Box 2

Errors and omissions in the balance of payments

The balance of payments is a double-entry account of foreign trade. It comprises the current account and the capital and financial account. The current account covers all trade in goods and services together with the balance on income (compensation of employees, dividends and reinvested earnings, and interest payments) and current transfers. While the current account shows current external receipts and expenditures, the capital and financial account shows capital flows, i.e. in- and outflows of capital in connection with transactions between residents and non-residents. The main items in the capital and financial account are capital transfers[1] and the financial account. The financial account is classified into direct investment, portfolio and other investment, and changes in the Central Bank's foreign reserves. Investment in Iceland by non-residents and residents' sales of foreign assets cause capital inflows, while debt service, amortisation and residents' investments abroad cause capital outflows.

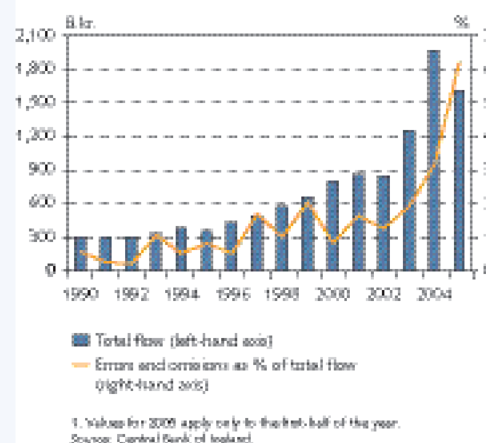
In theory, the current account and the capital and financial account should balance, whereby a current account surplus is deployed on external investment and/or reduction of foreign debt, while a current account deficit is funded by foreign borrowing or depletion of assets. In practice, however, this is not the case, because all balance of payments items are measured independently, irrespective of actual payment flows. Errors and omissions are a balancing item, i.e. a net figure, so that errors in individual items may cancel each other out if they have opposite numerical signs. Thus the errors and omissions item is not necessarily a measure of the quality of the balance of payments accounts, and a low figure need not imply more accurate accounting.

There are three main explanations for imperfect balance of payments measurements. First, a lag may occur because of individual transactions, for example investment in transportation hardware, borrowing, securities purchases, etc., are not recorded at the "correct" time relative to the actual payments flow. At constant prices and exchange rate, a lag will be levelled out over time. Second, valuation errors may creep in when the price of individual items is not "correctly" measured, neither in foreign nor domestic currency. In Iceland, exchange rate volatility has compounded this problem, especially when accompanied by lags in recording. Third, a balance of payments error may stem from an error in recorded volume. Individual items may be overestimated or underestimated due to documentation errors, or because transactions or capital movements between residents and non-residents are estimated rather than absolute.

Chart 1 shows that, as a ratio of total current account and capital and financial account flows, errors and omissions have increased in pace with rapidly growing total flows. The persistent negative error can probably be attributed to underestimated investments abroad by Icelanders. The abolition of currency controls and new investment opportunities, compounded by large changes in the financial sector, have not made data collection any easier in recent years and explain part of the growing error. Over the period 1995 to 2000, the errors and omissions figure was persistently negative, implying that it was systemic. The main explanation could lie in liberalisation of capital movements, in particular because data collection methods were not updated in good time to reflect new foreign currency regulations.

Chart 1

Errors and omissions and total current account and capital and financial account flows 1990-2005[1]



1. Values for 2005 apply only to the first half of the year.
Source: Central Bank of Iceland.

Chart 2

Errors and omissions and the current account balance as % of GDP 1991-2005[1]

1. Values for 2005 apply only to the first half of the year.
Source: Central Bank of Iceland.

1. Which do not involve changes in the stock of the external position.

Chart 3

Errors and omissions
Q1/1991 - Q2/2005

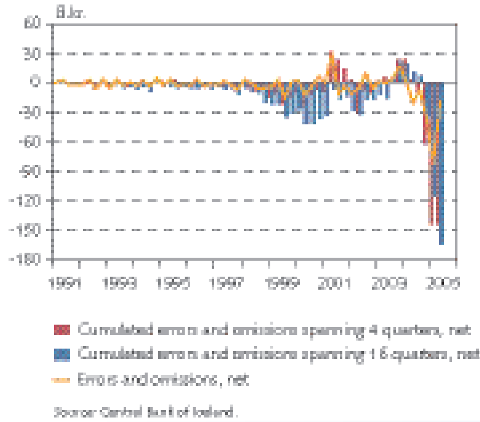
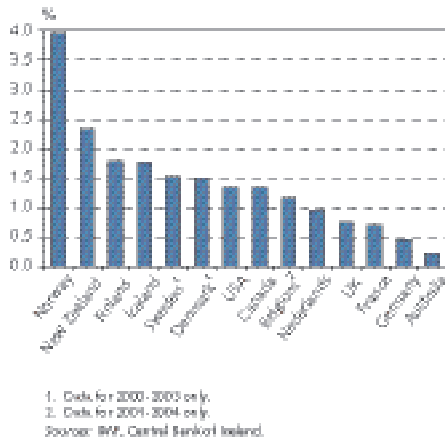


Chart 4

Errors and omissions as a ratio of total transactions and currency flows, on average over the period 2000-2004



When restrictions on foreign exchange transactions were lifted, data were lost which had previously been acquired by the Central Bank's foreign exchange supervision department, e.g. on the surrender of foreign currency receipts from exports. Seasonal errors have also become more volatile, but broadly cancelled each other out over the calendar year until 1996. Quarterly balance of payments figures are initially stated as provisional and generally need to be revised due to late data returns. At the end of the year, quarterly figures are adjusted to incorporate data from surveys in areas such as software exports, direct foreign investment and private sector foreign loan movements. Since 1997, the errors and omissions figure has grown quite markedly in króna terms, in line with increased external trade and capital movements. Chart 3 shows the quarterly errors and omissions figure in b.kr., and as a cumulative error spanning four and sixteen quarters.

Other Nordic countries also experienced an increase in errors and omissions when they abolished currency controls and restrictions on cross-border investment. They are therefore generally considered to originate in the capital and financial account. However, this view is not universal, because in Sweden an underestimated services item was eventually traced to intercompany transactions between multinational parent companies and subsidiaries.

Chart 4 presents errors and omissions figures for selected countries as a ratio of total transactions and average currency flows over the period 2000-2004. Norway's figure is by far the largest, followed by Finland and New Zealand. Iceland comes close behind Finland with an average of 2.5%. Naturally such a comparison is limited: for example, individual balance of payments items can have different weights in different countries, especially cross-border capital movements. Likewise, certain countries could be disadvantaged by the choice of this period as a sample due to economic and regulatory changes which could temporarily affect their data acquisition.