FINANCIAL DERIVATIVES

A SUPPLEMENT TO THE FIFTH EDITION (1993) OF THE

BALANCE OF PAYMENTS MANUAL

INTERNATIONAL MONETARY FUND

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Preface

This document comprises a new chapter on financial derivatives and modifications to the existing material on financial derivatives in the fifth edition of the *Balance of Payments Manual (BPM5)*.

In response to large-scale changes occurring in recent decades in the size and nature of financial derivative markets, the *System of National Accounts 1993 (1993 SNA)* and the *BPM5* presented new standards for the treatment of such derivatives. After the *1993 SNA* and the *BPM5* were published, markets for financial derivatives evolved to an even greater extent, and national statisticians requested clarification and amplification of the published standards.

These inquiries led to the creation of the Informal Group on the Measurement of Financial Derivatives. This informal group, the IMF Committee on Balance of Payments Statistics (the Committee), and the group of experts working on the draft of the IMF *Manual on Monetary and Financial Statistics* produced discussion papers that were widely distributed and commented upon in the international statistical community.

The process of discussion and commentary confirmed the view that financial derivatives should be treated as financial assets. Transactions in financial derivatives, in general, should be reported as separate transactions rather than as integral parts of the values of underlying transactions or as integral parts of the values of financial assets to which derivatives may be linked as hedges. The process also led to two significant changes in previous statistical standards. One was the change to a less restrictive view towards the classification of financial derivatives within the SNA asset boundary. This change permitted the inclusion of more over-the-counter (or non-exchange-traded) instruments. A second, related change was the recognition of interest rate swaps and forward rate agreements as financial assets and the recording of net cash settlement payments resulting from these contracts as financial transactions rather than investment income flows. In addition, it was agreed that a new functional category, financial derivatives, would be created for the balance of payments and a new instrument, financial derivatives, for the national accounts. These changes were adopted by the Committee and the Inter-Secretariat Working Group on National Accounts (ISWGNA) at their October 1997 meetings. In November 1997, the IMF Statistics Department released *The Statistical Treatment of Financial Derivatives*.

The ISWGNA and the Committee then asked that the IMF Statistics Department use *The Statistical Treatment of Financial Derivatives* as a base to prepare—for inclusion in the *1993 SNA* and the *BPM5*—text containing a definitive description of financial derivatives and recommended treatments for them. A version suitable for each publication was prepared, but the wording of the two versions is identical in many instances. The *BPM5* version, although subject to further review regarding the classification of financial derivatives as *direct investment* and *reserve assets,* was considered and adopted at the October 1998 meeting of the Committee.

At its October 1999 meeting, the Committee made a provisional decision to include financial derivatives in both of these functional categories

and to record such derivatives as separate items. This treatment is consistent with that described, in the October 1999 release of the provisional *IMF Operational Guidelines on the Data Template for International Reserves and Foreign Currency Liquidity,* for financial derivatives classified as *reserve assets.* This guideline will be reviewed in late 2000 or early 2001. The continued classification of financial derivatives within *direct investment* and *reserve assets* depends on the results of the review and on country experience in implementing the recommendations with regard to derivatives classified in *direct investment.*

The text that follows comprises two parts: a new, additional chapter for the *BPM*5 and an amendment to material in the existing *BPM*5.

The new chapter presents information on the functional category of *financial derivatives.* The underlying features of financial derivatives and treatments appropriate for specific derivatives are described. The amendment to the *BPM*5 shows, by means of shading and strikeout, clarifications and changes to the published manual. Only modified paragraphs and tables are shown—in the same order as chapters and paragraphs are shown in the 1993 text. The release of this addendum and amendment to the *BPM*5 was coordinated with finalization of the parallel revision to the *1993 SNA*. (The process of dissemination and adoption for the latter revision was more lengthy.) The revised *1993 SNA* was adopted by the United Nations Statistical Commission in February 2000.

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XXV. Financial Derivatives

Concept and Coverage

FD 1. A ***financial derivative contract*** is a *financial instrument that is linked to another specific financial instrument or indicator or commodity and through which specific financial risks (such as interest rate risk, foreign exchange risk, equity and commodity price risks, credit risk, etc.) can, in their own right, be traded in financial markets.* Transactions in financial derivatives are treated as separate transactions rather than as integral parts of the values of the underlying transactions to which they are linked. The value of a financial derivative derives from the price of an underlying item such as an asset or index. No principal amount that must be repaid is advanced, and no investment income accrues. Financial derivatives are used for a number of purposes—risk management, hedging, arbitrage between markets, and speculation, for example.

FD 2. Financial derivatives enable parties to trade specific financial risks to other entities that are more willing, or better suited, to take or manage these risks and that typically, but not always, do so without trading in primary assets or commodities. The risk embodied in a derivative contract can be traded either by trading the contract itself, as with options, or by creating a new contract embodying risk characteristics that match, in a countervailing manner, those of the existing contract. The latter practice, which is termed *offsetability*[1], occurs in forward markets. *Offsetability* means that it is often possible to eliminate the risk associated with a derivative by creating a new but "reverse" contract having characteristics that countervail the risk of the first derivative. Buying the new derivative is the functional equivalent of selling the first derivative because the result is the elimination of risk. The ability to countervail the risk in the market is therefore considered the equivalent of *tradability* in demonstrating value. The outlay that would be required to replace the existing derivative contract represents its value; actual offsetting is not required to demonstrate value.

FD 3. There are two broad types of financial derivatives. In a ***forward contract***, which is unconditional*, two counterparties agree to exchange a specified quantity of an underlying item (real or financial) at an agreed-upon price (the strike price) on a specified date*. In an ***option contract***, *the purchaser acquires from the seller a right to buy or sell, (depending on whether the option is a call or a put) a specified underlying item at a strike price on or before a specified date.* Unlike debt instruments, financial derivatives do not accrue investment income; nor are principal amounts advanced that must be repaid.

FD 4. The value of a financial derivative derives from the *price of the underlying item* (the *reference price)*. Because a future reference price is not known beforehand, the value of a financial derivative at maturity can only be anticipated or estimated. A reference price may be related to a commodity, a financial instrument, an interest rate, an exchange rate, another

[1] *Offsetability* should not be confused with an *offset,* which is the legal right of a debtor to net its claims against the same counterparty. It is recommended that positions be recorded on a gross basis whenever possible.

derivative, a spread between two prices, or an index or basket of prices. An observable reference price for the underlying item is essential for calculating the value of any financial derivative. If there is no observable prevailing market price for the underlying item, it cannot be regarded as a financial asset. Transactions in financial derivatives are treated as separate transactions rather than as integral parts of the values of the underlying transactions to which they are linked. Embedded derivatives, however, are not identified and valued separately from primary instruments. (See paragraph FD 6.)

FD 5. Financial derivative contracts are usually settled by net payments of cash. Exchange-traded contracts, such as commodity futures, are often settled before maturity. Cash settlement is a logical consequence of the use of financial derivatives to trade risks independently of the ownership of underlying items. However, some financial derivative contracts, particularly those involving foreign currency, are settled by deliveries of the underlying items.

FD 6. For balance of payments purposes, the following types of financial instruments are **NOT FINANCIAL DERIVATIVES.**

- A **FIXED PRICE CONTRACT FOR GOODS AND SERVICES** is not a financial derivative unless the contract is standardized so that the market risk therein can be traded in financial markets in its own right.

- **INSURANCE** is not a financial derivative. Insurance contracts provide individual institutional units with financial protection against the consequences of the occurrence of specified events. (In many instances, the value of this financial protection cannot be expressed in terms of market prices.) ***Insurance*** is a *form of financial intermediation through which funds are collected from policyholders and invested in financial or other assets. These assets are held as technical reserves to meet future claims arising from the occurrence of events specified in insurance policies*. That is, insurance is used to manage event risk primarily by the pooling, not the trading, of risk.

- **CONTINGENCIES**, such as guarantees and letters of credit, are not financial derivatives. The principal characteristic of a contingency is that one or more conditions must be fulfilled before a financial transaction takes place. Contingencies are typically not instruments that facilitate the trading of specific financial risks.

- An **EMBEDDED DERIVATIVE** (*a derivative feature that is inserted in a standard financial instrument and is inseparable from the instrument*) is not considered a financial derivative for balance of payments purposes. If a primary instrument such as a security or loan contains an embedded derivative, the instrument is valued and classified according to its primary characteristics—even though the value of that security or loan may well differ from the values of comparable securities and loans because of the embedded derivative. Examples are bonds that are convertible into shares and securities with options for repayment of principal in currencies that differ from those in which the securities were issued.

FD 7. In addition, **TIMING DELAYS** that arise in the normal course of business and may entail exposure to price movements do not, for balance of payments purposes, give rise to transactions and positions in financial derivatives. Timing delays include normal settlement periods for spot transactions in financial markets.

FD 8. Financial derivatives that can be valued separately from the underlying items to which they are linked are included—whether or not they are traded on an exchange—in the ***financial account*** of the balance of payments and in the international investment position.

Forwards

FD 9. In a ***forward contract***, *the counter-parties agree to exchange, on a specified date, a specified quantity of an underlying item (real or financial) at an agreed-upon contract price (the strike price).* This class of financial derivatives includes futures and swaps. ***Futures*** are *forward contracts traded on organized exchanges*. Futures and other forward contracts are typically, but not always, settled by payments of cash or provision of other financial instruments rather than by actual deliveries of underlying items. Futures are valued and traded separately from underlying items. If a forward contract is a ***swap contract***, *the counterparties exchange, in accordance with pre-arranged terms, cash flows based on the reference prices of the underlying items.* Forward rate agreements and forward foreign exchange contracts are common types of forward contracts. Interest-rate and cross currency interest-rate swaps are common types of swap contracts. (See paragraphs FD 27 and FD 28 for further discussion.)

FD 10. At the inception of a forward contract, risk exposures of equal market value are exchanged. Both parties are potential debtors, but a debtor/creditor relationship can be established only after the contract goes into effect. Thus, at inception, a contract normally has zero value. However, as the price of the underlying item changes during the life of the forward contract, the market value of each party's risk exposure will differ from the market value of zero at the inception of the contract. When a change in the price of the underlying item occurs, an asset (creditor) position is created for one party, and a liability(debtor) position is created for the other. The debtor/creditor relationship may change, in both magnitude and direction, during the life of a forward contract.

Options

FD 11. The *purchaser* of an ***option contract*** *pays a premium to the writer of the option. In return, the buyer acquires the right but not the obligation to buy (call option) or sell (put option) a specified underlying item (real or financial) at an agreed-upon contract price (the strike price) on or before a specified date.* A major difference between forward and option contracts is that either party to a forward contract is a potential debtor, whereas the buyer of an option acquires an asset, and the option writer incurs a liability. However, an option may expire without worth; it is exercised only if settling the contract is advantageous to the buyer. The option buyer may make gains of unlimited size, and the option writer may experience losses of unlimited size.

FD 12. Options are written on a wide variety of underlying items—such as equities, commodities, currencies, and interest rates (including caps, collars, and floors).[2] Options are also written on futures, swaps (known as *swaptions*), caps (known as *captions*), and other instruments.

FD 13. In organized markets, option contracts are usually settled in cash, but some types of option contracts are normally settled by purchases of underlying assets. For instance, a ***warrant*** is *a financial contract that gives the holder the right to buy, under specified terms, a certain number or amount of the underlying asset (such as equity shares)*. If a warrant is exercised, the underlying asset is usually delivered. Warrants can be traded separately from the underlying assets to which they are linked.

Recording of Financial Derivative Transactions and Positions

FD 14. The statistical treatment of financial derivatives for the balance of payments and the international investment position requires compilers and statisticians to

[2]A cap imposes an upper limit; a floor sets a lower limit; and a collar maintains upper and lower bounds on floating-rate interest payments or receipts.

•recognize the exchange of claims and obligations at the inception of a derivative contract as a true financial transaction creating asset and liability positions that normally have, at inception, zero value if the instrument is a forward and value equal to the premium if the instrument is an option

•treat any changes in the values of derivatives as holding gains or losses

•record secondary market transactions in marketable derivatives, such as options, as financial transactions

•record any payments made at settlements as transactions in financial derivative assets or liabilities (That is, no income arises from settlements of financial derivatives.)[3]

•record, in the international investment position, outstanding values of financial derivatives at market prices.

Valuation of positions

FD 15. A key characteristic of most derivative contracts is that the counterparties make commitments to transact, in the future and at agreed-upon prices, in underlying items. The present value (or market price) of a financial derivative is derived from the difference between the agreed-upon contract price of an underlying item and the prevailing market price (or the market price expected to prevail), appropriately discounted, of that item. For options, whether they are traded on an exchange or not, the prices are directly observable because option purchasers acquire assets (the rights to buy or sell specified underlying items) and the prices of those assets must be established. The price of an option depends on the potential price volatility of the underlying instrument, the time to maturity, interest rates, and the difference between the strike price and the market price of the underlying item. The value of a swap contract based on a notional principal amount is derived from the difference, appropriately discounted, between expected gross receipts and gross payments.

FD 16. Financial derivatives are valued at market prices prevailing on balance sheet recording dates. Price changes occurring between recording dates are classified as revaluation gains or losses. If market price data are unavailable, other fair value methods (such as option models or discounted present values) may be used to value derivatives.

Payments at inception

FD 17. The purchaser of an option pays a premium to the seller. The full price of the premium is recorded, by the buyer, as the acquisition of a financial asset and, by the seller, as the incurrence of a liability. Sometimes a premium is paid after the inception of a derivative contract. Then the value of the premium payment is recorded by the option purchaser as an asset that was financed by a loan from the option writer at the time the derivative was purchased.

FD 18. The creation of a forward contract does not normally require the recording of a transaction in a financial derivative because risk exposures of equal value are usually being exchanged. That is, there is zero exposure and zero value for both sides.

FD 19. *Commissions and fees paid—at inception or during the lives of derivatives—to banks, brokers, and dealers* are classified as ***payments for services***. These payments are rendered for services provided within current periods and are independent of asset and liability relationships created by the derivatives.

[3] Financial derivative transactions may take place directly between two parties or through intermediaries. In the latter case, there may be implicit or explicit service charges. Distinguishing an implicit service change is not usually possible. Therefore, it is recommended that net settlement payments for derivative contracts be recorded as financial transactions. When possible, service charges should be recorded separately.

Sales of derivatives in secondary markets

FD 20. Sales of derivatives in secondary markets—whether the markets are exchanges or over-the-counter—are valued at market prices and recorded in the ***financial account*** as transactions in financial derivatives.

Settlement payments

FD 21. ***Net settlement payments*** are *financial transactions that are similar to transactions at the maturities of other financial instruments.* At settlement, either a cash payment is made, or an underlying item is delivered.

- When a financial derivative is settled in cash, a transaction equal to the cash value of the settlement is recorded for the derivative. No transaction in the underlying item is recorded. In most instances, when a cash settlement payment is received, a reduction in a financial derivative asset (a credit) is recorded. When a cash settlement payment is made, a reduction of a financial derivative liability (a debit) is recorded. However, in some circumstances, this practice does not hold. When a contract (such as an interest rate swap) calls for ongoing settlement and a cash settlement is received, there is an increase in a financial derivative liability (a credit) if, at the time of the settlement payment, the contract is in a liability position. The reverse also applies; that is, when a contract calls for ongoing settlement, a cash payment is recorded as an increase in an asset (a debit) if, at the time of the settlement, the contract is in an asset position. If compilers are unable to implement this approach because of market practice, it is recommended that all cash settlement receipts be recorded as reductions in financial assets and all cash settlement payments be recorded as decreases in liabilities.

- When an underlying instrument is delivered, two transactions occur and both are recorded. The transaction in the underlying item is recorded at the market price prevailing on the day of the transaction. The transaction in the derivative is recorded as the difference, multiplied by the quantity, between the prevailing market price for the underlying item and the strike price specified in the derivative contract.

- When more than one contract is settled—in cash, at the same time, and with the same counterparty—some of the contracts being settled are in asset positions and some are in liability positions. In this situation, it is recommended that the transactions be recorded on a *gross basis* ; that is, the transactions in assets are recorded separately from those in liabilities and are thereby recorded as separate credit and debit flows. Recording the transactions on a gross basis is preferred to recording them on a *net basis*; that is, after the sum of the liability flows is subtracted from the sum of the asset flows, the resulting debit or credit is recorded as a single amount.[4] However, for practical reasons, there may be no alternative to net recording.

Margins

FD 22. Margins are payments of cash or deposits of collateral that cover actual or potential obligations incurred through financial derivatives—especially futures or exchange-traded options. The required provision of margin reflects market concern over counterparty risk and is standard in financial derivative markets

FD 23. ***Repayable margin*** consists of *cash or other collateral deposited to protect a counterparty against default risk.* Ownership of the margin remains with the unit that deposited it. Although its use may be restricted, a margin is classified as *repayable* if the depositor retains

[4] However, the net basis is recommended for transactions in financial derivatives classified as *reserve assets*.

the risks and rewards of ownership—such as the receipt of income or exposure to holding gains and losses. At settlement, a repayable margin (or the amount of repayable margin in excess of any liability owed on the derivative) is returned to the depositor. In organized markets, repayable margin is sometimes known as ***initial margin***.

FD 24. Repayable margin payments of cash are transactions in ***deposits***, not transactions in financial derivatives. A depositor has a claim on an exchange, brokerage, or other institution holding the deposit. Some countries may prefer to classify repayable margin deposits within *other accounts receivable/payable* in order to reserve the term *deposits* for monetary aggregates. When a repayable margin deposit is made in a non-cash asset (such as securities), no transaction is recorded because no change in ownership has occurred. The entity (the issuer of the security) on which the depositor has a claim is unchanged.

FD 25. The payment of ***nonrepayable margin*** is a transaction in a derivative; the payment is made to reduce a financial liability created through a derivative. In organized exchanges, nonrepayable margin (sometimes known as ***variation margin***) is paid daily to meet liabilities recorded as a consequence of the daily marking of derivatives to market value. The entity that pays nonrepayable margin no longer retains ownership of the margin or has the right to the risks and rewards of ownership. A payment of nonrepayable margin is recorded as a reduction in financial derivative liability (a debit); the contra-entry is a reduction (probably in *currency and deposits*) in a financial asset (a credit). The receipt of nonrepayable margin is recorded as a reduction in a financial derivative asset (a credit); the contra-entry is an increase (probably in *currency and deposits*) in a financial asset (a debit).

FD 26. Arrangements for margining can be complex, and procedures differ among countries. In some countries, repayable and nonrepayable margins are recorded in a single account, and it may be difficult to distinguish between the two types. The actual institutional arrangements (such as the identities of units making payments and types of instrument used) must be reviewed. The key test is whether the margin is repayable or whether payment of the margin represents an effective transfer of ownership between counterparties to the financial derivative contract.

Treatment of Selected Financial Derivatives

Specific interest-rate contracts

FD 27. An ***interest-rate swap*** contract consists of *a contract to exchange, in one currency and during a specified period of time, cash flows related to interest payments or receipts on a notional amount of principal that is never exchanged*. Such swaps are often settled through net cash payments from one of the counterparties to another. A ***forward rate agreement*** (FRA) is *a contract in which the counterparties agree on an interest rate to be paid, at a specified settlement date, on a notional amount of principal that is never exchanged.* FRAs are settled by net cash payments; that is, the difference between the rate agreed upon and the prevailing market rate at the time of settlement is recorded as a transaction in the balance of payments. The buyer of an FRA receives payment from the seller if the prevailing rate exceeds the rate agreed upon. The seller receives payment from the buyer if the prevailing rate is lower than the rate agreed upon. The existence of active financial markets in these contracts results in holding gains and losses. The creation of interest rate swaps and FRA contracts normally requires no entries in the ***financial account*** because there are no exchanges of value at the inception of these contracts. Net cash settlement payments for interest-rate swaps and FRAs are classified in the ***financial account*** as transactions in financial derivatives. Interest-rate swaps usually

involve ongoing settlements during the lives of the contracts; FRAs are usually settled at contract maturity.

Specific foreign currency contracts

FD 28. A ***foreign exchange swap*** contract consists of *a spot sale/purchase of currencies and a simultaneous commitment to a forward purchase/sale of the same currencies*. A ***forward foreign exchange*** contract consists of *a commitment to transact, at a designated future date and agreed-upon exchange rate*, *in a specified amount of specified foreign currencies.* A ***cross currency interest-rate swap*** contract (also known as a ***currency swap***) consists of *an exchange of cash flows related to interest payments and, at the end of the contract, an exchange of principal amounts in specified currencies at a specified exchange rate.* There may also be an exchange of principal at the beginning of the contract. In that case, subsequent repayments that comprise both interest and amortization of principal may be made over time and according to pre-arranged terms. Streams of interest payments resulting from swap arrangements are recorded in the ***financial account*** as transactions in financial derivatives, and repayments of principal are recorded in relation to relevant instruments.

FD 29. For foreign currency financial derivative contracts, it is necessary to distinguish between a transaction in a derivative contract and the requirement to deliver and receive underlying principal associated with the contract.

- In contrast to the creation of other forward contracts, the creation of a foreign currency financial derivative contract does not normally lead to the recording, in the ***financial account***, of a transaction in financial derivatives. Any initial sale or purchase of currency is a transaction that is recorded, at the exchange rate agreed upon by the counterparties, in the *other investment* category of the ***financial account***.
- The exchange rate for the forward sale or purchase of currencies through a foreign currency derivative contract is agreed upon by the counterparties when the terms of the contract are established. The derivative contract acquires value as the prevailing market exchange rate differs from the exchange rate agreed upon in the contract.
- At the time of settlement, the difference between the values (which are measured in the unit of account and at the prevailing exchange rate) of the currencies exchanged are allocated to a transaction in a financial derivative. In other words, if the value of the currency received exceeds that of the currency paid, a reduction in a financial derivative asset (a credit) is recorded. The contra-debit entry is an increase in another asset (probably *other investment—assets, currency and deposits*) classified in the ***financial account.*** When the value of the currency received is less than that of the currency paid, the opposite applies. That is, a reduction in a financial derivative liability (a debit) is recorded. The contra-credit entry is a reduction in another item (probably *other investment—assets, currency and deposits*) classified in the ***financial account***.

Credit Derivatives

FD 30. The financial derivatives described in previous sections are related to ***market risk***, which pertains to *changes in the market prices of securities and commodities and to changes in interest and exchange rates*. Other types of financial derivatives are used primarily to trade ***credit risk***. These ***credit derivatives***, which are *designed for trading in loan and security default risk, can be either forward or option contracts*. Like other financial derivatives, credit derivative contracts are frequently drawn up according to standard legal agreements that specify procedures for the provision of margin, which serves as a basis for market valuation.

FD 31. There are a number of common types of credit derivatives. A ***total return swap*** consists of *swapping of cash flows and capital gains and losses related to the liability of a lower-rated creditor for cash flows related to a guaranteed interest rate, such as an interbank rate, plus a margin*. A ***spread option*** is a *contract with value derived from an interest rate spread between higher quality credit and lower quality credit*. For example, if the spread narrows sufficiently, the option holder benefits from exercising the option. A ***credit default swap*** consists of *swapping, usually on an ongoing basis, the risk premium inherent in an interest rate on a bond or a loan in return for a cash payment that is made in the event of default by the debtor.* Some credit default swap contracts require that one party make only a single payment to the other in order to be financially protected against the risk of a catastrophe befalling the creditor. Reference prices for these single-premium contracts, which are more properly classified as forms of insurance rather than financial derivatives, may not be readily available.

Selected Supplementary Information

FD 32. Because financial derivatives are risk-transferring instruments, there may be interest—from analytical and policymaking points of view—in presenting transactions and positions in financial derivatives by type (option and forward) and by category of risk (foreign exchange, interest-rate, and other).

PART II OF FINANCIAL DERIVATIVES

AMENDMENTS TO THE FIFTH EDITION (1993) OF THE *BALANCE OF PAYMENTS MANUAL*

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VIII. Classification and Standard Components of the Balance of Payments

[. . .]

Capital and Financial Account

[. . .]

Financial account (2.B)

176. The classification of standard components in the ***financial account*** is based on these criteria:

All components are classified according to type of investment or by functional subdivision (*direct investment, portfolio investment, financial derivatives, other investment, reserve assets*).

For the category of *direct investment*, there are directional distinctions (abroad or in the reporting economy) and—for the equity capital, ~~and~~ other capital, and financial derivative components within this category—asset or liability distinctions.

For the categories of *portfolio investment, financial derivatives,* and *other investment,* there are the customary asset/liability distinctions.

Particularly significant for *portfolio investment* and *other investment* is the distinction by type of instrument (equity or debt securities, trade credits, loans, currency and deposits, other assets or liabilities). In this *Manual*, traditional and new money market and other financial instruments ~~and derivatives~~ are included in *portfolio investment*.

For *portfolio investment, financial derivatives*, and *other investment,* there are distinctions by sector of the domestic creditor for assets and by sector of the domestic debtor for liabilities. These distinctions serve to facilitate links with the income accounts, the international investment position, the SNA, and other statistical systems.

The traditional distinction, which is based on original contractual maturity of more than one year or one year or less, between long- and short-term assets and liabilities applies only to *other investment*. In recent years, the significance of this distinction has clearly diminished for many domestic and international transactions. Consequently, the long- and short-term distinction is accorded less importance in the *1993 SNA* and in the fifth edition of the *Manual* than previously. However, because the maturity factor remains important for specific purposes—analysis of external debt, for example—it is retained, in the fifth edition of the *Manual*, for *other investment*.

177. *Direct investment*—reflecting the lasting interest of a resident entity in one economy (direct investor) in an entity resident in another economy (direct investment enterprise)—covers all transactions between direct investors and direct investment enterprises. That is, *direct investment* covers the initial transaction between the two and all subsequent transactions between them and among affiliated enterprises, both incorporated and unincorporated. Direct investment transactions occurring abroad and in the reporting economy are subclassified into equity capital, reinvested earnings, ~~and~~ other

capital (intercompany transactions), and financial derivatives. For equity capital, ~~and~~ other capital, and financial derivatives, claims on and liabilities to affiliated enterprises and to direct investors are distinguished. Transactions between affiliated banks and between other affiliated financial intermediaries are limited to equity and permanent debt capital. (See paragraph 372.)

178. *Portfolio investment* covers transactions in equity securities and debt securities; the latter are ~~subsectored~~ subclassified into bonds and notes and money market instruments. ~~and financial derivatives (such as options) when the derivatives generate financial claims and liabilities~~. Various new financial instruments, other than financial derivatives, are covered under appropriate instrument classifications. Transactions covered under *direct investment* and *reserve assets* are excluded.

New paragraph

178a. The *financial derivative* category covers financial instruments that are linked to other specific financial instruments, indicators, or commodities and through which specific financial risks (such as interest rate risk, foreign exchange risk, equity and commodity price risks, credit risk, etc.) can, in their own right, be traded in financial markets. Transactions in financial derivatives should be treated as separate transactions rather than as integral parts of the values of the underlying transactions to which they are linked.

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*****

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* See **Selected Supplementary Information** table for components.
** Memorandum items: 5.1 Gross premiums
5.2 Gross claims

Standard Components of the Balance of Payments

	Credit	Debit
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		
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		

* See **Selected Supplementary Information** table for components.
** If distributed branch profits are not identified, all branch profits are considered to be distributed.

	Credit	Debit
1.2 Other sectors		
1.2.1 Migrants' transfers		
1.2.2 Debt forgiveness		
1.2.3 Other		
2. Acquisition/disposal of nonproduced, 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		
1.1.4 Financial derivatives		
1.1.4.1 Claims on affiliated enterprises		
1.1.4.2 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		
1.2.4 Financial derivatives		
1.2.4.1 Claims on direct investors		
1.2.4.2 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		

	Credit	Debit
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~~		
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. Financial Derivatives		
3.1 Assets		
3.1.1 Monetary authorities		
3.1 2 General government		
3.1.3 Banks		
3.1.4 Other sectors		
3.2 Liabilities		
3.2.1 Monetary authorities		
3.2.2 General government		
3.2.3 Banks		
3.2.4 Other sectors		
4. ~~3~~ Other investment		
4. ~~3.~~1 Assets		

Standard Components of the Balance of Payments

	Credit	Debit
4. ~~3.~~1.1 Trade credits		
4. ~~3~~.1.1.1 General government		
4. ~~3~~.1.1.1.1 Long-term		
4. ~~3~~.1.1.1.2 Short-term		
4. ~~3~~.1.1.2 Other sectors		
4. ~~3~~.1.1.2.1 Long-term		
4. ~~3~~.1.1.2.2. Short-term		
4. ~~3~~.1.2 Loans		
4. ~~3~~.1.2.1 Monetary authorities		
4. ~~3~~.1.2.1.1 Long-term		
4. ~~3~~.1.2.1.2 Short-term		
4. ~~3~~.1.2.2 General government		
4. ~~3~~.1.2.2.1 Long-term		
4. ~~3~~.1.2.2.2 Short-term		
4. ~~3~~.1.2.3 Banks		
4. ~~3~~.1.2.3.1 Long-term		
4. ~~3~~.1.2.3.2 Short -term		
4. ~~3~~.1.2.4 Other sectors		
4. ~~3~~.1.2.4.1 Long-term		
4. ~~3~~.1.2.4.2 Short-term		
4. ~~3~~.1.3 Currency and deposits		
4. ~~3~~.1.3.1 Monetary authorities		
4. ~~3~~.1.3.2 General government		
4. ~~3~~.1.3.3 Banks		
4. ~~3~~.1.3.4 Other sectors		
4. ~~3~~.1.4 Other assets		
4. ~~3~~.1.4.1 Monetary authorities		
~~4~~ ~~3~~.1.4.1.1 Long-term		
~~4~~ ~~3~~.1.4.1.2 Short-term		
4. ~~3~~.1.4.2 General government		
~~4~~ ~~3~~.1.4.2.1 Long-term		
~~4~~ ~~3~~.1.4.2.2 Short-term		
4. ~~3~~.1.4.3 Banks		
4. ~~3~~.1.4.3.1 Long-term		
4. ~~3~~.1.4.3.2 Short-term		
4. ~~3~~.1.4.4 Other sectors		
4. ~~3~~.1.4.4.1 Long-term		
4. ~~3~~.1.4.4.2 Short-term		
4. ~~3~~.2 Liabilities		
4. ~~3~~.2.1 Trade credits		
4. ~~3~~.2.1.1 General government		
4. ~~3~~.2.1.1.1 Long-term		
4. ~~3~~.2.1.1.2 Short-term		
4. ~~3.~~2.1.2 Other sectors		
4. ~~3~~.2.1.2.1 Long-term		
4. ~~3.~~2.1.2.2 Short-term		

Standard Components of the Balance of Payments

	Credit	Debit
4. ~~3~~.2.2 Loans		
4. ~~3~~.2.2.1 Monetary authorities		
4. ~~3~~.2.2.1.1 Use of Fund credit and loans from the Fund		
4. ~~3~~.2.2.1.2 Other long-term		
4. ~~3~~.2.2.1.3 Short-term		
4. ~~3~~.2.2.2 General government		
4. ~~3~~.2.2.2.1 Long-term		
4. ~~3~~.2.2.2.2 Short-term		
4. ~~3~~.2.2.3 Banks		
4 ~~3~~.2.2.3.1 Long-term		
4 ~~3~~.2.2.3.2 Short -term		
4. ~~3~~.2.2.4 Other sectors		
4.~~3~~.2.2.4.1 Long-term		
4.~~3~~.2.2.4.2 Short-term		
4. ~~3~~.2.3 Currency and deposits		
4. ~~3~~.2.3.1 Monetary authorities		
4. ~~3~~.2.3.2 Banks		
4. ~~3~~.2.4 Other liabilities		
4. ~~3~~.2.4.1 Monetary authorities		
4. ~~3~~.2.4.1.1 Long-term		
4. ~~3~~.2.4.1.2 Short-term		
4. ~~3~~.2.4.2 General government		
4. ~~3~~.2.4.2.1 Long-term		
4. ~~3~~.2.4.2.2 Short-term		
4. ~~3~~.2.4.3 Banks		
4. ~~3~~.2.4.3.1 Long-term		
4. ~~3~~.2.4.3.2 Short -term		
4. ~~3~~.2.4.4 Other sectors		
4. ~~3~~.2.4.4.1 Long-term		
4. ~~3~~.2.4.4.2 Short-term		
5.~~4~~ Reserve assets		
5.~~4.~~1 Monetary gold		
5.~~4.~~2 Special drawing rights		
5.3 Reserve position in the Fund		
5.~~4.4~~ Foreign exchange		
5.~~4.~~4.1 Currency and deposits		
5.~~4.~~4.1.1 With monetary authorities		
5.~~4.~~4.1.2. With banks		
5.~~4.~~4.2 Securities		
5.~~4.~~4.2.1. Equities		
5.~~4.~~4.2.2 Bonds and notes		
5.~~4.~~4.2.3 Money market instruments ~~and financial derivatives~~		
5.4.3 Financial derivatives		
5.~~4.~~5 Other claims		

XIII. Other Services

[. . .]

Definitions

[. . .]

258. *Financial services* cover financial intermediary and auxiliary services (except those of insurance enterprises and pension funds) conducted between residents and nonresidents. Included are intermediary service fees, such as those associated with letters of credit, bankers' acceptances, lines of credit, financial leasing, and foreign exchange transactions. (For the latter, the spread between the midpoint rate and the buying/selling rate is the service charge.) Also included are commissions and other fees related to transactions in securities—brokerage, placements of issues, underwritings, and redemptions; ~~and arrangements of swaps, options, and other hedging instruments;~~ commissions and fees paid for the arrangement of financial derivative contracts; commissions of commodity futures traders; and ~~services related to~~ asset management services, financial market operational and regulatory services, security custody services, etc. [6b] Service charges on purchases of International Monetary Fund resources are included among an economy's financial service payments, as are charges (similar to commitment fees) associated with undrawn balances under stand-by or extended arrangements with the IMF.

[6b] Financial derivative transactions may take place directly between two parties or through intermediaries. In the latter case, there may be implicit or explicit service charges. It is not usually possible to distinguish implicit service charges. Therefore, it is recommended that net settlement payments of derivative contracts be recorded as financial transactions. However, when possible, service charge components should be recorded separately.

XIV. Income

[. . .]

Definition and Classification

[. . .]

274. *Investment income* (property income in the SNA) covers income ~~derived from a resident entity's ownership of foreign financial assets~~ earned on the provision of nonproduced capital. Such provision is usually evidenced by the ownership of foreign financial assets. Financial derivative assets do not represent the provision of finance capital; their value derives from changes in the prices of factors used to construct derivative contracts. Therefore, no investment income is earned on financial derivatives. The most common types of *investment income* are income on equity (dividends) and income on debt (interest). Dividends, including stock dividends, are the distributed earnings allocated to shares and other forms of participation in the equity of incorporated private enterprises, cooperatives, and public corporations. Dividends represent income that is payable without a binding agreement between the creditor and the debtor. Among other types of income on equity are (i) earnings of branches and other unincorporated direct investment enterprises and (ii) direct investors' shares of earnings of incorporated direct investment enterprises. (The latter type of earnings, which are not formally distributed, are earnings other than dividends.) Shares of reinvested earnings attributed to direct investors are proportionate to the participation of the direct investors in the equity of the enterprise. Also, in principle, income is imputed to households from net equity in life insurance reserves and pension funds and included indistinguishably ~~under~~ within *other investment*. Interest, including discounts in lieu of interest, comprises income on loans and debt securities (i.e., bank deposits, bills, bonds, notes, and trade advances). ~~Net interest flows arising from interest rate swaps also are included (See paragraph 406)~~. Interest is payable in accordance with a binding agreement between the creditor and the debtor.

[. . .]

Portfolio investment income

280. Portfolio investment income comprises income transactions between residents and nonresidents and is derived from holdings of shares, bonds, notes, and money market instruments ~~and associated with financial derivatives~~. This category is subdivided into income on equity (dividends) and income on debt (interest). See Chapter 19 for details on new financial instruments ~~and treatment of financial derivatives, such as options~~s. included in *portfolio investment*. The financial instrument classification scheme for portfolio investment income is consistent with that in the ***financial account*** and with that in the international investment position. Subsectoring into domestic institutional sectors (monetary authorities, general government, banks, and other) is shown under **Selected Supplementary Information.** (See the table at the end of Chapter 8.) A variety of other supplementary disaggregations by foreign sector, etc. may be desirable for specific analytical purposes.

XVI. Structure and Characteristics of the Capital and Financial Account

Coverage

[. . .]

308. The standard components of both the **current account** and the **capital and financial account** are discussed in Chapter 8. Coverage of the **capital and financial account** is described in paragraphs 172 through 181, and the classification of components appears at the end of the chapter. Capital and financial account transactions presented in this *Manual* are the same as those reflected in the capital and financial accounts of the SNA external accumulation accounts. However, in the balance of payments, the primary basis for classification of the ***financial account*** is functional category (i.e., *direct investment*, *portfolio investment*, *financial derivatives*, *other investment*, and *reserve assets*) while the SNA classification is primarily by type of instrument: monetary gold, currency and deposits, loans, etc. (See Chapter 3 for details of the relationship between the two sets of accounts.) The structure of the **capital and financial account** also is generally compatible with other statistical systems of the IMF and is consistent with the classification of related income components of the **current account** and with the international investment position.

[. . .]

Financial Account

Coverage

[. . .]

315. ~~However, options and other~~ Financial derivatives are included among financial items; ~~in accordance with the treatment of these items in the *SNA*. These instruments~~ this treatment is consistent with the SNA treatment of financial derivatives. There are active financial markets in these instruments, and they can be valued by reference to the market prices of the derivatives themselves or to the market prices of the ~~commitments~~ real or financial items underlying the derivatives. ~~Thus,~~ Both parties to a derivative contract recognize a financial ~~instrument~~ asset; one party recognizes a liability and the other recognizes a claim. Alternatively, this value could be viewed as the amount one party must pay to the other party in order to extinguish the contract. As a result, derivatives satisfy the definition (see paragraph 314) of foreign financial assets and liabilities. A full discussion of financial derivatives ~~instruments~~ appears in ~~Chapter 19~~ the chapter devoted to that subject.

[. . .]

Transactions in assets

[. . .]

318. To establish whether a transaction involving a foreign asset is a transaction between a resident and a nonresident, the compiler must know the identities of both parties. The information available on transferable claims constituting foreign assets

may not, however, permit identification of the two parties to the transaction. That is, a compiler may not be able to ascertain whether a resident, who acquired or relinquished a transferable claim on a nonresident, conducted the transaction with another resident or with a nonresident, or whether a nonresident dealt with another nonresident or with a resident. Thus, a recommendation that the balance of payments be confined solely to asset transactions between residents and nonresidents would be difficult or impossible to implement. Also, the introduction, in the *Manual*, of a domestic sectoral breakdown for the *portfolio investment, financial derivative,* and *other investment* components of the ***financial account*** makes it necessary to record certain transactions between resident sectors within the economy—although such transactions cancel each other for the total economy. As a result, recorded transactions may include not only those that involve assets and liabilities and take place between residents and nonresidents but also those that involve transferable assets of economies and take place between two residents and, to a lesser extent, transactions that take place between nonresidents. (See paragraph 334.)

[. . .]

Net recording

324. Two or more changes in a specific asset, or changes in two or more different assets classified in the same standard component, are consolidated in a single entry. This entry reflects the net effect of all the increases and decreases that occur during the recording period in holdings of that type of asset. For example, purchases (by nonresidents) of securities issued by resident enterprises of an economy are consolidated with sales (by nonresidents) of such securities, and the net change is recorded for that item. Net decreases in claims or other assets and net increases in liabilities are recorded as credits; net increases in assets and net decreases in liabilities are recorded as debits. There is one exception: it is recommended that transactions in financial derivatives classified as *reserve assets* be recorded only as a single amount; that is, after the change in liabilities is deducted from the change in assets. It is recognized that, in practice, this approach may be the only means by which transactions in financial derivatives classified in other categories (*direct investment* and *financial derivatives*) can be recorded.

[. . .]

Functional types of investment

330. ~~Four~~ Five broad categories of investment, each of which is dealt with in a subsequent chapter, are distinguished.

Direct investment

The direct investor seeks a significant voice in the management of an enterprise operating outside his or her resident economy. To achieve this position, the investor must almost invariably provide a certain, often substantial, amount of the equity capital of the enterprise. The direct investor may also decide to supply other capital to further enterprise operations. Because of the direct investor's special relationship to the enterprise, his motives in supplying capital will be somewhat different from those of other investors. Thus, the capital supplied by a direct investor will probably exhibit characteristic behavior. *Direct investment* is classified primarily on a directional basis—resident direct investment abroad and nonresident investment in the reporting economy—and is subdivided into equity capital, reinvested earnings, ~~and~~ other capital and financial derivatives. Equity capital and other capital, in turn, are subdivided into asset and liability transactions. (Related income, however, is shown on a net basis in the **current account**.)

Portfolio investment

Cross-border investment in equity and debt securities (other than *direct investment*) is both quantitatively and analytically significant. Such cross-border investment therefore warrants separate recording and coverage, particularly in view of the trend towards free international movement of capital and the growth of new financial instruments and new market participants. Coverage of this category is expanded to reflect these developments and to include money market debt instruments ~~and financial derivatives,~~ as well as longer-term debt and equity securities.

Financial Derivatives

The number and the importance of transactions (particularly those taking place outside organized markets) in options and forwards (including swaps) have increased in recent years. The treatment of financial derivatives as a separate functional category reflects their increased importance, as well as the differences between financial derivatives and other types of financial instruments. With financial derivatives, no capital is advanced or repaid; nor is any interest accrued. In the first and second printings of the *BPM5*, data on financial derivatives were formerly classified within a subcategory of *portfolio investment.* Compilers may continue with this approach if activity in financial derivatives is too limited to justify presenting data on these instruments in a separate functional category, but compilers should separately classify data if activity in financial derivatives is significant.

Other investment

This residual group comprises many different kinds of investments. In practice, it is not feasible to draw any further functional distinctions among the various types because the reasons underlying the flows are too numerous and varied. Other breakdowns are therefore used to distinguish behavioral differences among components of this category (i.e., trade credits, loans, currency and deposits, use of Fund credit, loans from the Fund, etc.).

Reserve assets

These are foreign financial assets available to, and controlled by, the monetary authorities for financing or regulating payments imbalances or for other purposes. *Reserve assets* consist of monetary gold, SDRs, reserve position in the Fund, foreign exchange, and other claims. Changes in the holdings of reserves may reflect payments imbalances or responses to them, official exchange market intervention to influence the exchange rate, and/or other actions or influences.

[. . .]

Type of instrument

332. For *portfolio investment*, the type of instrument is the primary classification (i.e., equity and debt securities). Debt securities are subdivided into bonds and notes and money market instruments. ~~and financial derivatives~~. Although the sectoral subdivision for *portfolio investment* is secondary, there is no implication that, in certain instances, it may not be of equal interest to the compiling economy. The same holds true for *financial derivatives* and *other investment*.

Domestic sector

333. For assets, the institutional sector of the domestic (resident) creditor and, for liabilities, that of the domestic debtor often are factors that influence transactions in financial items. The sectoring also improves links with the IMF and

other statistical systems, including the SNA. This *Manual* distinguishes four sectors—monetary authorities, general government, banks, and other sectors—for ~~both~~ *portfolio investment, financial derivatives,* and *other investment*.[8]

[. . .]

Long- and short-term investment
[. . .]

[8] See Appendix 2.

339. In the categories of *direct investment*, *portfolio investment*, *financial derivatives,* and *reserve assets*, long- and short-term investments are not formally distinguished. For *direct investment*, such a distinction is not made because it is essentially determined by arbitrary enterprise decisions and because of the fact that there is no meaningful analytic distinction between the two maturities for intercompany flows. For *portfolio investment, financial derivatives,* and *reserve assets*, formal maturity is not likely to be a significant factor affecting the behavior of components in these categories.

XVIII. Direct Investment

[. . .]

Direct Investment Capital

[. . .]

369. The components of direct investment capital transactions, which—as noted in paragraph 330—are recorded on a directional basis (i.e., resident direct investment abroad and nonresident direct investment in the recording economy), are equity capital, reinvested earnings, ~~and~~ other capital associated with various intercompany debt transactions, and financial derivatives. Equity capital comprises equity in branches, all shares in subsidiaries and associates (except nonparticipating, preferred shares that are treated as debt securities and included under *direct investment*-other capital—see paragraph 370), and other capital contributions. Reinvested earnings consist of the direct investor's share (in proportion to direct equity participation) of earnings not distributed as dividends by subsidiaries or associates and earnings of branches not remitted to the direct investor. If such earnings are not identified, all branch earnings are considered, by convention, to be distributed. Because undistributed (reinvested) earnings result in additions to direct investors' equity in subsidiaries and branches, these earnings are included as direct investment capital transactions in amounts equal to (and with opposite sign) the corresponding entries recorded under direct investment income. (See paragraphs 278, 288, and 321.)

[. . .]

New paragraph

370a. The subcategory of *direct investment–*financial derivatives covers financial derivative transactions between directors and direct investment enterprises unless the transactions are part of the usual banking transactions described in paragraph 372.

[. . .]

372. The recording of intercompany transactions that (1) take place between affiliated banks (depository institutions) and affiliated financial intermediaries (e.g., security dealers) or SPEs serving solely as financial intermediaries and (2) are recorded as direct investment capital transactions is limited to those transactions associated with permanent debt (loan capital representing a permanent interest) and equity (share capital) investment or, in the case of branches, to transactions associated with fixed assets. Deposits and other claims and liabilities (including financial derivatives) related to the usual banking transactions of depository institutions and claims and liabilities of other financial intermediaries are classified, as appropriate, within the categories of *portfolio investment*, *financial derivatives,* or *other investmen*t. The stock of foreign assets and liabilities of banks and other financial intermediaries (international investment position) should be treated in a parallel manner.

[. . .]

Extent of Net Recording

375. *Direct investment* is often referred to as an asset for the economy of the direct investor and as a liability for the economy in which the direct investment enterprise operates. Actually, investor and enterprise have claims on, or liabilities to, each other—although the investor could be expected to have net foreign claims and the enterprise to have net foreign liabilities. It is recommended in the *Manual* that direct investment transactions in equity capital, ~~and~~ other capital (intercompany debt), and financial derivatives be recorded for assets (claims) and liabilities. Thus, in addition to a net investment transaction for each of these components, separate entries are made for the change in claims of direct investors on, and the change in liabilities to affiliated enterprises. These entries are made under *direct investment*-abroad and vice versa for *direct investment*-in reporting economy. For recording *direct investment* in the international investment position, the same entries are made. See the table presenting the standard components of the international investment position at the end of Chapter 23. However, as noted in Chapter 23, the related direct investment income on equity and debt is shown on a net basis for each direction.

XIX. Portfolio Investment

Coverage

385. *Portfolio investment* includes ~~in addition to~~ equity securities and debt securities in the form of bonds and notes and money market instruments. ~~and financial derivatives such as options.~~ Excluded are any of the aforementioned instruments included in the categories of *direct investment* and *reserve assets*. The expanded coverage in transactions reflects changes in international financial markets in recent years and includes the introduction of many new financial instruments within the framework of continuous innovation.

[. . .]

Classification and Definitions

387. The categories of financial instruments classified and defined in the *Manual* are generally consistent with those in the SNA. The major components of *portfolio investment*, which are classified under assets and liabilities, are equity securities and debt securities. Both are usually traded (or tradable) in organized and other financial markets. Debt securities are subdivided into bonds and notes and money market instruments. ~~and financial derivatives, including varieties of new financial instruments~~.

[. . .]

389. Debt securities cover (i) bonds, debentures, notes, etc. and (ii) money market or negotiable debt instruments. ~~and (iii) financial derivatives or secondary instruments, such as options, that usually do not extend to actual delivery and are utilized for hedging of risks, investment, and trading purposes~~.

390. Bonds, debentures, notes, etc. usually give the holder the unconditional right to a fixed money income or contractually determined variable money income. (Payment of interest is not dependent upon the earnings of the debtor.) With the exception of perpetual bonds, bonds and debentures also provide the holder with the unconditional right to a fixed sum as a repayment of principal on a specified date or dates. Included are nonparticipating preferred stocks or shares; convertible bonds; and bonds with optional maturity dates—the latest of which is more than one year after issue.[9] This category also includes negotiable certificates of deposit with maturities of more than one year; dual currency bonds; zero coupon and other deep discounted bonds; floating rate bonds; indexed bonds; and asset-backed securities, such as collateralized mortgage obligations (CMOs) and participation certificates. (Mortgages are not classified as bonds but are included under loans.)

[. . .]

~~392.~~ ~~Certain financial instruments give the holder the qualified right to receive an economic benefit in the form of cash, a primary financial instrument, etc. at some future date. These instruments are referred to as derivatives or secondary instruments in that they are linked to either specific financial instruments or indicators (foreign currencies, government bonds, share price indices, interest rates, etc.) or to particular commodities (gold, sugar, coffee, etc.) that may be purchased or sold at a future date. Derivatives also may be linked to a future~~

[9] ~~The conversion (into equities) option may be considered a tradable derivative (i.e., an asset separate from the underlying security). See paragraph 392. Separation of the value of a transaction into the value of the bond and the value of the option may be effected by reference to transactions in similar bonds traded without options.~~

~~exchange, according to a contractual arrangement, of one asset for another. The instrument, which is a contract, may be tradable and have a market value. When that is the case, the characteristics of the instrument as a contingent asset or liability (not to be recorded in the balance of payments or in SNA sectoral balance sheets) change and give rise to treatment of the instrument as an actual financial asset or liability in the **financial account**. Among derivative instruments are options (on currencies, interest rates, commodities, indices, etc.), traded financial futures, warrants, and arrangements such as currency and interest rate swaps.~~

~~**393.** Transactions in derivatives are treated as separate (mainly financial) transactions rather than being included as integral parts of underlying transactions to which they may be linked as hedges. There are several reasons for this treatment, which is consistent with that in the SNA. The counter party to a derivative transaction will be a different transactor than the transactor for the underlying transaction being hedged. Also, the two parties to the derivative transaction may have different motives — hedging, dealing in the instrument involved, or acquiring the derivative as an investment. Even if both parties are hedging, the hedging may be associated with different financial or other assets. If derivative transactions were included as integral parts of underlying transactions, such treatment would lead to asymmetries of measurement in the balance of payments accounts. For example, the counter party to a derivative contract that hedges an underlying position with a resident may also be a resident. In such an instance, the inclusion of the derivative as part of the underlying transaction would result in the incorrect inclusion of transactions in the balance of payments.~~

Selected Recording Issues

395. The expanded coverage, which includes traditional and new money market ~~and derivative~~ instruments and innovative long-term securities, of *portfolio investment* raises issues concerning the recording of balance of payments entries associated with these instruments. Such issues are discussed, for selected instruments, in subsequent paragraphs.

[. . .]

~~**398.** Among money market and derivative instruments and arrangements, the treatments of short-term notes issued under NIFs, options, warrants, swaps, traded financial futures, and forward rate agreements are noted subsequently.~~

[. . .]

~~**401.** Options are contracts that give the purchaser of the option the right, but not the obligation, to buy (a call option) or to sell (a put option) a particular financial instrument or commodity at a predetermined price (strike price) within a specific time span or on a specified date. Some leading types of options are those on foreign currencies, interest rates, equities, commodities, specified indexes, etc. The buyer of the option pays a premium (the option price) to the seller (writer or issuer) for the latter's commitment to sell or purchase the specified amount of the underlying instrument or commodity or to provide, on demand of the buyer, appropriate remuneration. By convention, in this *Manual* and in the *SNA*, that commitment is treated as a liability of the seller and represents the current cost to the seller of buying out his contingent liability.~~

~~**402.** Conceptually, the payment of the premium referred to previously includes two elements: the purchase price of a financial asset and a service charge. In practice, it often is not possible to identify the service element separately. If the latter can be distinguished, it should be entered under financial services. If not, it is recommended that the full premium be recorded in the balance of payments as the acquisition of a financial asset by the buyer and as an incurrence of a liability by the seller. Subsequent trading (sales) of options is~~

recorded in the **financial account**, as is the exercise or purchase/sale of the underlying financial instrument. If an option actually proceeds to delivery, which is not the usual case, the acquisition or sale of the underlying asset (real or financial) is recorded at the prevailing market price in the appropriate balance of payments component. Offsetting that entry is the actual amount payable or receivable; the difference between that amount and the prevailing market price is reflected in an entry that extinguishes the option contract. If an option contract is closed out prior to delivery, the actual amount payable or receivable is offset by the entry extinguishing the option contract. When initial margin payments and subsequent increases or decreases are payable by the parties to options, the payments should be recorded as both assets and liabilities in the financial account under other investment, currency and deposits in the ***financial account***. Payments into, and withdrawals from, these accounts sometimes may be reflected in transactions in the traded options to which the accounts relate and, if so, are recorded under option transactions in the ***financial account***.

403. Warrants (a particular form of option) are tradable instruments giving the holder the right to buy from the issuer of the warrant (usually a corporation) a certain number of shares or bonds under specified conditions for a designated period of time. Warrants can be traded apart from the underlying securities to which the warrants are linked and thus have a market value. The treatment of warrants is the same as that for other options, and the issuer of the warrant is considered, by convention, to have incurred a liability, which is the counterpart of the asset held by the buyer and reflects the current cost of buying out the issuer's contingent liability.

404. Another variety of tradable warrant (usually issued by investment intermediaries) is a currency warrant, the value of which is based on the amount of one currency required to purchase another currency at or before the expiration date of the warrant. Currency warrants and cross-currency warrants with payments denominated in third currencies should be treated in a similar manner to other warrants.

405. A swap is a contractual arrangement involving two parties who agree to exchange, over time and according to predetermined rules, streams of payment on the same amount of indebtedness. The two most prevalent varieties of swaps are interest rate swaps and currency swaps. An interest rate swap involves an exchange of interest payments of different character (e.g., fixed rate and floating rate, two different floating rates, fixed rate in one currency and floating rate in another, etc.). A currency swap involves an exchange of specified amounts denominated in two different currencies and subsequent repayments reflecting principal and/or interest. (Central bank currency swap arrangements usually undertaken for exchange rate policy purposes and involving the temporary exchange of deposits as of a particular date and the reversal of the transaction at a future date are referred to in paragraph 434.)

406. Balance of payments entries for streams of interest payments associated with swap transactions are recorded, on a net basis, in the **current account**, and streams of principal repayments are recorded in the ***financial account***. Although neither party to a swap arrangement is considered to be the provider of a service to the other, any payment to a third party involved in arranging the swap is recorded under financial services.

407. A futures contract is an agreement between two parties to exchange a real asset for a financial asset, or to exchange, on a specified date at a predetermined rate, two financial assets. Traded financial futures, including those for interest rates, currencies, commodities, equities, or other indices, are recorded in the ***financial account*** in a manner similar to the recording of options. Transactions associated

with nontraded financial futures are likely to occur infrequently and are recorded under the other assets or other liabilities components of *other investment*.

408. A forward rate agreement (FRA) is an arrangement according to which two parties agree on an interest rate to be paid, on a specified settlement date, on a notional amount of principal that is never exchanged. At that time, the settlement payment (i.e., the difference between the rate agreed upon and the prevailing market rate at the time of settlement) is recorded as a transaction in the balance of payments. The buyer of the FRA receives payment from the seller if the prevailing rate exceeds the rate agreed upon; the seller receives payment from the buyer if the prevailing rate is lower than the rate agreed upon. These payments are recorded as interest income in the **current account** of the balance payments. Because there is only a notional (not an actual) underlying asset, there are no entries in the ***financial account***.

XX. Other Investment

Coverage

411. *Other investment* is a residual category that includes all financial transactions not covered in *direct investment, portfolio investment*, *financial derivatives*, or *reserve assets* (discussed in Chapter 21).

Classification

412. As is the case with *portfolio investment*, assets and liabilities for *other investment* are classified primarily on an instrument basis. The sectors of domestic creditor or debtor—the secondary basis for the classification—are monetary authorities, general government, banks, and other sectors. (For the definitions of sectors, see Appendix 2.) In contrast to those for *direct investment*, ~~and~~ *portfolio investment*, and *financial derivatives,* the maturity distinction (long- or short-term) for *other investment* is a third-level basis of classification.

413. The instrument subclassification for *other investment* (as is that for *portfolio investment*) is closely linked to the SNA categories for financial assets. (See Chapter 3.) While the relative importance of types of investment differs considerably among economies, the types reflect most of the financial instruments and channels utilized for the acquisition of assets and incurrence of liabilities—other than for *direct investment, portfolio investment, financial derivatives*, and *reserve assets*. The instrument classification comprises trade credits, loans (including the use of Fund credit and loans from the Fund), currency and deposits (both transferable and other), and other assets and liabilities (for example, miscellaneous accounts receivable and payable).

Definitions and Recording

[. . .]

421. Deposits comprise both transferable and other deposits. Transferable deposits consist of deposits that are exchangeable on demand at par without restriction or penalty, freely transferable by check or giro order, and otherwise commonly used to make payments. Deposits may be denominated in domestic or foreign currencies. With the exclusion of transferable deposits, other deposits ~~include~~ comprise all claims, including repayable margins for financial derivatives, that reflect evidence of deposit. Typical examples are non-transferable savings deposits, time deposits; and shares (evidence of deposit),which are legally or practically redeemable on demand or on short notice, in savings and loan associations, credit unions, building societies, etc.

422. Other assets and liabilities cover any items other than loans and currency and deposits. For example, capital subscriptions to international nonmonetary organizations are classified ~~under this category~~ within this subcomponent, as are miscellaneous accounts receivable and payable. In countries where repayable margins for financial derivatives are not classified as deposits, the repayable margins should be recorded as other assets and liabilities.

423. As noted in paragraph 372, transactions (other than those associated with permanent debt and equity investment) of banks and other financial intermediaries in ~~a~~ direct investment relationships are included in *portfolio investment, financial derivatives*, or *other investment*. Thus, loans and deposits of such institutions are included, as described in paragraphs 415 and 421, within those components.

XXI. Reserve Assets

Concept and Coverage

424. *Reserve assets*, the ~~fourth~~ fifth major functional category of the ***financial account***, is an important component of balance of payments statistics and an essential element in the analysis of an economy's external position. *Reserve assets* consist of those external assets that are readily available to and controlled by monetary authorities for direct financing of payment imbalances, for indirectly regulating the magnitude of such imbalances through intervention in exchange markets to affect the currency exchange rate, and/or for other purposes. (See paragraphs 425 and 432.) The category of *reserve assets,* as defined in this *Manual,* comprises monetary gold, SDRs, reserve position in the Fund, foreign exchange assets (consisting of currency and deposits, ~~and~~ securities, and financial derivatives), and other claims. (See paragraph 443.) Securities that do not satisfy the requirements of *reserve assets* are included in *direct investment* and *portfolio investment*.

[. . .]

Classification

[. . .]

New paragraph

442a. Transactions in financial derivatives (for example, forwards, futures, swaps, and options) that take place with nonresidents should be recorded in *reserve assets* only if such transactions pertain to the management of reserve assets, are integral to the valuation of such assets, and are controlled by monetary authorities. In addition, such financial derivatives must be highly liquid and settlement payments must be made in foreign currency. Unlike transactions in all other items, financial derivative transactions in *reserve assets* should be recorded after transactions in liability positions are subtracted from transactions in asset positions. This method of recording will sometimes result in negative net asset positions.

XXIII. International Investment Position

[. . .]

Classification

464. Classification of the international investment position (and of changes to the IIP) has two dimensions. (See the table at the end of this chapter.) In the rows of the table, the primary distinction is between assets and liabilities; the difference between the two represents the net position. Fully consistent with the balance of payments ***financial account***, the first IIP subclassification is by function. Assets are divided into *direct investment*, *portfolio investment*, *financial derivatives*, *other investment*, and *reserve assets*; liabilities are divided the same way (except for *reserve assets*).

465. Within the functional categories and in concordance with the *income* component of the **current account** and with the ***financial account*** in the balance of payments, *direct investment* is subdivided into equity capital plus reinvested earnings, ~~and~~ other capital (intercompany debt), and financial derivatives. Claims on, and liabilities to, affiliated enterprises are shown separately. *Portfolio investment* is classified primarily by instrument—equity securities and debt securities ~~and financial derivatives~~—and secondarily by appropriate sectors. *Financial derivatives* are classified by sector. *Other investment* also is classified first by instrument and then by sector. ~~Included are~~ *Other investment* covers trade credits, loans, currency and deposits, and other assets and liabilities (such as capital subscriptions to international, nonmonetary organizations and miscellaneous accounts receivable and payable). *Reserve assets* are largely interchangeable from a functional standpoint. (See paragraphs 437 through 443.)

[. . .]

Valuation of Components

[. . .]

468. *Portfolio investment* (equity securities and debt securities ~~and financial derivatives~~) is valued at current market prices at the appropriate reference dates. For equities that are listed in organized markets or are readily tradable, the value of outstanding stocks should be based on actual prices. The value of equities that are not quoted on stock exchanges or otherwise traded regularly should be estimated by using the prices of quoted shares that are comparable as to past, current, and prospective earnings and dividends. Alternatively, the net asset values of enterprises to which the equities relate could be used to estimate market values if the balance sheets of the enterprises are available on a current value basis. For debt securities that are listed in organized markets or are readily tradable, the outstanding value of stocks also should be determined on the basis of current market prices. For debt securities that are not readily tradable, the net present value of the expected stream of future payments/receipts associated with the securities could be used to estimate market value. (The net present value of any future receipt is equal to the value of that receipt when discounted at an appropriate interest rate.)

469. *Financial derivatives* are valued, for the international investment position, at market prices current on appropriate reference dates. It is recommended that gross asset and gross liability data be compiled by summing,

respectively, the values of all individual contracts in asset positions and the values of all individual contracts in liability positions. [13a] If market prices data are unavailable, other fair value methods, such as option models or discounted present values, may be used to value financial derivatives. ~~Principles for valuation of financial derivatives in the investment position are, in some respects, less definitive than for other portfolio investment instruments. There are ongoing efforts by national and international accounting bodies to define standards for the measurement and recording of derivatives. Thus, in the *Manual*, a thorough treatment of derivative valuation is not attempted—particularly in view of continued innovations in this area. Rather, brief valuation guidelines that are consistent with those in the *SNA* and applicable to a number of existing derivatives are presented subsequently.~~

470. ~~Traded options, warrants, and traded financial futures, all of which are treated as financial assets, are included in the position at market values on the appropriate accounting dates.~~ For an option, the market value recorded is either the current value of the option—that is, the prevailing market ~~rate~~ price—or the amount of the premium paid as a proxy. The counterpart liability is attributable, by convention, to the writer of the option and is valued at the current ~~value~~ cost of buying out the rights of the option holder. For a warrant, the counterpart liability of the issuer is the current ~~value of buying out~~ outlay required to buy out the exercise rights of the holder. ~~A contract for a currency swap~~ A forward is recorded at market value; when payments are effected, the value of the asset and associated liability is amortized and subsequently reflected in the position on the appropriate accounting date. The market value of a forward contract can switch from an asset position to a liability position (and vice versa) between reporting dates. The switch is a result of movement in the price of the underlying item(s) from which the value of the forward is derived. All price changes, including those that result in such switches of position, are treated as revaluations. When a switch in position occurs (and there are no settlement payments), the market value of the gross asset/liability position at the close of the previous accounting period is revalued to zero, and the gross liability/asset position is revalued from zero to the market value at the end of the present accounting period.

[. . .]

New paragraph

473a. The net marked-to-market values of financial derivative contracts (forwards, futures, swaps and options, for example) with nonresidents should be recorded in *reserve assets* only if the derivative contracts pertain to the management of reserve assets, are integral to the valuation of such assets, and are controlled by the monetary authorities. In addition, such derivative contracts must be highly liquid, and settlement thereof must be executed in foreign currency. Unlike all other items recorded in the position, financial derivatives—if reported as *reserve assets*—should be recorded after liability positions are deducted from asset positions, even if the result is a negative net asset position.

[13a] There is one exception, which pertains to *reserve assets,* to this recommendation. See paragraph 473a.

Standard Components of the International Investment Position

	Changes in Position Reflecting				
Position at Beginning of Year	Trans-actions	Price Changes	Exchange Rate Changes	Other Adjust-ments	Position at End of Year

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
1.3 Financial derivatives
1.3.1 Claims on affiliated enterprises
1.3.2. 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~~

*****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~~ disaggregations are shown for the components of each, although these sub-items do not strictly conform to the overall headings of **Assets** and **Liabilities.**

Standard Components of the International Investment Position

	Position at Beginning of Year	Changes in Position Reflecting: Trans-actions	Price Changes	Exchange Rate Changes	Other Adjust-ments	Position at End of Year
3. Financial Derivatives						
3.1. Monetary authorities						
3.2 General government						
3.3 Banks						
3.4 Other sectors						
4. ~~3~~. Other investment						
4. ~~3~~.1 Trade credits						
4. ~~3~~.1.1 General government						
4. ~~3~~.1.1.1 Long-term						
4. ~~3~~. 1.1.2 Short-term						
4. ~~3~~. 1.2 Other sectors						
4. ~~3~~. 1.2.1 Long-term						
4. ~~3~~. 1.2.2 Short-term						
4. ~~3~~. 2 Loans						
4. ~~3~~.2.1 Monetary authorities						
4. ~~3~~.2.1.1 Long-term						
4. ~~3~~.2.1.2 Short-term						
4. ~~3~~.2.2 General government						
4. ~~3~~. 2.2.1 Long-term						
4. ~~3~~. 2.2.2 Short-term						
4. ~~3~~. 2.3 Banks						
4. ~~3~~.2.3.1 Long-term						
4. ~~3~~. 2.3.2 Short -term						
4. ~~3~~.2.4 Other sectors						
4. ~~3~~. 2.4.1 Long-term						
4. ~~3~~. 2.4.2 Short-term						
4. ~~3~~. 3 Currency and deposits						
4. ~~3~~.3.1 Monetary authorities						
4. ~~3~~.3.2 General government						
4. ~~3~~.3.3 Banks						
4. ~~3~~.3.4 Other sectors						
4. ~~3~~. 4 Other assets						
4. ~~3~~. 4.1 Monetary authorities						
4. ~~3~~. 4.1.1 Long-term						
4. ~~3~~. 4.1.2 Short-term						

Standard Components of the International Investment Position

	Changes in Position Reflecting				
Position at Beginning of Year	Trans-actions	Price Changes	Exchange Rate Changes	Other Adjust-ments	Position at End of Year

4. ~~3~~. 4.2 General government
    4. ~~3~~. 4.2.1 Long-term
    4. ~~3~~. 4.2.2 Short-term
4. ~~3~~. 4.3 Banks
    4. ~~3~~.4.3.1 Long-term
    4. ~~3~~.4.3.2 Short-term
4. ~~3~~.4.4 Other sectors
    4. ~~3~~.4.4.1 Long-term
    4. ~~3~~.4.4.2 Short-term

5. ~~4.~~ Reserve assets

5. ~~4.~~ 1 Monetary gold
5. ~~4.~~ 2 Special drawing rights
5. ~~4.~~ 3 Reserve position in the Fund
5. ~~4.~~ 4 Foreign exchange
    5. ~~4.~~ 4.1 Currency and deposits
        5. ~~4.~~ 4.1.1 With monetary authorities
        5. ~~4.~~ 4.1.2 With banks
    5. ~~4.~~ 4.2 Securities
        5. ~~4.~~ 4.2.1 Equities
        5. ~~4.~~ 4.2.2 Bonds and notes
        5. ~~4.~~ 4.2.3 Money market instruments ~~and financial derivatives~~
    5.4.3 Financial derivatives (net)
5. ~~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
1.3 Financial derivatives
    1.3.1 Claims on direct investors
    1.3.2 Liabilities to direct investors

Standard Components of the International Investment Position

	Position at Beginning of Year	Changes in Position Reflecting: Trans-actions	Price Changes	Exchange Rate Changes	Other Adjust-ments	Position at End of Year
2. Portfolio investment						
2.1 Equity securities						
2.1.1 Banks						
2.1.1 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. Financial Derivatives						
3.1. Monetary authorities						
3.2 General government						
3.3 Banks						
3.4 Other sectors						
4.~~3~~ Other investment						
4.~~3~~.1 Trade credits						
4.~~3~~.1.1 General government						
4.~~3~~.1.1.1 Long-term						
4.~~3~~.1.1.2 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~~ disaggregations are shown for the components of each, although these sub-items do not strictly conform to the overall headings of **Assets** and **Liabilities.**

Standard Components of the International Investment Position

		Changes in Position Reflecting			
Position at Beginning of Year	Trans-actions	Price Changes	Exchange Rate Changes	Other Adjust-ments	Position at End of Year

4. ~~3~~.1.2 Other sectors
    4. ~~3~~.1.2.1 Long-term
    4. ~~3~~.1.2.2 Short-term
4. ~~3~~.2 Loans
    4. ~~3~~.2.1 Monetary authorities
        4. ~~3~~.2.1.1 Use of Fund credit and loans from the Fund
        4. ~~3~~.2.1.2 Other long-term
        4. ~~3~~.2.1.3 Short-term
    4. ~~3~~.2.2 General government
        4. ~~3~~.2.2.1 Long-term
        4. ~~3~~.2.2.2 Short-term
    4. ~~3~~.2.3 Banks
        4. ~~3~~.2.3.1 Long-term
        4. ~~3~~.2.3.2 Short-term
    4. ~~3~~.2.4 Other sectors
        4. ~~3~~.2.4.1 Long-term
        4. ~~3~~.2.4.2 Short-term
4. ~~3~~.3 Currency and deposits
    4. ~~3~~.3.1 Monetary authorities
    4. ~~3~~.3.2 Banks
4. ~~3~~.4 Other liabilities
    4. ~~3~~.4.1 Monetary authorities
        4. ~~3~~.4.1.1 Long-term
        4. ~~3~~.4.1.2 Short-term
    4. ~~3~~.4.2 General government
        4. ~~3~~.4.2.1 Long-term
        4. ~~3~~.4.2.2 Short-term
    4. ~~3~~.4.3 Banks
        4. ~~3~~.4.3.1 Long-term
        4. ~~3~~.4.3.2 Short-term
    4. ~~3~~.4.4 Other sectors
        4. ~~3~~.4.4.1 Long-term
        4. ~~3~~.4.4.2 Short-term

Appendix I. Relationship of the Rest of the World Account to the Balance of Payments Accounts and the International Investment Position

[. . .]

Conversion Procedures

[. . .]

Classification and Linkages

[. . .]

511. Coverage of account V.III.2, the SNA ***financial account,*** is identical with that of the ***financial account*** of the **capital and financial account** in the balance of payments, although the level of detail is different. (See Table 4 at the end of this appendix.) In the SNA, financial assets are classified primarily by type of instrument. In the balance of payments, financial items are classified primarily by function: *direct investment, portfolio investment, financial derivatives, other investment* (including loans), and *reserve assets*. In addition to categories identifying types of financial instruments (insurance technical reserves being an exception), the balance of payments contains an abbreviated ~~breakdown~~ disaggregation by sector (monetary authorities, general government, banks, and other sectors) to provide links with other bodies of economic and financial statistics such as money and banking, government finance, international banking, and external debt. Furthermore, to conform with the *SNA,* the *Manual* states that entries in the ***financial account*** of the balance of payments are recorded, in principle, on a net basis (increases less decreases in assets or liabilities). However, gross recording is included as supplementary information (for example, in the case of drawings and repayments on long-term loans).

Appendix II. A Note on Sectors

512. As presented in the *Manual*, the sectorization of the balance of payments *portfolio investment, financial derivatives* and *other investment* accounts and related components of the international investment position strengthens the links between the international accounts, the SNA, and IMF statistical systems such as money and banking, government finance, and international banking. In addition, the sectorization enhances the analytic usefulness of the accounts.

Appendix V. Selected Issues in Balance of Payments Analysis

[. . .]

General Framework

[. . .]

556. In addition to current transactions (i.e., those involving the exchange of goods, the provision of services, and the receipt and payment of income and transfers), the flow of financial transactions (i.e., those involving changes in financial claims on, and liabilities to, the rest of the world) must be analyzed. As noted in chapters 8 and 16, these transactions have two main components: (i) narrowly defined financial transactions in *direct investment*, *portfolio investment*, *financial derivatives,* and *other investment* (including trade credits, loans, and deposits) and (ii) transactions in *reserve assets*. There are direct linkages between these components of a country's international transactions. For example, imports of goods are often financed by nonresident suppliers so that an increase in imports will typically be matched by a financial inflow. At the expiration of the financing period, the payment to the nonresident supplier will involve either a drawdown of foreign assets (e.g., foreign deposits held by domestic banks) or the replacement of the liability to the nonresident supplier by another liability to nonresidents. There are also close connections between many ***financial account*** transactions. For example, the proceeds from the sale of bonds in foreign capital markets (a financial inflow) may be temporarily invested abroad in short-term assets (a financial outflow).