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Note on Understanding Balance of Payments

In today's global economy, more and more businesses are looking across national borders to access new markets, low-cost suppliers, and talent. Globalization has been driven by many factors, including economic liberalization, rapid growth in emerging economies, and the decline of cross-border transaction costs.

In business, firm managers must keep track of imports, exports, and cross-border investments; tracking these flows is relatively straight forward. Likewise, national governments must keep track of financial flows into and out of their countries. They do so by using balance of payment (BOP) accounting, a system for measuring a country's sources and uses of foreign exchange over a specified period of time, generally one year.

Policy makers, economists, and business analysts use BOP indicators to track a country's economic performance and position vis-à-vis the rest of the world. They also provide insights into potential country risks. In this note, you will gain an understanding of how BOP accounting works, how a BOP statement is organized, and what some of the important numbers mean.

How Balance of Payments Accounting Works

Definition

The International Monetary Fund (IMF) defines BOP as "a statistical statement that systematically summarizes, for a specific time period, the economic transactions of an economy with the rest of the world."[1] These transaction flows that occur between domestic and foreign residents involve such things as payments for goods and services, interest income and dividends, gifts, provision of labor and capital, and financial assets.[2]

A BOP statement is organized into two main accounts: the *current account* and the *capital and financial account*. The current account includes:

- Trade in goods and services,
- Investment income (interest, dividends), and
- Transfers (gifts).

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