

BALANCE OF PAYMENTS

The balance of payment of a country is a systematic record of all economic transactions between its residents and residents of foreign countries.

Economic transaction - These are the transactions which cause transfer of value. In the context of foreign transactions value is transferred by the resident of one country to the resident of the other country.

For example:- when export of goods or services are made by country 'A' to country 'B', then value is transferred by country B to country A in terms of foreign ex-change.

Economic Transaction in BOP: -

- Visible items which include all types of physical goods exported imported.
- Invisible items which include all types of services.
- Capital transfers which are concerned with capital receipts and capital payment.

Balance of Trade: - It is difference between export of goods and import of goods.

Balance of Trade = Exports of visible items – Imports of invisible items.

It does not account for invisible items of trade as well as capital transfers.

Name of three items which are not included in BOT are:-

- Export and import of services such as of shipping, insurance and banking.
- Interest and dividend payments between the countries.
- Expenditure by the tourists.

Current account: - It is that account which records imports and exports of goods and services and unilateral transfers.

Components of current account:-

- Export and import of goods (or of visible items)
- Export and import of services (or invisible items).
- Unilateral transfers from one country to the other. These are not trading transactions. There is no payment in response to the receipt of unilateral transfers. Eg. : - gifts, aids, donations.

Important observations: -

- All exports (of goods and services) are recorded as positive (+) items as these result in the flow of foreign exchange into the country.
- All imports (of goods and services) are recorded as negative (-) items as these cause the flow of foreign exchange out of the country.

- Balance occurring on account of export and import of goods is regarded as balance of visible trade.
- Balance occurring on account of export and import of services is recorded as balance of invisible trade.
- Receipts of unilateral transfers are recorded as positive items.
- Payments of unilateral transfers are recorded as negative items.

**Current account balance = Balance of visible trade +
Balance of Invisible trade +
Balance of unilateral transfers.**

Capital Account: - It is that account which records all such transactions between residents of country and rest of the world which cause a change in the asset or liability status of the residents of a country or its government.

Components of capital account: -

1. **Foreign investment:** - It has two sub-components.
 - **FDI (Foreign Direct Investment)** – It refers to the purchase of asset in rest of the world which allows control over the asset. Eg. Purchase of a firm by TATA in rest of the world.
 - **Portfolio Investment** – It refers to purchase of an asset in rest of the world, without any control over that asset. Eg. purchase of some shares of a company by TATA in rest of the world.
2. **Borrowing:** It has two sub-components.
 - **Commercial borrowings** – It refers to borrowings by a country (including govt. And the private sector) from the international money market. This involves market rate of interest without considerations of any concession.
 - **Borrowings as external assistance** – It refers to borrowings by a country with considerations of assistance. It involves lower rate of interest compared to that prevailing in the open market.
3. **Banking capital Transactions** – It refers to transactions of external financial assets and liabilities of commercial banks and co-operative banks operating as authorized dealers in foreign exchange. These transactions include NRI deposits.

Important Observations

1. All capital transactions causing flow of foreign exchange into the country are recorded as positive items in the capital account of BOP. Eg: loans from rest of the world, foreign direct investment or portfolio investment by the non-residents in our country.
2. All capital transactions causing flow of foreign exchange out of the country are recorded as negative items in the capital account of BOP.
3. While FDI and portfolio investment are non-debt creating capital transactions, borrowings are debt creating capital transactions.
4. **Capital account balance =**
Inflow of foreign exchange an account of the sale of domestic assets or borrowings from rest of the world (-)
Outflow of foreign exchange an account of the purchase of foreign asset or loans to rest of the world.

Important Note:

- Decreases in official reserves are shown as positive (+) items in the BOP accounts because their sale causes the flow of foreign exchange into the country.
- Increases in official reserves are shown as negative (-) items in the BOP accounts, because their purchases (through foreign exchange) causes flow of foreign exchange out of the country.

Autonomous and accommodating items of Balance of payments (BOP):-

Autonomous items: - These are those items of BOP accounts

- Which are related to such transactions as are determined by the motive of profit maximization?
- Which are not conditioned by the BOP status of the country? Positive/ negative if favorable/ unfavorable.
- Which are not meant to establish BOP country?
- Which are above the Lined Items?

Accommodating Items: - These are those items of BOP accounts:

- Which are not related to such transactions as are determined by the motive of profit maximization
- Which are conditioned by the positive or negative BOP status of the country?
- Which are meant to establish BOP identity
- Which are below the Lined Items?

Disequilibrium in Balance of Payments: - It is a state of either BOP status or surplus BOP status. Equilibrium in BOP is achieved when the net balance of all receipts and payments is zero.

Two types of Disequilibrium in BOP:-

1. **Surplus BOP disequilibrium** – when the net balance of all receipts and all payments as positive.
2. **Deficit BOP disequilibrium** – when the net balance of all receipts and payments is negative.

Causes of Disequilibrium:

a) Economic Factors

- Huge development expenditure by the govt.:- causes to deficit BOP equilibrium.
- Business cycle in terms of
 - Recession/ depression- deficit BOP equilibrium
 - Recovery/ Boom-surplus BOP equilibrium
- Inflation Rate
 - High- deficit BOP equilibrium (import increases)
 - Low – surplus BOP equilibrium (export increases)

b) Political Factors

- Political Instability :- increases credit side of BOP
- Government Policies:-
 - Unfavorable – increases debit side of BOP
 - Favorable :- increases credit side of BOP

c) Social Factors

- Change in taste and preferences
 - Favorable change :- surplus BOP equilibrium
 - Unfavorable change :- deficit BOP equilibrium,

- Cross- Border Prejudices
 - Favorable change:- surplus BOP equilibrium
 - Unfavorable change – deficit BOP equilibrium

Balance of Payments

Credit	Amount	Debit	Amount
Export of goods	550	Import of goods	800
Export of services	150	Import of services	50
Transfer payments from the rest of the world	100	Transfer payment to the rest of the world	80
Capital receipts	200	Capital Payment	70

1. Balance of trade = Exports of goods – Import of goods.
= 550-800
= (250).
2. Balance of services = Export of services (-) import of services
= 150-50
= 100
3. Balance of transfer payment = Transfer Receipts (-) Transfer payments
= 100-80
= 20
4. Balance of payment on current A/c = (1) +(2)+(3)
= (250) +100+20
= (130).
5. Balance of payment on capital A/c. = Capital receipts (-) capital payments
= 200-70
= 130
6. Balance of payment = Total receipts (credit side) (-) Total payments (debit side)
= 1000-1000
= 0.