Balance of Payment (BOP)

Module 2

Definition

What is Balance of payment?

According to Bo Sodersten, “The balance of payments is merely a way of listing receipts and payments in international transactions for a country”

01 The balance of payments of a country is a systematic record of all its economic transactions with the outside world in a given year

02 It is a statistical record of the character and dimensions of the country’s economic relationships with the rest of the world.

03 Balance of payment (BoP) is an accounting statement which records economic transactions between Normal Resident of a specific country with the rest of the world

Accounting Principles related to BOP

1. **Residence Principle**:
    a. Distinguishes between residents and non-residents in the compilation of the Balance of Payments (BoP).
    b. Residence is determined by the center of economic interest, not national identity or legal criteria.
    c. An economic entity is considered a resident if its economic activities occur significantly in the country for one year or more.
2. **Double-entry Bookkeeping Principle**:
    a. BoP accounts are constructed based on the principle of double-entry bookkeeping.
    b. Each transaction is recorded on both the credit and debit sides of the balance sheet.
    c. Total debit and total credit must always be equal, ensuring the balance of payments "balances" in an accounting sense.
3. **Principle of the Uniform System for Valuation of Transactions**:
    a. Transactions in the BoP are valued using market prices aligned with economic transactions.
    b. Market prices refer to specific transaction prices, promoting comparability of BoP accounts across countries.
4. **Principle of Timing**:
    a. Transactions are reflected on both the credit and debit sides of the BoP simultaneously.
    b. Both parties involved in a transaction record the operation under the same number, corresponding to the date of execution.
5. **Principle of Unit of Account**:
    a. The unit of account used for internal payments and accounting within a country is employed in BoP compilation.
    b. Many countries keep their BoP accounts in U.S. dollars, ensuring consistency and comparability on an international scale.

Importance of BOP

It reveals the economic and financial details of a country

BOP helps the government on trade and fiscal policies

The BOP statement can be an indicator to determine whether the currency of a country is appreciating or depreciating

The government can formulate appropriate policies to divert the funds
and technology imported to the critical sectors of the economy that can drive future growth.

It provides important information to understand and analyze the economic dealings of one country with the other

Types of Balance of Payment

Favorable BOP

Excess of goods and services exported plus capital transferred to abroad over the goods and services imported and capital transfers from abroad is known as favourable balance of payments

Unfavorable BOP

An imbalance in a nation's balance of payments in which payments made by the country exceed payments received by the country. This is also termed a balance of payments deficit

Structure of BOP

Current Account

- Monitors inflow and outflow of goods and services.
- Encompasses payments and receipts for manufactured goods, raw materials, tourism, engineering, business services, and transportation.
- Includes visible (goods) and invisible (services) trade.

Trade Balances

- Represents the difference between exports and imports of visible goods.
- Visible items are tangible and measurable, indicating a nation's surplus or deficit.

Capital Account

- Tracks capital transactions between countries, including the sale and purchase of assets like properties.
- Encompasses flow of taxes, sales and purchases of fixed assets related to migration.
- Major components: investments, foreign exchange reserves, and loans and borrowings.

Account of Financing

- Finances or bridges the surplus or deficit on the current account, capital account, and errors or omissions.
- Involves external assistance (loans), gross drawing from the IMF, allocation of SDRs, and changes in reserves (increase or decrease).

Disequilibrium of Balance of Payment

When a country’s current account is at a deficit or surplus, its balance of payments (BOP) is said to be in disequilibrium. A disequilibrium in the balance of payment means its condition of Surplus Or deficit.

A Surplus in the BOP occurs when Total Receipts exceeds Total Payments.

Thus, **BOP= CREDIT>DEBIT.**

A Deficit in the BOP occurs when Total Payments exceeds Total Receipts.

Thus, **BOP= CREDIT<DEBIT**

Types of Disequilibrium

1. Cyclical Disequilibrium.
2. Secular Disequilibrium.
3. Structural Disequilibrium.
4. Short run Disequilibrium.
5. Fundamental Disequilibrium.

Types of Disequilibrium

There are 5 types of Disequilibrium

Cyclical Disequilibrium

- Arises from cyclical fluctuations influenced by varying paths of business or trade cycles in different countries.
- Short-term in nature, tied to business cycle movements.

Secular Disequilibrium

- Long-term imbalance in the balance of payments due to persistent, gradual changes in the economy.
- Caused by factors like capital formation, population growth, and technological changes.

Structural Disequilibrium

- Result of structural changes in specific sectors, both domestically and internationally.
- Alters demand or supply conditions for exports or imports, influenced by factors such as technology, tastes, attitude toward foreign investment, and political disturbances.

Other Disequilibrium

Short-run Disequilibrium:

- Temporary imbalance lasting for a short period, typically around a year.
- Often associated with international borrowing and lending activities, with less severe consequences.

Fundamental or Long-run Disequilibrium

- Persistent and long-term imbalance in a country's balance of payments.
- Coined by the International Monetary Fund (IMF) to denote chronic deficits caused by dynamic factors.
- Signifies a more serious and enduring threat to the country's economic stability.

Causes of Disequilibrium

Trade Cycles

Cyclical fluctuations, differing phases, and amplitudes in different countries can lead to cyclical disequilibrium.

Population Growth:

High population growth in poor countries amplifies import needs and reduces export capacity, contributing to disequilibrium.

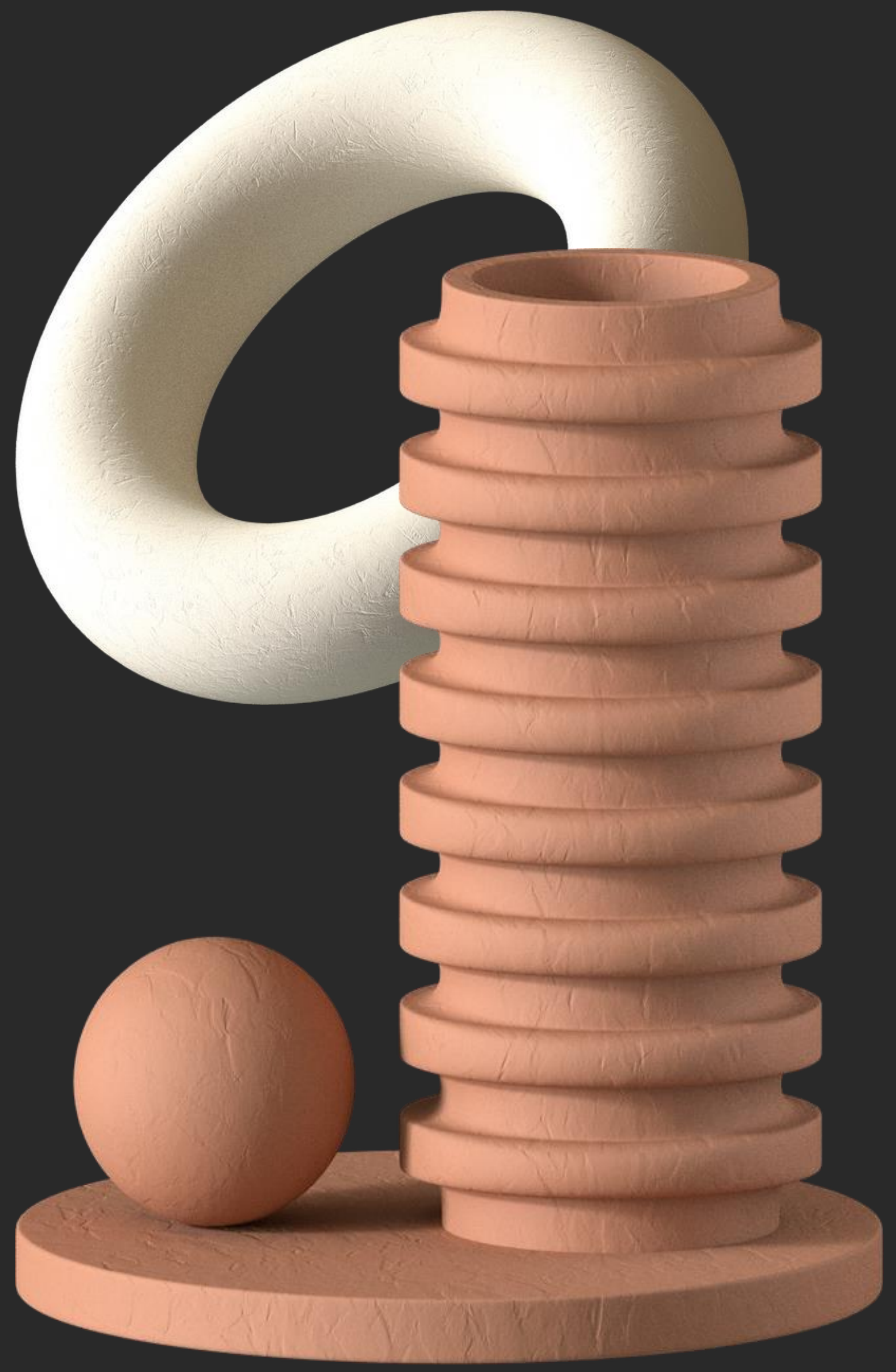
Huge Developmental and Investment Programmes

Developing economies undergoing extensive development and investment programs may experience disequilibrium due to increased imports for industrialization, while export growth may not match.

Changing Export Demand

Increased domestic production in advanced countries for foodstuffs, raw materials, and substitute goods can alter export demand, causing structural disequilibrium in agrarian underdeveloped nations.

Measures to Correct Disequilibrium in Balance of Payments



Monetary Policy:

Adjusting money supply and credit through measures by the Central Bank to impact prices and economic activity.

Fiscal Policy:

Government's policy on income and expenditure, including adjustments to development and non-development expenditure and taxation based on the economic situation.

Exchange Rate Depreciation:

Reducing the value of the domestic currency to correct imbalances. Depreciation makes imports costlier and exports cheaper, potentially addressing the trade deficit.

Devaluation:

Lowering the official currency's exchange value, making exports more competitive and imports more expensive, contributing to a reduction in the balance of payments deficit.

Deflation:

Reducing the quantity of money to lower prices and incomes, which can control consumption and boost exports, thereby improving the balance of payments.

Exchange Control:

Directing exporters to surrender foreign exchange earnings and rationing available foreign exchange among licensed importers.

Export Promotion:

Stimulating exports through measures such as reducing export duties, providing cash assistance and subsidies to exporters, and exempting export goods from various taxes.

Import Substitutes:

Encouraging the production of goods that can replace imports, saving foreign exchange in the short run.

Import Control:

Regulating imports through measures like quotas and tariffs, setting maximum quantities for imported goods and services during specific periods.

Importance of Balance of Payments (BOP) Statistics:

Economic Health Indicator

- BOP statistics provide a comprehensive snapshot of a country's economic health by detailing its transactions with the rest of the world. It helps assess the overall economic performance.

Policy Formulation

- Governments use BOP data to formulate economic policies. For instance, trade deficits or surpluses might prompt policy adjustments to stimulate exports or control imports.

Exchange Rate Policy

- BOP data, especially the current account, influences exchange rate policies. Persistent deficits may lead to currency depreciation, while surpluses may support currency appreciation.

External Debt Management

- BOP statistics aid in managing external debt. Countries with chronic deficits may face challenges in servicing debt, while those with surpluses can use them to repay debt or invest.

Importance of Balance of Payments (BOP) Statistics:

Investment Decisions:

Investors use BOP information to assess a country's economic stability. It influences investment decisions, helping investors gauge the risks associated with a country.

Trade Policy Evaluation:

BOP data assists in evaluating the effectiveness of trade policies. It reveals whether a country's efforts to promote exports or control imports are achieving the desired results.

Early Warning of Economic Issues:

BOP data serves as an early warning system for potential economic issues. Large and sustained deficits or surpluses can indicate underlying economic imbalances.

Global Economic Relations:

BOP statistics are vital for understanding a country's position in the global economy and its economic relationships with other nations.

Limitations of Balance of Payments Statistics:

Inaccuracy and Data Gaps:

BOP statistics are subject to inaccuracies due to estimation methods and reporting discrepancies. Data gaps, especially in services and capital flows, can limit their reliability.

Valuation Issues:

Valuation of goods and services in different currencies can lead to distortions. Fluctuating exchange rates may affect the accuracy of values in the BOP accounts.

Time Lags:

BOP data often has time lags, making it less timely for immediate policy adjustments. Delays in data availability can impact the effectiveness of decision-making.

Hidden Transactions:

Certain transactions, such as illegal trade or unrecorded financial flows, may not be captured in official BOP statistics, leading to an incomplete picture of a country's economic transactions

Other Limitations

Changing Definitions:

- Changes in BOP definitions and methodologies over time can make comparisons across periods challenging. Revisions in reporting standards may affect the consistency of data.

Limited Information on Quality of Trade:

- BOP data may not provide detailed information on the quality or nature of traded goods and services. It lacks granularity, making it less useful for assessing the overall economic impact of trade.

Unrecorded Capital Flows:

- Certain capital flows, such as remittances and some types of foreign investments, might not be accurately captured, impacting the assessment of a country's financial health.

Definition

What is Capital Account Convertibility:

Capital account convertibility refers to the ability to freely and efficiently exchange domestic financial assets for foreign financial assets and vice versa

01 It implies that a country's residents and non-residents can transact in financial assets, including stocks, bonds, and other securities, without significant restrictions.

02 Capital account convertibility contrasts with current account convertibility, which allows the free movement of goods and services.

03 The primary objectives of capital account convertibility include fostering economic efficiency, attracting foreign investment, promoting financial market development, and integrating the domestic economy with global financial markets.

Types of Capital Flows:

Capital account convertibility encompasses various types of capital flows, including foreign direct investment (FDI), portfolio investment, loans, and other financial instruments.

Countries must carefully manage the risks associated with sudden capital outflows or inflows, which can impact exchange rates, interest rates, and financial stability.

Capital account convertibility is often considered a milestone in a country's financial liberalization journey, but its implementation requires careful planning and consideration of the potential risks and benefits. Countries may choose different approaches based on their economic conditions, institutional capabilities, and policy objectives.

Do you have any questions?

Send it to us! We hope you learned something new.