BALANCE OF PAYMENTS

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Abstract

Balance of payments is a systematic statistical recording of economic transactions realised between the home economy and the rest of the world during the given time period. Therefore, it an exclusively the transactions between the home and foreign entities, while as a home entity we regard physical body with the abode in the home country or legal body with the seat in the home country. Foreigners are then all physical and legal bodies, which cannot be described as home entities. The followed time period can be different.

Key words: balance of payments, account: current, capital, financial, balance of errors, foreign exchange reserves

INTRODUCTION

Every balance of payments construed according to the International Monetary Fund (IMF) recommendations consists, in the frame of its structure, of five basic parts:
1. current account
2. capital account
3. financial account
4. balance of errors and omissions
5. foreign exchange reserves account.

The **current account** itself is formed by:
1. trade balance
2. balance of services
3. balance of yields
4. balance of current transactions

Trade balance records export and import of goods (not services). In the frame of this item, there are recorded also so-called improvement relationships, when the commodities are imported to the country only with the aim of its improvement or repair and further export.

Import and export is the object of the **balance of services**. We include there transport, tourism, communication, construction, financial, computer and information services, licence payment, other trade services, personal, cultural and recreational services and government services.

Balance of yields includes incomes and other compensations to home entities for employment abroad (incomes and compensations to foreigners employed in the home country) and the incomes and expenditures connected with the foreign investments flows.

Current transactions balance records the transactions, which do not lead to the origin of liabilities or claims towards foreign countries. Therefore, it regards the transactions of international character. These transactions are divided into official (governmental) and other (private) ones. There belongs namely economic aid among countries, contributions to international institutions, gifts, retirement payments, alimonies and remittances. Current transactions influence directly the disponible income and decrease thus the income and consumer potential of the donor.

Capital account records international transactions of the capital character. It regards namely the transfers connected with migration of population, debt relieves and ownership rights to investments. Further, there are recorded the transfers of non-production non-financial tangible assets (land plots for embassies) and non-tangible rights (patents, copyrights).

Financial account includes four items:

direct investments

portfolio investments

financial derivates

other investments

A transaction is described as **direct investment** if the foreign owner acquires 10% and higher share in the basic assets of the home business company and co-operative and vice versa. Further, there is included supplying or accepting financial means or other assets, which can be evaluated by money or the rights in the frame of economic relations, based on direct investment and also profit re-investments.

Portfolio investments are investments into the property and debt shares securities. In case of property securities, it namely regards investments into shares if the share in the basic assets of the business company is lower than 10%. In debt securities then prevail obligations.

Financial derivates are represented namely by forwards, futures, swaps and options. It regards terminated contracts (the date of signing the contract differs from the date of settlement) derived from the basic asset (share, currency etc.). Their importance is not great with regard to the total balance of accounts.

Other investments represent namely credits granted to home entities by foreign entities or vice versa. From the time viewpoint, they can be divided into long-term and short-term ones, from the viewpoint of the subject then into credits granted or accepted by the central bank, business banks, government or other sectors**.**

The role of the item **Balance of errors and omissions** in the balance of payments is specific, since it is computed only after the elaboration of the balance of payments itself as the difference between the credit and debit items, so that the balance of payments is always levelled (its balance should be zero). Even if, from the accounting viewpoint the total of credit operations should always equal the total of debit operations, in reality it is not so, since a whole series of operations can be only estimated by the central bank at elaborating the balance of payments. It regards namely tourism and the import or export of goods not liable to custom duties, for private use. For example, if I buy abroad mountaineering rope and bring it home, it regards import of goods, which should appear as a debit item in the balance of payments. However, since it is not my duty to announce the transaction anywhere, the central bank can hardly record it correctly into the balance of payments. Another problem is represented by illegal transactions, which cannot, from the sense of the matter, appear in the balance of payment. If the balance of errors and omissions is relatively high (in relation to the balances of other items), it is obvious that the central bank is not very successful in its elaboration. However, a low balance does not automatically mean a high reliability of the data included in the balance since there might occur a mutual compensation of the non-recorded credit and debit transactions.

The **account of foreign currency reserves** shows how the foreign currencies reserves of the central bank increased or decreased during the given period. Foreign currency reserves increase (decrease) if the total of the individual above-mentioned items is positive (negative). Since the balance of payments as a whole has to be always levelled, the change of the foreign currency reserves is recorded into it with the opposite sign. It means that if this item in the balance of payments is recorded as a minus (plus) number, the foreign currency reserves of the central bank have increased (decreased) during the period in question. The level of the foreign currency reserves changes namely as a consequence of the central bank interventions, when the bank buys or sells foreign currencies according to the need. Further, foreign currencies reserves can change as a consequence of the accepted yields from the existing foreign currency reserves, credits in foreign currency and their instalments paid by the central bank. The foreign currency reserves can change also in consequence of the evaluation or devaluation of the home currency. If the home currency devalves (or evalves) in average to the currencies forming the foreign currency reserves during the given period, then the foreign currency reserve increase (decrease). In the balance of payments, there is followed only the change of the so-called **official foreign currency reserves**, which are the reserves of the central bank (or the Ministry of Finances). Thus, the reserves of the business banks are not followed there.

Besides the above-mentioned horizontal structure, also the **vertical structure** of the balance of payments is very important. It regards three columns forming every balance of payments. The first column serves for recording the **credit operations**; the second then records the **debit transactions**. The **difference** between credit and debit operations (balance) is recorded in the third column.

The differentiation of debit and credit items can be made by several ways. As a criterion, there can serve for example the relationship of the transaction to the foreign currency supply or demand. If the given transaction increases the foreign currency supply, then it regards credit operation. In case the transaction increases foreign currency demand, we ascribe it as debit transaction. Simply said, credit transactions mean the inflow of money (or assets evaluated by money) from abroad to the home economy. On the other hand, debit transactions lead to outflow of money from the home economy abroad. Then, if a home entity sells goods abroad or supplies a service to foreign entity, it regards credit transaction, since

He/she will probably sooner or later get a certain financial sum or other financially evaluated counterbalance for it. Therefore, it means inflow of money to the home economy. The same situation regards incomes and transfers. If a home entity gets a wage, dividend or interest payment from abroad, it regards credit transfer. The same applies in case when he/she gets a financial or tangible gift from foreign entity.

The transactions in frame of the current account are regarded in the same way. If a foreign entity for example buys 50% share in the home joint-stock company, it regards credit transactions, since in fact we have exported an asset and got paid for it. If the home bank grants a credit to a foreign entity, it regard debit transaction, since our bank has in fact bought an asset from the foreign entity.

We have already mentioned, than an increase (decrease) of foreign currency reserves is recorded with the minus (plus) sign. The increase (decrease) of foreign currency reserves is thus regarded as the debit (credit) transaction. The explanation is again quite simple. In case of the foreign currency reserves, the central bank in fact acquires a claim to a certain asset in the foreign bank. Therefore, it exported capital and purchased an asset.

The individual transactions should be recorded into the balance of payments on the double-entry principle. From the accounting viewpoint of the balance of payments is then every credit transaction accompanied by debit transaction and vice versa. This is the reason why every balance of payments as a whole has to result in zero balance. From this viewpoint, there is very important the item **other investments** where the opposite transactions to most real transactions are recorded.

Foreign commodities of the value of 1 million EURO and the commodities are immediately paid for, then the sum appears as credit in the **trade balance** and simultaneously as debit in the frame of short-term **other investments**. The reasoning is simple. The home firm in fact acquired an asset at the foreign bank (importer bank), what from the accounting viewpoint of the balance of payments means a purchase of foreign asset and export of capital by the home firm (more precisely, by its bank).

Tab. 2: Balance of payment scheme

	Credit (+)	Debit (–)	Balance
A. Current account			
Trade balance			
Balance of services			
Balance of yields			
Current transfers			
B. Capital account			
C. Financial account			
Direct investments			
Portfolio investments			
Financial derivates			
Other investments			
D. Balance of errors and omissions			
E. Change of foreign currencies reserves			

EXTERNAL ECONOMIC BALANCE

Balance of payments and its individual items belong to the most closely followed indicators in the process of evaluating the shape of the external economic balance of the economy. The opinions on the testimonial ability of the balance of payments differ.

If we want to use the balance of payment for evaluation of the external economic balance, it is necessary first to set the criteria according to which we finally decide, whether the given shape of external economic balance is suitable for the given economy or not.

From the balance of payments viewpoint, the notion of external economic non-balance does not make much sense, since the balance of payments as a whole is always levelled. Also the balance of payments excluding the item of the foreign currency reserves changes is always levelled, if the central bank does not intervene in the currency market, what is, however, secured only in the systems of floating home currency exchange rate. It is of course true that the foreign currency reserves are changing even in the cases when the central bank does not intervene in the foreign currency market. However, these changes are usually negligible.

From this viewpoint, it is then more suitable to speak of the external economic balance shape than of the external economic balance or non-balance. In the situation when home subjects want to import more goods and services tan they are exporting and are not able to finance this deficit by the net yields or transfers received from abroad, they have to export assets fro which they receive capital, which they use for covering the current account deficit.

On the opposite, in the situation when home subjects export abroad more goods and services than they import, they have to buy foreign assets for the overlapping foreign currencies, and thus they in fact enable foreign subjects to buy an additional amount of goods and services in the home country. Both institutions are levelled from the balance of payments viewpoint. However, these two balanced situations differ by their shape. It is obvious that neither of them can last forever.

At the beginning, it is necessary to note that the only direct risk of the in the long-term unsustainable shape of the external economic balance is the gradual or jump devaluation of currency, which is sometimes called currency crisis. This usually occurs in case when the country registers in the long term a considerable deficit of the current account, which is from a great part financed by the inflow of portfolio or other investments. Jump devaluation of currency brings about some other problems, which can endanger the external economic balance. It regards namely inflation pressures, which are usually brought about by the currency devaluation and further also the inability of home subjects to cover their liabilities in foreign currencies from the reason of their considerably deepened indebtness as a result of the home currency devaluation.

As a suitable shape of external economic balance, there can the thus regarded such a shape which is sustainable in the long term and does not indicate for future the jump devaluation of the home currency.

A unanimous criterion how to discern the shape of the external economic balance sustainable in the long term from the unsustainable one does not exist. If we want to evaluate the shape of external economic balance, it is necessary to define such a level of the followed balance result, which would be able to supply a satisfactory answer. In the economic practice, there is used a series of different balances, from the trade balance to the complex balance of payments. The choice of the most suitable balance criterion is to a considerable extent a subjective matter and it depends considerably on the concrete conditions in which are the given economy found. An important factor influencing the choice of the suitable balance indicator is the exchange regime, in the fixed exchange rate regimes the balance deficit is levelled by other mechanisms than in the floating exchange rate regimes, where the levelling is done through the exchange rate changes.

EXCHANGE RATE

The inseparable part of the foreign economic relationships analysis are the questions connected with exchange rate. If we record the price of foreign currency in the units of home currency, we speak of the exchange rate recorded in the so-called direct quotation (e.g. 30 CZK/EUR). If we, on the other side, express the price of home currency in the units of foreign currency, it regards the exchange rate recorded in the indirect quotation (e.g. 0.03 EUR/CZK). To avoid the possible misunderstandings, we will further work only with the exchange rate recorded in the direct quotation.

If the price of the Czech crown of EURO expressed in CZK decreases, we speak of strengthening (valuation, appreciation). Less CZK now suffices for the purchase of 1 EURO, i.e. the CZK exchange rate in the direct quoting (in numeral expression) has decreased. On the opposite, increase of the CZK price of 1 EURO means weakening (devaluation, depreciation) recorded in the direct quotation increased.

According to the set of rules applied at managing of the individual exchange rates, we can divide the individual currencies (exchange rate regimes) into:

- exchangeable currencies
- non-exchangeable currencies.

Exchangeable currencies can be further divided into:

- currencies with fixed exchange rate
- currencies with floating exchange rate.

Non-exchangeable currencies are not traded in the international currency market. Their exchange rates are thus not created by the market forces but they are set according to administration decision**.** These exchange rates therefore cannot reflect the level and dynamics of the basic market factors.

On the opposite, exchange rates of the **exchangeable currencies** origin at the currency market by the interaction of supply and demand. At that, there are valid the same relationships as in any other commodity market. The increased of supply of the given currency leads at the otherwise identical conditions to the decline of price (devaluation) of this currency. On the opposite, increase of demand for the given currency evolves under the otherwise identical conditions the growth of price (evaluation) of the relevant commodity.

For exchangeable currencies with **fixed exchange rate**, the central bank usually declares the so-called central parity (central exchange rate), in the frame of which the market exchange rate can freely fluctuate. However, as soon as the exchange rate shows a tendency to leave the relevant oscillation zones, the central bank is obliged to intervene in the currency market, so that it prevented the excessive appreciation or depreciation of the currency. If then for example the given currency exchange rate starts an excessive evaluation in relationship to the central parity and the declared oscillation zones, the central bank has to sell the home currency for the relevant foreign currency. The home monetary reserves and the foreign currency reserves of the central bank decrease in this case. The development of the home monetary reserves is thus to a considerable extent depending on the exchange rate development, what limits the autonomy of the central bank currency policy. If the central bank wants to have the home monetary stocks fully under its control, it has to “sterilise” the interventions by the operations in free market.

What is the base of the so-called **sterilisation of the exchange rate intervention**? Let us presuppose that the home currency exchange rate is devaluating considerably. In the fixed exchange rate system, the central bank has to intervene through the purchase of home currency, what leads to the undesirable decrease of the home money stocks. The central bank then starts to buy securities in the free market, what in turn increases the home money stocks. At the sterilised intervention against the home currency, the central bank analogically sells not only the home currency in the money market, but also securities in the free market. While in the first case the central bank increases the home money socks, in the second case it decreases it, so that in total the home money stocks do not change at all.

The **central parity** can be in the fixed exchange rate system expressed not only towards one currency (national or supra-national), but also to the basket of selected currencies. The historical possibility then is setting of the gold content of the relevant currency. If the home currency central parity is expressed in relation to the basket of selected currencies, the home currency has to be stable to the whole basket, i.e. not only towards the individual currencies included in the basket. The home currency can evaluate (devaluate) considerably towards one currency, if it simultaneously devalues (evalues) towards the other currencies in the basket. The weight (share) of the individual currencies in the basket is usually different, while a greater share is usually that of the currencies in which the major mart of the given country trade is realised.

If it comes to the official change of the central exchange rate, we speak of the **devalvation**, resp. **revalvation** of the home currency. In devalvation, the central parity is modified so that the price of the foreign currency expressed in the units of the home currency increases, i.e. the central exchange rate registered in direct quotation increases quantitatively. Revalvation of the home currency, on the other hand, means decrease of the foreign currency price. Too frequent changes of the official parity decrease, on one hand, the credibility of the declared fixed exchange rate system, on the other hand, they enable a more flexible adaptation of the exchange rate to market factors. A specific system of the fixed exchange rate is in this aspect an exchange rate system with the regular changes of the central exchange rate, so-called **crawling peg**, which enables for the exchange rate to adapt better to the market factors (the central parity changes for example in dependence to the inflation differential development – in this case we speak of the fixed real exchange rate system) but at the same time it secures a certain stability of the exchange rate.

The system of fixed exchange rate with regular changes of the central parity thus shows both the features characteristic for the fixed exchange rate systems as the attributes typical for the floating course regimes.

The **scope of the oscillation zones** can be set in a different way for the currencies with fixed exchange rate. The wider are the oscillation zones, the more often has the central bank, under otherwise identical conditions, intervene in the foreign currency market, what puts considerable demands on the foreign currency reserves of the central bank and lowers the autonomy of the currency policy.

On the other hand, more narrow oscillation zones secure a more stable exchange rate, what among other means a lower exchange rate risk of the international economic transactions. A specific case is then the fixed exchange rate system without oscillation zones, so-called currency **board**. The central bank has here to sustain the exchange rate level permanently on the central parity, which can change only in exceptional cases. The approach issues from the so-called monetary approach to the balance of payment, which regards as the main source of inequalities of the balance payments the non-balance between the supply and demand of money in the home money market. If supply of money exceeds demand, there occurs the balance of payments deficit, which creates a pressure on the home currency devaluation. The central bank has to intervene by purchasing the home currency, what decrease the home money stocks (supply). Non-sterilised exchange rate intervences thus automatically renew the balance in the money market and thus also the equilibrium of the balance of payments.

In the system of **floating exchange rate**, the central bank is under no obligation to intervene in the money market. In practice, however, the central bank does occasionally intervene also in the floating exchange rate system, even if it is not obliged to do so by an oscillation zones or central parity. In this case, we speak of the directed (impure) floating. Less often we can meet with the so-called pure (free) floating, which represents the model situation when central bank does not intervene in any way into the exchange rate market development. In reality, however, practically every central bank does influence the home currency exchange rate in some way. As a pure floating are then regarded such systems of floating exchange rate, where the central bank influences the home currency exchange rate only to a minimum extent, however, there is no defined clear measure of this. The division of floating exchange rates into directed and pure floating is then a rather relative matter.

Besides the real level of the exchange rate, there exists also the so-called theoretical level of exchange rate. It is such value of exchange rate, which corresponds to the level, and dynamics of the basic market factors. The individual theories of the exchange rate determination differ considerably, however, which factors are decisive for the exchange rate determination.

CONCLUSION

The construction of the individual balances issues from the accounting principles of the balance of payments. If we know that the balance of payments as a whole is always levelled, then the sum of the items selected by us has always to equal the sum of the remaining items with the opposite signs. The usual procedure is from the top down, while the balance of payments is always cut in half by an imaginary line. The items above the line then appear at the left side of the equation and define the requested balance; the items beneath the line are put to the right side of the equation. It regards the items from which the eventual deficit of the selected balance was financed, or, in the opposite, the items into which the surplus was dissolved.

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