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Understanding The Current Account In The Balance Of Payments

by Reem Heakal (Contact Author | Biography)

The balance of payments (BOP) is the place where countries record their monetary transactions with the rest of the world. (For more on the BOP, see this article.) Transactions are either marked as a credit or a debit. Within the BOP there are three separate categories under which different transactions are categorized: the current account, the capital account and the financial account. In the current account, goods, services, income and current transfers are recorded. In the capital account, physical assets such as a building or a factory are recorded. And in the financial account, assets pertaining to international monetary flows of, for example, business or portfolio investments are noted. In this article, we will focus on analyzing the current account and how it reflects an economy's overall position.

The Current Account

The balance of the current account tells us if a country has a deficit or a surplus. If there is a deficit, does that mean the economy is weak? Does a surplus automatically mean that the economy is strong? Not necessarily. But to understand the significance of this part of the BOP, we should start by looking at the components of the current account: goods, services, income and current transfers.

1. ***Goods*** - These are movable and physical in nature, and in order for a transaction to be recorded under "goods", a change of ownership from/to a resident (of the local country) to/from a non-resident (in a foreign country) has to take place. Movable goods include general merchandise, goods used for processing other goods, and non-monetary gold. An export is marked as a credit (money coming in) and an import is noted as a debit (money going out).
2. ***Services*** - These transactions result from an intangible action such as transportation, business services, tourism, royalties or licensing. If money is being paid for a service it is recorded like an import (a debit), and if money is received it is recorded like an export (credit).
3. ***Income*** - Income is money going in (credit) or out (debit) of a country from salaries, portfolio investments (in the form of dividends, for example), direct investments or any other type of investment. Together, goods, services and income provide an economy with fuel to function. This means that items under these categories are actual resources that are transferred to and from a country for economic production.
4. ***Current Transfers*** - Current transfers are unilateral transfers with nothing received in return. These include workers' remittances, donations, aids and grants, official assistance and pensions. Due to their nature, current transfers are not considered real resources that affect economic production.

Now that we have covered the four basic components, we need to look at the mathematical equation that allows us to determine whether the current account is in deficit or surplus (whether it has more credit or debit). This will help us understand where any discrepancies may stem from, and how resources may be restructured in order to allow for a better functioning economy.

Here are the variables that go into the calculation of the current account balance (CAB):

X = Exports of goods and services
M = Imports of goods and services
NY = Net income abroad
NCT = Net current transfers

The formula is CAB=X−M+NY+NCT.

What Does It Tell Us?
Theoretically, the balance should be zero, but in the real world this is improbable, so if the current account has a deficit or a surplus, this tells us something about the state of the economy in question, both on its own and in comparison to other world markets.

A surplus is indicative of an economy that is a net creditor to the rest of the world. It shows how much a country is saving as opposed to investing. What this means is that the country is providing an abundance of resources to other economies, and is owed money in return. By providing these resources abroad, a country with a CAB surplus gives receiving economies the chance to increase their productivity while running a deficit. This is referred to as financing a deficit.

A deficit reflects an economy that is a net debtor to the rest of the world. It is investing more than it is saving and is using resources from other economies to meet its domestic consumption and investment requirements. For example, let us say an economy decides that it needs to invest for the future (to receive investment income in the long run), so instead of saving, it sends the money abroad into an investment project. This would be marked as a debit in the financial account of the balance of payments at that period of time, but when future returns are made, they would be entered as investment income (a credit) in the current account under the income section.

A current account deficit is usually accompanied by depletion in foreign−exchange assets because those reserves would be used for investment abroad. The deficit could also signify increased foreign investment in the local market, in which case the local economy is liable to pay the foreign economy investment income in the future.

It is important to understand from where a deficit or a surplus is stemming because sometimes looking at the current account as a whole could be misleading.

Analyzing the Current Account

Exports imply demand for a local product while imports point to a need for supplies to meet local production requirements. As export is a credit to a local economy while an import is a debit, an import means that the local economy is liable to pay a foreign economy. Therefore a deficit between exports and imports (goods and services combined) - otherwise known as a balance of trade deficit (more imports than exports) - could mean that the country is importing more in order to increase its productivity and eventually churn out more exports. This in turn could ultimately finance and alleviate the deficit.

A deficit could also stem from a rise in investments from abroad and increased obligations by the local economy to pay investment income (a debit under income in the current account). Investments from abroad usually have a positive effect on the local economy because, if used wisely, they provide for increased market value and production for that economy in the future. This can allow the local economy eventually to increase exports and, again, reverse its deficit.

So, a deficit is not necessarily a bad thing for an economy, especially for an economy in the developing stages or under reform: an economy sometimes has to spend money to make money. To run a deficit intentionally, however, an economy must be prepared to finance this deficit through a combination of means that will help reduce external liabilities and increase credits from abroad. For example, a current account deficit that is financed by short-term portfolio investment or borrowing is likely more risky. This is because a sudden failure in an emerging capital market or an unexpected suspension of foreign government assistance, perhaps due to political tensions, will result in an immediate cessation of credit in the current account.

Conclusion

The volume of a country's current account is a good sign of economic activity. By scrutinizing the four components of it, we can get a clear picture of the extent of activity of a country's industries, capital market, its services and the money entering the country from other governments or through remittances. However, depending on the nation's stage of economic growth, cycle, its goals, and of course the implementation of its economic program, the state of the current account is relative to the characteristics of the country in question. But when analyzing a current account deficit or surplus, it is vital to know what is fueling the extra credit or debit and what is being done to counter the effects (a surplus financed by a donation may not be the most prudent way to run an economy). On a separate note, the current account also highlights what is traded with other countries, and it is a good reflection of each nation's comparative advantage in the global economy.

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