1 Balance-of-Payments Accounting and the Foreign-Exchange Market

CONCEPTS OF THE BALANCE OF PAYMENTS

There are two distinct concepts of the balance of payments which must not be confused: the market balance of payments, and the accounting balance of payments. The market balance of payments refers to the balance of supply and demand for a country's currency in the foreign-exchange market at a given rate of exchange. If the exchange rate is fixed, the market balance of payments would be in balance only by chance. If it is not in balance and the exchange rate must be maintained, the monetary authorities would have to intervene to achieve balance by buying their own currency with foreign exchange if the home currency were in excess supply or by selling their own currency for foreign exchange if the home currency were in excess demand. If the exchange rate is allowed to float freely, however, the market balance of payments must always balance because the exchange rate is the price which equates the supply and demand for a currency in the foreign-exchange market.

The accounting balance of payments is a record of all the financial transactions in goods, services and capital assets which have taken place between a country's residents and the residents of other countries within an arbitrary accounting period, normally one year. Like most accounting records, this concept of the balance of payment is an ex post concept, the record of accounts being compiled by double-entry book-keeping. For there to be a deficit or surplus on the balance of payments, using this concept of the balance of payments, certain
sections of the account must be taken. Which sections should be looked at is considered later when we examine the question of what is meant by balance-of-payments equilibrium, and how equilibrium should be defined for the sensible conduct of economic policy.

Given these two distinct concepts of the balance of payments, the meaning of a balance-of-payments deficit or surplus will be different in each case, and movements in the different balances might be quite unrelated. In particular it must be stressed, and this will be a constant theme throughout the book, that a market balance of payments does not guarantee a balance-of-payments equilibrium in any objective sense. It depends how equilibrium is defined within the framework of the accounting balance of payments. As we shall see later, only if there is no concern about the balance between the exchange of real goods and services and complete indifference to the value of the exchange rate can the market balance of payments be said to give balance-of-payments equilibrium within the accounting framework. This feature of the book distinguishes it from many others in which the belief is expressed that if exchange rates are left to find their own level, giving a market balance of payments, there will be a balance-of-payments equilibrium obviating the need for corrective action. This view is not only naive in principle, because there are many different definitions of equilibrium, but is contradicted by the facts - no more so than by the continual corrective discretionary actions of governments since floating exchange rates became prevalent in the world economy.

THE ACCOUNTING BALANCE OF PAYMENTS

The accounting balance of payments is a record of a country’s financial transactions with the rest of the world in an accounting period, normally one year. It is constructed on the principle of double-entry book-keeping, and as such always balances. For every credit there is a debit, and for every debit there is a credit. The financial transactions recorded include payments and receipts for physical goods (imports and exports), which are called visible items; payments and receipts for services, which are called invisible imports and exports, and capital transactions. Any receipt from the rest of the world which increases the net claim on foreigners is recorded as a credit in a country’s balance of payments, but the net claim on foreigners itself is recorded as a debit. Similarly, any payment to the rest of the world which increases