000 from a German bank. At the end of 1993, the C$/US$ exchange rate is C$ 1 = US$ 1. Therefore, the value of Cromania's liability (measured in its international investment position in terms of Cromanian dollars) at the end of 1993 is C$ 1,000. There are no further transactions in 1994. At the end of 1994, Cromania's exchange rate depreciates to C$ 1 = US $0.8, and the value of Cromania's liability (in terms of C$) increases to C$ 1,250. Thus, the values shown in Cromania's international investment position changed over time even though there were no transactions.

693. The foregoing example illustrates an important result. When the unit of account *depreciates* against the currency of denomination, the impact—in terms of the unit of account—of exchange rate changes will be *positive*. The corollary is that when the unit of account *appreciates*, the impact of exchange rate changes will be *negative*.

694. In addition to transactions, price changes, and exchange rate variations, other adjustments may have an impact on the level of an economy's external financial assets and liabilities. These adjustments include the allocation or cancellation of SDRs, the monetization or demonetization of gold, reclassifications, write-offs, and measurement errors.

695. Even though monetary gold and SDRs are not claims on another party, by convention, these items represent financial assets. However, because monetary gold and SDRs do not represent claims, there are no transactions associated with the creation or extinguishment of these instruments.[33] Nevertheless, the creation or extinguishment of these instruments does have an impact on the changes in values shown in IIP statements.

696. Reclassifications (typically resulting from changes in investment motivations of creditors) of assets and liabilities affect the composition of IIP statements. Such reclassifications are not considered transactions as there is no provision of economic values by one party to another. For example, an investor purchases, for $600, 6 percent of the shares of a nonresident enterprise. A week later, the investor purchases, for $500, another 5 percent of the shares of the same enterprise. The first transaction is classified as *portfolio investment*. The second transaction, which raised the investor's shareholding above the 10 percent threshold, is classified as *direct investment*.[34] The 6 percent of shares purchased in the first transaction is then reclassified from *portfolio investment* to *direct investment* as these shares now constitute part of the direct investment shareholding. The reclassification is *not* recorded in the balance of payments; it is a non-transaction adjustment that explains the change in IIP statements from one period to the next.

697. In addition, write-offs of bad debts are not considered BOP transactions. However, such write-offs affect the values of financial assets and are reflected in non-transaction adjustments that explain changes in IIP statements from period to period.

698. In practice, measurement errors also have an impact on the reconciliation of statements. Such errors may arise from—for example—the use of

[33]A transaction consists of the transfer of economic value from one economic unit to another. As the creation and extinguishment of SDRs and monetary gold do not involve such transfers, no transactions take place. In the fourth edition of the *BPM*, creation and extinguishment of these instruments were considered transactions. However, to preserve the double entry nature of the system, corresponding and offsetting notional counterpart entries were required.

[34]Direct investment transactions include those transactions that establish the direct investment relationship.

Table 13.1 Reconciliation of Essendonia's IIP Statements

Item	Position as of December 31, 1994	Changes in Position Reflecting: Transactions*	Price Changes	Exchange Rate Changes	Other Adjustments	Position as of December 31, 1995
Assets						
Direct investment	1,100	+106	+94	+203	+35	1,538
Portfolio investment	850	+328	+78	+162	–35	1,383
Other investment	2,320	–1,345	—	+384	–13	1,346
Reserve assets	1,640	+32	+107	+322	+72	2,173
Total	**+5,910**	**–879**	**+279**	**+1,071**	**+59**	**6,440**
Liabilities						
Direct investment	3,104	–158	–45	+95	–16	2,980
Portfolio investment	252	+29	+12	+13	+18	324
Other investment	2,445	+866	—	+242	+7	3,560
Total	**5,801**	**+737**	**–33**	**+350**	**+9**	**6,864**
Net International Investment Position**	**109**	**–1,616**	**+312**	**+721**	**+50**	**–424**

*A positive sign denotes a net increase in assets or liabilities; a negative sign denotes a net decrease. This sign convention differs from that used in BOP statistics.

**Assets minus liabilities

different sources to measure stocks and transactions, reporting errors made by data providers, or sampling. If different samples are used to measure stocks and transactions, or if there are changes from period to period in samples used to measure stocks, the sample error present in any sample survey contributes to reconciliation errors. Although some measurement errors may be unavoidable, they should be kept to a minimum. Any significant, unexplained changes in IIP statements should be investigated and resolved.

699. Period-to-period changes in a country's international investment position can be explained in terms of BOP transactions, price changes, exchange rate changes, and other adjustments. To facilitate analysis of both the international investment position and the balance of payments, countries are encouraged to publish—at least for broad aggregates—tables showing the reconciliation of changes in the international investment position. An example is provided in table 13.1.

700. The international investment position is also closely related to the *investment income* component of the **current account**. This component measures income accruing on an economy's external financial assets and liabilities. The relationship between stocks and income is often expressed in terms of yields, which—in simple form—can be determined by expressing income as a percentage of the average stock of investment to which that income relates. The higher the yield, the greater the rate of return on an investment. Yields are affected by many factors, including (in the case of dividends and other types of income in the form of profits) the profitability of the enterprise in which an investment is made, the general level of interest rates pertaining to the currency in which the investment is denominated, and the riskiness of the investment. The yield on a particular investment may change over time—as a result of changes in the market value of the investment or in the income accruing on the investment—or the yield may remain fixed. The yield remains fixed (1) when the market value of an investment is not subject to price changes (as is typically the case with instruments like deposits and loans) and the income is fixed or (2) when relative changes in the value of an investment and the income on the investment are the same.

701. Because of the important relationship between stocks recorded in the international investment position and *investment income*, analysis of the international investment position and the balance of payments is often enhanced by presenting these two sets of statistics together. For example, table 13.1 could be usefully augmented by the addition, on the right-hand side of the table, of a column listing the

Illustration 13.3

	Stocks				Valuation Changes*		
	Beginning of Period	End of Period	Change	Transactions*	Total	Price	Exchange Rate
In millions of £stg.	10.00	11.20	+1.20	–2.40	+3.60	+3.60	—
Exchange rate	1.7	1.6		1.75		1.8	
In millions of $Z	17.00	17.92	+0.92	–4.20	+5.12	+6.48	–1.36

*A positive sign denotes a net increase in assets; a negative sign denotes a net decrease. This sign convention differs from that used in BOP statistics.

investment income accrued on Essendonia's external financial assets and liabilities during 1995.

702. There is no direct relationship between IIP and BOP transactions other than those recorded in the ***financial account*** or as *investment income*. However, there is an indirect relationship because, in the BOP double entry accounting system, the balance recorded in the ***financial account*** must be matched by a balance of the same magnitude but opposite sign in all of the other items. Therefore, to the extent that a BOP entry made outside the ***financial account*** has an offsetting entry in the ***financial account***, the **current account** transaction affects the international investment position.

Calculation of Price and Exchange Rate Changes

703. The impact of price changes on an economy's external financial assets and liabilities can be directly measured only in exceptional circumstances, and the impact of exchange rates can never be directly measured. Therefore, to show these items in the IIP reconciliation, the compiler (or data provider) typically resorts to indirect measurement. The following example illustrates the calculation of such valuation changes.

704. At the beginning of an accounting period, the central bank of Zebraland holds 10 units, each valued at £stg. 1 million, of British government securities. During the period, 2 units are sold at the market value of £stg. 1.2 million each. The remaining 8 units further appreciate in market price, to £stg. 1.4 million each, by the end of the period.[35] The exchange rate of the pound sterling (£stg.) vis-à-vis the Zebraland dollar ($Z), which is the unit of account used to compile Zebraland's IIP and BOP statistics, is £stg. 1 = $Z l.7 at the beginning of the period, £stg. 1 = $Z l.75 at the time of the transaction, and £stg. 1 = $Z l.6 at the end of the accounting period. The average exchange rate for the period is £stg. 1 = $Z 1.8. For Zebraland, the values (expressed in millions of £stg and in millions of $Z) of stocks, transactions, and valuation changes in these securities are shown in illustration 13.3.

705. Stock data at the beginning and end of the period and transaction values were calculated in terms of Zebraland dollars by applying the relevant exchange rates shown in the table. The total change in stocks was derived by calculating the difference between opening and closing balances. The total valuation change was derived as a residual by deducting transactions from the total change in stocks. As shown in the table, the total valuation change consists of two components. The valuation change reflecting—in terms of the transaction currency (pounds sterling)—the change in the price of the financial claim is equal to the total valuation change because exchange rate changes do not have any influence on this item. The price change in Zebraland dollars was calculated by multiplying the price change in pounds sterling by the period average for the rate at which pounds sterling and Zebraland dollars were exchanged.[36] The valuation change reflecting the change in the exchange rate of the transaction currency vis-à-vis the recording unit of account was derived as a residual. Both types of valuation changes in an economy's external financial assets and liabilities are excluded from the balance of payments.

706. The foregoing example contained no other adjustments, such as reclassifications or write-offs. If

[35]For the sake of simplicity, it is assumed that the increase in the market value of the securities is not attributable to interest accrued but not due for payment. Such interest would be recorded as a transaction in the balance of payments; see chapter 6 of the *Textbook* for further details.

[36]The exchange rate prevailing on the date that a valuation change occurs should theoretically be used to convert a valuation change denominated in one currency to another currency. In practice, it is unlikely that the compiler will have access to such detailed information on the timing of valuation changes. Therefore, period average exchange rates are used in the example.

required, such adjustments are deducted, along with transactions, from the total change in stocks in the calculation of valuation changes. Other adjustments are converted from the currency of denomination to the unit of account by using the exchange rate prevailing on the dates the adjustments took effect. If such information is unavailable, period average exchange rates could be used.

707. In practice, the collection of statistics on valuation changes can sometimes be very difficult. To compile these figures on the basis of balance sheet data only, the compiler must know the amount outstanding whenever a change in the market price took place. This information must include any change resulting from fluctuation—in relation to the unit of account in which the BOP statement is compiled—of the exchange rate for the currency in which the asset is denominated. This method of measuring valuation changes is not feasible in a period when exchange rates fluctuate frequently. Therefore, it is suggested that compilers collect data on transactions, and that valuation changes be calculated by deducting transactions from changes derived from opening and closing balances. In addition, allowance should be made for reclassifications or changes in coverage of the economy or its residents because these changes also affect the outstanding amounts of external assets and liabilities.

708. When the unit in which a financial item is denominated differs from the unit in which the BOP statement is expressed, total changes in value should be calculated by first converting the outstanding amounts to the desired unit of account and then calculating the difference. The impact of exchange rate changes on total changes in stocks can only be derived as a residual.

Classifying the International Investment Position

709. The primary type of classification in an economy's IIP statement is the distinction between assets and liabilities. For *portfolio investment*, *reserve assets*, and *other investment*, assets and liabilities are measured on a strict gross basis. For *direct investment*, a directional basis (abroad or in the reporting economy) of measurement is used. Recorded under assets is an economy's direct investment abroad, which is equal to the claims of resident direct investors on direct investment enterprises located abroad minus the claims of these direct investment enterprises on the resident direct investors. Recorded under liabilities is direct investment in the compiling economy, which is equal to the claims of nonresident direct investors on direct investment enterprises located in the reporting economy minus the liabilities of the nonresident direct investors to the resident direct investment enterprises.

710. The second level of classification applied to the international investment position is that of function. Four functional types of investment are identified: *direct investment*, *portfolio investment*, *other investment*, and *reserve assets*. The definitions of these functional types of investment are the same for the international investment position and the balance of payments.

711. The third level of classification in the international investment position is by instrument of investment. Different instruments of investment are identified for different functional types of investment. For example, *direct investment* is divided into (1) equity capital and reinvested earnings and (2) other capital; *portfolio investment* is divided into equity securities and debt securities (bonds and notes, money market instruments and financial derivatives). The definitions of each instrument are the same for the international investment position and the balance of payments.

712. Instruments recorded as *portfolio investment* and *other investment* are further subdivided by domestic sector. For assets, this sector is that of the asset holder. For liabilities, the sector of the debtor is recorded. The trade credits, loans, and other components of *other investment* are also cross-classified by original maturity—that is, long- or short-term.[37]

713. The classification systems adopted for the international investment position and the BOP ***financial account*** are closely related and very similar. The main difference between the two is the type of primary classification. The international investment position is divided primarily into asset and liability components; the BOP ***financial account*** is divided primarily by functional type of investment. A close relationship also exists between the classification of *investment income* in the BOP **current account** and in the IIP classification,

[37]A number of countries cross classify debt instruments by residual, as well as original, maturities, although no such classification is shown in the BOP standard components. Residual maturity comprises the time remaining from the date of an IIP statement to the expiration of a financial instrument.

although the former is far less detailed (in terms of BOP standard components) than the latter.

Valuation of the International Investment Position

714. The principle of valuation used in compilation of the balance of payments and the international investment position is *market valuation.* Such consistency is important when analysis of both sets of statistics is undertaken concurrently.

715. In the *BPM,* market prices are defined as *amounts of money that willing buyers pay to acquire something from willing sellers; the exchanges are made between independent parties and on the basis of commercial considerations only.* This definition obviously pertains to transactions, and the international investment position measures stock positions. When transactions in financial assets and liabilities occur on or very close to the reference date for the international investment position, the market prices pertaining to the transactions are good measures of the market prices of the stock positions attributable to the transactions. However, for stock positions for which there are no very recent transactions, alternative measures of market value are necessary. For instruments that are readily tradable, the mid-point of bid and offer rates (typically available from an organized exchange) on the date for which the international investment position is being prepared or the recent transaction price of a similar instrument could be used. A range of market value proxies, which are discussed subsequently, could be used for other types of instruments.

Equity Instruments (other than life insurance)

716. It should be possible to value positions in equity investments involving shares (stocks) in publicly traded enterprises by using information from stock exchanges on bid and offer rates or recent transaction prices. This method will probably be possible for most *portfolio investment* and some instruments classified under *direct investment*-equity. For valuing other types of equity investment (for example, equity investment by a parent enterprise in a wholly owned subsidiary), alternative methods should be used. Probably the best alternative method is the *net asset value method.*

717. The net asset method of valuation involves subtracting the value of enterprise nonequity liabilities from assets; the difference is equal to enterprise net asset value attributable to shareholders. Net asset value divided by the number of shares outstanding equals net asset value per share; to establish the value of a particular shareholder's investment, the number of shares held by the investor is multiplied by the net asset value per share.[38]

718. To obtain—by the net asset value method—good quality estimates of the market values of investments, enterprise assets (in particular) and nonequity liabilities must be valued at current market prices and not at historical cost. If enterprise accounts are not prepared on this basis, the compiler could, in significant cases, seek supplementary information from the enterprise in order to make the necessary adjustments.

719. If an enterprise is unable to provide such information, the compiler could adjust those components of the enterprise balance sheet most likely to be subject to price changes. The compiler could make such adjustments by using information about (1) the times at which assets were acquired or liabilities incurred and (2) price movements (typically established from price indexes) for the particular class of asset or liability.

720. Alternatively, the compiler could establish an estimate of the market value of an equity investment by using price movements for a similar type of investment to adjust transactions associated with that investment. For example, in 1990, a direct investor acquires 50 percent of an enterprise in the chemical industry for $100 million. Between 1990 and 1994, the price of publicly traded shares of chemical enterprises increases by an average of 35 percent. The market value of the direct investor's holding at the end of 1994 could then be estimated at $135 million.[39] More sophisticated models could be developed. For an example, see the model discussed in paragraphs 721–722 of the *Balance of Payments Compilation Guide* for measuring the stock of direct investment in land. For a general discussion of deriving stocks from transactions in the area of portfolio investment, see paragraphs

[38]This method is based on the assumption that each share carries equal weight. If each share does not, the calculation of net asset value per share should be amended accordingly.

[39]When such an approach is used to measure direct investment, it will probably be necessary to adjust the price increases observed in related investments for the component of the price increase attributable to reinvested earnings, which are recorded as transactions in BOP statistics.

740–743 of the *Guide*. Another possibility for establishing the market value of equity investment is to obtain a directors' valuation of the enterprise.

Life Insurance

721. The surrender values of life insurance policies represent possible proxies for the market values of these policies. The surrender value is the amount that an insurance enterprise would pay a policyholder to redeem a policy prior to the expiration of the policy term.

Financial Derivatives

722. Options should be valued on the basis of market prices prevailing on the date on which the IIP statement is prepared. If no market exists for a particular type of option, market value can be approximated by using a financial formula known as the Black-Scholes formula. (This formula is quite complex; however, compilers need not understand its exact nature.) Most organizations with significant options operations use (in their balance sheets or supplementary accounts) this or similar formulae to value their positions. Therefore, in practice, the compiler should accept the valuation of option positions provided by principals unless there is serious doubt as to the validity in terms of market valuation principles.

723. For the international investment position, financial derivatives other than options are valued by reference to market prices of similar instruments. If the derivatives being valued are traded infrequently, they could be valued by calculating the net present value (NPV) of the future transactions and receipts expected under the contract. (For an explanation of NPV, see illustration 13.4.) If the NPV of future transactions is positive—that is, net receipts are expected—the derivative contract should be shown in the international investment position as an asset. On the other hand, if net payments are expected, the contract should be shown as a liability. Enterprises with significant positions in derivative contracts will, at least in management reports, probably value derivative positions in a similar manner.

Other Securities

724. Current market prices should be used to value other types of tradable investments (e.g., bonds and bills) for IIP positions. For debt securities not readily tradable, the NPV (as described in illustration 13.4) of future payments could be used to estimate market value. Alternatively, such debt securities could be valued at issue prices, plus the amortization of any discounts or premiums, plus any non-discount interest accrued but not due for payment.[40] (The amortized discount or premium would be reflected as income in enterprise accounting records and used to adjust the balance sheet value of the asset or liability.) The values derived from this method differ from those derived by using the NPV method to the

Illustration 13.4 Net Present Value (NPV)

The **net present value** (NPV) of any financial instrument can be established by dividing the expected net future receipts (that is, receipts minus payments) associated with the instrument by a relevant discount factor. The discount factor is the compound interest rate relevant to the currency in which the instrument is denominated and to the debtor institution. For example, if the interest rate for U.S. dollars applicable to a particular enterprise is 10 percent per annum, payments due in two years should be divided by 1.21 (1.1^2) to establish the present value of those payments.

Formally:

$PV = FA((1 + i)^n)$ in which

PV = present value

FA = future amount receivable or payable

i = an appropriate interest rate (expressed as a decimal)

n = number of periods before amount becomes due

$NPV = SUM(PV_R) - SUM(PV_P)$ in which

PV_R = present value of future amounts receivable

PV_P = present value of future amounts payable

If the NPV of an instrument is positive (that is, the PV of future amounts receivable is greater than the PV of future amounts payable), the instrument is a financial asset. If the NPV is negative (that is, the PV of future amounts receivable is less than the PV of future amounts payable), the instrument is a liability.

[40] For any period t, the value of a discount (or premium) amortized for that period can be calculated as:

$AD_t = ((\text{Discount} * i) / ((1 + i)^n - 1)) * ((1 + i)^{(t-1)})$ in which

AD_t = amortized discount applicable to period t

n = number of periods in life of security

i = (percentage interest rate prevailing at time of issue) / 100

Therefore, an estimate of the value of a security could be derived by summing the discount (or premium) amortized for each period and adding this amount (plus any non-discount income accrued but not due for payment) to the issue price.

extent that interest rates change between the date a security is issued and the date for which the international investment position is being compiled. On conceptual grounds, the NPV method is preferred.

725. Alternatively, it may be possible to derive stocks of investment from transactions. (See paragraphs 740–743 of the *Balance of Payments Compilation Guide* for further information.)

Monetary Gold, SDRs, Reserve Position in the International Monetary Fund, and Use of Fund Credit and Loans from the Fund

726. Monetary gold is valued, in the international investment position, by reference to prevailing market prices for gold; monetary gold should not be valued at acquisition price or some other notional value such as SDR 35 per ounce. Holdings of SDRs are valued at face value (in SDRs) and converted to the unit of account as appropriate. The valuation of a country's reserve position in the Fund is based on the IMF's calculations (in SDRs) and converted to the unit of account as appropriate.[41]

727. A country's use of Fund credit is also valued according to IMF calculations. In national currency terms, this amount equals the value of any purchases plus "maintenance of value payments" prescribed by the IMF. These maintenance of value payments maintain a constant position in SDR terms and are treated as exchange rate changes, rather than transactions, in the IIP reconciliation (in national currency terms). Loans from the Fund are valued according to the amount outstanding (in SDRs) and converted to the unit of account as appropriate.

Loans Traded in Secondary Markets

728. In recent years, loans to a number of heavily indebted countries have been subject to significant discounts in secondary markets. To conform with the market value principle, secondary market quotations—not legal obligations—are the basis for valuation of positions in these instruments. However, debtor countries are likely to value obligations on the basis of amounts that they are contractually obliged to repay, and this practice leads to asymmetries between debtor and creditor positions.

Other Instruments

729. For IIP purposes, other (nontradable) assets and liabilities (such as loans, deposits, currency, and trade credits) are valued on the basis of the face value of amounts outstanding plus any interest accrued but not due for payment. In general, such values are considered acceptable proxies for market values.

730. Because the values of nontradable debt instruments are typically not subject to price changes, the procedure for deriving stocks from transactions is relatively straightforward if the compiler has information on the currencies in which the instruments are denominated. If the compiler has a base period estimate of stocks, he or she simply adjusts for any write-offs, reclassifications, or other non-transaction adjustments in order to derive estimates of stocks of investment (in the currency of denomination) for successive periods. These estimates of stocks are converted to the unit of account by using the exchange rates applicable to the dates to which the estimates relate. The impact of exchange rate changes can then be derived as the difference (in the unit of account) between IIP statements and transactions (plus, when necessary, other adjustments).

A Practical Example of IIP Compilation

731. The following example illustrates the nature of the international investment position and the kind of information that could be used to construct an IIP statement. The example contains information available to the BOP compilers of Zebraland and the December 31, 1991 IIP statement derived from this information.

(1) BOP compilers in Zebraland prepare a consolidated balance sheet dated December 31, 1991. This consolidated balance sheet is based on balance sheets prepared, on a historical cost basis, by the direct investment enterprises in Zebraland. All direct investment enterprises in Zebraland are 50 percent owned by nonresident direct investors; the other 50 percent of shares are owned by residents.

[41]A country's reserve position in the International Monetary Fund equals the country's quota, minus holdings of the country's national currency in the Fund's Number 1 Account (or equivalent in securities), minus any outstanding purchases of Fund credit that the country has made.

Consolidated Balance Sheet of Zebraland as of December 31, 1991

(in millions of Zebraland dollars)

Assets

Land and structures in Zebraland	100
Machinery	60
less depreciation	–15
Loans to unrelated nonresidents	22
Bank accounts with resident banks	48
Trade credits extended to unrelated nonresidents	17
Total assets	232

Liabilities

Loans from nonresident direct investors	14
Loans from resident banks	74
Trade credits received from unrelated nonresidents	8
Zero-coupon bonds issued to unrelated nonresidents	
Value at issue	15
Accrued interest	7
Total liabilities	118

Net worth

Subscribed capital	100
Accumulated retained earnings	14
Total net worth	114

Further investigations by BOP compilers revealed that the market value, as of December 31, 1991, of land and structures held by direct investment enterprises was $Z 140 million.

(2) In 1991, nonresidents were, for the first time, allowed to purchase shares in enterprises traded on the Zebraland stock exchange. In 1991, the value of nonresident share purchases was $Z 60 million. The average stock exchange index in 1991 was 120. The stock exchange index at the end of 1991 was 132.

(3) A survey of importers and exporters, which included the direct investment enterprises, established that, as of December 31, 1991, outstanding trade credit extended by Zebraland enterprises was $Z 35 million and outstanding trade credit received was $Z 28 million.

(4) Zebraland's banks, which are not direct investment enterprises, reported the following foreign assets and liabilities, which were valued on the basis of market values, as of December 31, 1991. The information is presented in millions of Zebraland dollars.

Assets

Deposits with unrelated banks	15
Investment in fixed assets held by branches abroad	35
Loans to branches abroad	180
Securities issued by foreign governments	45

Liabilities

Deposits of unrelated banks	24
Loans from unrelated foreign banks	65
Commercial paper (3-month) held by nonresidents	82
Perpetual bonds held by nonresidents	26

(5) The Debt Management Office of the Zebraland government reported the following information, in millions of Zebraland dollars, regarding Zebraland's foreign liabilities:

Face value of outstanding loans to government as of December 31, 1991	140
Face value of government securities on issue as of December 31, 1991	70
Face value of outstanding private enterprise loans guaranteed by the Zebraland government as of December 31, 1991	126

With regard to government securities, the policy of the Zebraland government is to issue 10-year bonds at face value. The BOP compilers found that, because of changes in interest rates, these bonds were trading, on average, at a 10 percent discount from face value.

The government does not guarantee the debt of direct investment enterprises or that of Zebraland's banks.

(6) The Central Bank of Zebraland reported the following information on holdings of reserves as of December 31, 1991:

Monetary gold	20,000 ounces
SDRs	SDR 5 million
Reserve position in the International Monetary Fund	SDR 4 million
Holdings of U.S. Treasury Bonds	US$ 20 million
$US deposits with German banks	US$ 17 million

The BOP compilers determined that, at the close of trading on December 31, 1991:

The market price of gold was $Z 400 per ounce.
The midpoint $Z/$US exchange rate was US$ 1 = $Z 2.
The SDR/$US exchange rate was SDR 1 = US$ 1.2.

Statement of Zebraland's International Investment Position as of December 31, 1991

*Numbers in parentheses refer to sources of information used to compile the items. When appropriate, notes describing the compilation method are provided at the end of the table.

(in millions of Zebraland dollars)

Assets		
Direct investment abroad		
Equity capital and reinvested earnings		
Claims on affiliated enterprises	35	(4)
Portfolio investment		
Debt securities-banks	45	(4) See Note 1
Other investment		
Trade credits-other sectors	35	(3) See Note 2
Loans		
Banks	180	(4) See Note 3
Other sectors	22	(1)
Deposits-banks	15	(4)
Reserve assets		
Monetary gold	8	(6) See Note 4
SDRs	12	(6) See Note 5
Reserve position in the Fund	9.6	(6) See Note 6
Foreign exchange		
Currency and deposits-with banks	34	(6)
Securities-bonds and notes	40	(6)
Total foreign financial assets	**435.6**	
Liabilities		
Direct investment in Zebraland		
Equity capital and reinvested earnings		
Liabilities to direct investors	77	(1) See Note 7
Other capital		
Liabilities to direct investors	14	(1)
Portfolio investment		
Equity securities-other sectors	66	(2) See Note 8
Debt securities		
Bonds and notes		
General government	63	(5) See Note 9
Banks	26	(4)
Other sectors	22	(1) See Note 10
Money market instruments-banks	82	(4)
Other investment		
Trade credits-other sectors	28	(3) See Note 11
Loans		
General government	140	(5)
Banks	65	(4)
Other sectors	126	(5)
Currency and deposits-banks	24	(4)
Total foreign liabilities	**733**	
Net international investment position	**–297.4**	

Notes to Zebraland's Statement of International Investment Position as of December 31, 1991

Note 1—The information is insufficient to classify the securities as bonds and notes or money market instruments.

Note 2—Trade credits extended by direct investment enterprises are included in this estimate.

Note 3—It is assumed that bank loans to branches abroad do not represent permanent debt capital.

Note 4—Valued at market values ($Z 400 per ounce)

Note 5—SDR 5 converted to US$ and then converted to $Z by use of market exchange rates

Note 6—SDR 4 converted to US$ and then converted to $Z by use of market exchange rates

Note 7—Direct investors' share (50 percent) of net worth, at book values, of enterprise (114) *plus* impact of revaluing land to market values (140–100)

Note 8—The market value was calculated by multiplying the value of acquisitions made in 1991 by the stock exchange index at the end of 1991 and then dividing the result by the average stock exchange index for 1991.

Note 9—The face value of government securities held by nonresidents was discounted by 10 percent to derive a proxy for market valuation.

Note 10—Zero coupon bonds issued by direct investment enterprises. The accrued interest has been added to the value at issue; the resulting amount should be a reasonable proxy for market valuation.

Note 11—Trade credits received by direct investment enterprises are included in this estimate.