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BALANCE OF PAYMENTS

"The 'Balance of Payments' of a country is a systematic record of all economic transactions between the residents of the reporting country and the residents of foreign countries during a given period of time."

—Charles P. Kindleberger, *International Economics*, p. 17.

MEANING OF BALANCE OF PAYMENTS

Introduction

The balance of payments of a country system record of its monetary transactions with other countries of the world during a given period (in a year).

Charles P. Kinderberger defines balance of payments as "a systematic record of all economic transactions between the residents of the reporting country and the residents of foreign countries during a given period of time."

According to Bosodersten, "The balance of payments is merely a way of listing receipts and payments in international transactions for a country."

It is an important index which reflects the true economic position of a country in a given period, whether the country is a creditor country or a debtor country, and whether its currency is rising or falling in its external value. There are various types of monetary transactions taking place amongst the countries of the world. Broadly speaking, we can classify them under three heads : (1) The exports and imports of a country give rise to monetary transactions with other countries. The exports give rise to receipts from foreign countries while imports result in payments which are to be made to foreign countries for imported goods. (2) The international lending and borrowing also give rise to monetary transactions amongst the countries of the world. (3) The servicing of foreign debts and their final repayments also result in international payments and receipts. Thus, the balance of payments is an annual record of the international receipts and payments of a country during a year. It is a summarized statement of all international receipts and payments and indicates the real monetary position of the country concerned.

BALANCE OF TRADE AND BALANCE OF PAYMENTS

The balance of trade of a country shows its trade transactions with the rest of the world during the course of a year. It indicates the relationship between the value of exports and the value of imports of the country in question. But the balance of trade takes into account only *visible* exports and imports. The visible exports and imports are those which are actually recorded at the ports. The balance of trade of a country is, thus, the relationship between the aggregate value of exports and the aggregate value of imports during the course of a year. If the money value of exports is greater than the money value of imports, the balance of trade is said to be favourable to the country. On the contrary, if the money value of imports is greater than the money value of exports, the balance of trade is said to be unfavourable for the country.

But it is not only the visible imports and exports which give rise to international payments and receipts. There can be several other items known as *invisible* items which can give rise to international receipts and payments. The invisible items are those which are not recorded at the ports. These items are the services rendered by shipping, insurance and banking companies, debt repayment and payment of interest, expenditure by tourists, payment of dividends on capital invested by foreigners, war

ne commercial

indemnities, etc. The balance of trade takes into account only the payments and receipts on account of visible exports and imports. Hence, it does not indicate truly the international monetary position of a country. If we wish to know the real international monetary position of a country, it shall be more appropriate to refer to the balance of payments of the country concerned. The balance of payments is a wider and a more comprehensive concept than the balance of trade. In addition to the values of visible exports and imports, the balance of payments also includes various types of invisible imports and exports or non-commodity items which give rise to international receipts and payments.

STRUCTURE OF BALANCE OF PAYMENTS

It is usually composed of two sections, *i.e.*, (I) Current Account, and (II) Capital Account.

(I) Balance of Payments – Current Account

Current accounts mainly consists two sub-group – (1) Merchandise of the trade Account, and (2) Invisible account. The first sub-group namely merchandise refers to the value of exports and imports, *i.e.*, all goods exported and imported are recorded in the current account. The difference between exports and imports of a country is the balance of trade. If the exports exceeds imports, the balance of trade is favourable. In the opposite side it is unfavourable.

However, these imports and exports are purely commercial and have nothing to do with monetary gold. The second sub-group namely is invisibles. The invisible account usually comprises the services account and gift or charitable account. The services account records all the services rendered and received by the residents of the nation. It consists of such items like banking and insurance charges, interest on loans, travel expenses, transportation charges etc. Similarly, the gifts or charities consists of all those items which are received or given away free by residents of the nation. It may be in kind or in cash. It goes without saving that these are all referred to as invisible transactions in the balance of payment theory and, therefore, recorded in the invisible account. It is interesting to note that the International Monetary Fund

India's Over-all Balance of Payments

Current Account

	In U. S. $ (Millions)					In Indian Rupee (Crores)				
	1990-91	1992-93	1993-94	1994-95	1995-96	1990-91	1992-93	1993-94	1994-95	1995-96
Sub-Group (1) Visibles— Merchandise	46,392	42,106	47,752	58,697	73,879	83,239	1,23,625	1,49,776	1,84,299	2,47,123
(i) Exports	18,477	18,869	22,683	26,857	32,467	33,153	54,762	71,146	84,326	1,08,601
(ii) Imports	27,915	23,237	25,069	91,840	41,412	50,086	68,863	78,630	99,923	1,38,522
(iii) Trade Balance	–9,438	–4,368	–2,386	–4,983	–8,945	–16,933	–14,101	–7,484	–15,647	–29,921
Sub Group (2) Invisibles— (Net)	–242	842	1,228	2,349	3,511	–435	1,337	3,848	7,376	11,744
(i) Non-Factor Services	980	1,129	535	–371	94	1,758	2,698	1,677	–1,165	314
(ii) Investment Income	–3,752	–3,423	–3,270	–3,952	–4,479	–6,732	–10,503	–10,259	–12,409	–14,982
(iii) Private Transfer	2,069	2,773	3,595	6,200	7,480	3,711	8,089	11,275	19,467	25,050
(iv) Official Transfers	461	363	367	472	416	828	1,053	1,155	1,482	1,392
Current Account Balance	–9,680	–3,526	–1,158	–2,634	–5,434	–17,368	–12,764	–3,636	–8,272	–18,177

(Source : *R. B. I. Report on Currency and Finance, 1995-96.*)

includes the following items as invisible transactions :

1. *Travel* for reasons of business, education, health, pleasure or international conventions.

2. *International Transportation* of goods, including warehousing, while in transit, and other transit expenses.

3. *Insurance premiums* and payments of claim.

4. *Investment income* including receipts of interest, dividends, rents and profits from abroad. A country may receive interest from foreigners (governments) on loans extended to him. Likewise, a country has to pay interest and dividends to foreigners on accounts borrowed from either by private individuals or by government.

5. *Miscellaneous* service items such as advertising, commission, pensions, patent fees, royalties, subscription to periodicals, membership fees and receipts and payments for services rendered by exports and technicians of countries to one another.

6. *Transfer payments* representing unilateral receipts and payments by private individuals or by government and includes such things as gift, donations, grants etc.

7. *Repayment of Commercial Credit.*

8. *Contractual amortization* and depreciation of direct investment.

The table given on p. 427 shows both visible and invisible items of trade. The first sub-group is of merchandise shows visible items and the second sub-group is of invisibles. Thus the balance of payments on current account includes both 'visible' and 'invisible' items of trade.

(II) BALANCE OF PAYMENT – CAPITAL ACCOUNT

The Capital Account in the balance of payments includes short-term as well as long term international borrowing and lending. This includes (I) external assistance which means borrowings from foreign countries under concessional rate of interest ; (2) Commercial borrowings under which the Indian Government and Private Sector borrows funds from world money markets at higher rate of interest. Besides these ; it includes (3) short term credit ; (4) NRI deposits ; (5) foreign investment ; (6) rupee debt service, and (7) other capital accounts. The table given below shows the balance of payments on capital account position of India :

India's Overall Balance of Payments

Capital Account

	In U. S. $ (Millions)					In Indian Rupee (Crores)				
	1990-91	1992-93	1993-94	1994-95	1995-96	1990-91	1992-93	1993-94	1994-95	1995-96
1. Eternal Assistance (Net)	2,210	1,859	1,901	1,434	.780	–3,965	5,750	5,964	4,504	2,609
(a) Disbursement	3,397	7,306	3,476	392	2,978	6,095	10,173	10,904	10,024	9,961
(b) Amortisation	–1,187	–1,443	–1,575	–1,758	–2,198	–2,130	–4,423	–4,940	–5,520	–7,352
2. Commercial Borrowings (Net)	2,249	–358	607	1,029	527	4,035	–1,094	1,905	3,231	1,763
3. Short Term Credit (Net)	1,074	160	330	–769	160	1,929	–3,174	–2,412	1,036	535
4. NRI Deposits (Net)	1,536	2,001	1,205	811	945	2,756	6,097	3,780	2,546	3,161
5. Foreign Investment (Net)	102	555	4,235	4,895	4,143	184	1,700	13,283	15,370	13,858
6. Rupee Debt Service	–1,193	–878	–1,053	–1,050	–963	–240	–2,335	–3,302	–3,297	–3,221
7. Other Capital (Net)	1,210	866	3,709	1,290	–1,367	2,168	5,020	11,634	4,034	–4,540
8. Total Capital Account	7,188	2,966	9,835	8,739	4,225	12,897	11,964	30,852	27,424	14,165

(Source : *R. B. I. Report on Currency and Finance*, Vol. II, 1995-96.)

It should be remembered that changes in the balance of payments produce deep repercussions on the functioning of the economy. A 'surplus' in the balance of payments means an inflow of income into the country, more economic activity and more employment for the people. A 'deficit' in the balance of payments, on the contrary, implies an *outflow* of income abroad, less of economic activity and less of employment at home.

MEANING OF DISEQUILIBRIUM IN BALANCE OF PAYMENTS

A country's balance of payments is in equilibrium when there is perfect equality between the supply and the demand for foreign exchange. A position of disequilibrium in the balance of payments of a country exists when the demand for foreign exchange exceeds its supply or *vice versa*. When the demand for foreign exchange exceeds its supply, there is said to be a *deficit* in the balance of payments. On the contrary, when the supply of foreign exchange exceeds its demand, there is said to be a *surplus* in the balance of payments. Whether the balance of payments is in surplus or in deficit, there exists a disequilibrium which is not desirable in the larger economic interests of the country. It is very seldom that there is a perfect equilibrium in the country's balance of payments. It is either in deficit or in surplus. The disequilibrium in the balance of payments whether it is due to deficit or surplus is undesirable and bad for the country concerned. The surplus disequilibrium may not be so bad for the country as the deficit disequilibrium is. The reason is that the burden of bringing about adjustment in the balance of payments falls more heavily on the deficit than on the surplus countries.

Causes of Disequilibrium in the Balance of Payments

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The various causes of disequilibrium in the balance of payments may be classified under three heads :

(1) *Natural Factors*. Natural calamities, such as, the failure of rains or the coming of floods may easily cause disequilibrium in the balance of payments by adversely affecting agricultural and industrial production in the country. The exports may decline while the imports may go up, causing a discrepancy in the country's balance of payments.

(2) *Economic Factors*. The economic factors can be further subdivided under the following four subheads :

(i) *Cyclical Fluctuations*. Business fluctuations induced by the operation of the trade cycle may also cause disequilibrium in a country's balance of payments. For example, if there occurs a business recession in foreign countries it may easily cause a fall in the exports and exchange earnings of the country concerned, resulting in a disequilibrium in the balance of payments.

(ii) *Inflationary Spiral at Home*. An inflationary rise in prices within the country may also produce disequilibrium in the balance of payments. The prices of export items may go up, causing a decline in the volume of exports from the country concerned. The inflationary spiral within the country may also result in an increase in the volume of imports.

(iii) *Capital Movements*. The capital movements (if they happen to be on a large scale) can also cause disequilibrium in the balance of payments of a country. A massive inflow of foreign capital into a country is followed by an unfavourable balance of payments. A large outflow of capital, on the other hand, is accompanied by a favourable balance of payments.

(iv) *Miscellaneous Factors*. The changes in the tastes, habits, fashions of the people ; the discovery of new substitutes for exports ; the development of alternative sources of supply, etc., may also produce disequilibrium in the country's balance of payments. For example, the invention of synthetic rubber led to a serious decline in the export of natural rubber from countries like Malaysia, Burma, etc., during and after the Second World War.

(3) *Political Factors*. The political factors may also produce serious disequilibrium in the country's balance of payments. For example, the existence of political instability may result in disrupting the productive apparatus within the country, causing a decline in exports and an increase in imports. Likewise, the payment of war reparations or indemnities may also cause serious disequilibrium in the country's balance of payments. The imposition of heavy war reparations on Germany after the First World War produced a serious disequilibrium in its balance of payments.

Measures to correct Disequilibrium in the Balance of Payments

The various measures to eliminate the disequilibrium in the balance of payments can be classified under two subheads :

1. *Automatic Measures*. The disequilibrium in the balance of payments may automatically disappear after some time when certain forces come into operation in the economy. For example, the disequilibrium in the balance of payments of a country under the gold standard was automatically corrected through the inflow and outflow of gold. If the balance of payments was unfavourable, there was an outflow of gold from the country, causing a contraction in the volume of currency and credit, and ultimately a fall in the domestic price level. This encouraged exports while it discouraged imports. The equilibrium in the balance of payments was automatically restored after some time. The opposite process worked when the balance of payments of the country was favourable.

Likewise, the equilibrium in the balance of payments of a country on the paper standard was automatically corrected through fluctuations in its rate of exchange. For example, if the country's balance of payments was unfavourable, the demand for foreign exchange exceeded its supply, and consequently, the exchange value of its currency went down. The fall in its exchange value encouraged exports while it discouraged imports. The equilibrium in the balance of payments was automatically restored after the lapse of some time. The opposite process worked when the balance of payments of the country turned favourable.

The automatic measures discussed above did not produce the desired results in the short period. Nor were they effective in dealing with a serious and fundamental disequilibrium in the balance of payments. The country concerned had, therefore, to resort to certain deliberate measures to bring about an improvement in the balance of payments.

2. *Deliberate Measures*. The deliberate measures can be discussed under two subheads :

(1) *Trade measures*. The following trade measures could be undertaken by the country concerned to correct disequilibrium in its balance of payments.

(i) *Encouragement to Exports*. To remove the deficit in the balance of payments, it is essential to maximize the country's exports. The exports of a country can be pushed up in two ways :

(a) *Reduction in Export Duties*. The government should either reduce or altogether abolish the export duties so that the export of goods becomes cheaper in foreign countries ;

(b) *Subsidies to Export Industries*. The government should give subsidies to the export industries within the country to enable them to cut down their production costs and improve their competitive position in the international market.

(ii) *Reduction in Imports*. It is essential to cut down imports in order to eliminate the deficit in the balance of payments of the country. The imports can be reduced by adopting the following measures :

(a) *Imposition of New Import Duties and the Enhancement of the Existing Import Duties*. This step will go a long way in making imported goods more expensive within the country. Consequently, the demand for the imported goods will automatically decline in course of time.

(b) *Import Quota System*. The imports of the country can also be cut down through the adoption of the import quota system. This system can be discussed under the following subheads :

(i) *Licence Quota System*. Under this system, the importers have to secure import licences from the government and these licences are granted by the government after taking an overall view of the import position of the country.

(ii) *Unilateral Quota System*. Under this system, the country imposes two types of restrictions on its imports :

(a) *Global Quota System*. Under this, the government fixes in advance the global quota for every imported item. The country cannot import more than the quota fixed by the government. But, to the extent of the quota, the importers can import the commodity concerned from any country.

(b) *Allocated Quota System*. Under this system, the government not only fixes the global quota of the commodity concerned but also decides in advance how much of the commodity is to be imported from individual countries.

(iii) *Bilateral Quota System*. Under this system, the government fixes the maximum quota of a commodity which is to be imported from abroad. Up to the extent of this quota, the commodity can be imported at a concessional import duty. If, however, the importers exceed the quota, they have to pay a penal rate of import duty.

(iv) *Import Prohibitions*. This is an extreme measure which is sometimes adopted by the government of a country to eliminate the disequilibrium in the balance of payments. Under this, the government prohibits altogether the import of certain goods which are considered to be non-essential from the national point of

n the commercial banks.

view. Developing countries trying to bring about speedy economic development through planning often resort to this method to check the consumption of imported luxury goods by the affluent sections of the community.

(2) *Monetary Measures.* The following monetary measures are taken either singly or in combination by the government to deal with the disequilibrium in the balance of payments :

(i) *Currency Devaluation.* The government of the country may resort to the devaluation of its currency to eliminate or to reduce the deficit in the balance of payments. Devaluation implies a deliberate reduction in the external value of the currency of the country. Devaluation always encourages exports by cheapening them in foreign countries. On the contrary, devaluation has the effect of discouraging imports by making them more expensive within the country. For example, if the currency of a country is devalued, then its purchasing power in foreign countries automatically goes down. In other words, the imported goods become more expensive than before. Hence, devaluation discourages imports into the country. On the contrary, the purchasing power of the devalued currency increases in terms of foreign currencies as a consequence of devaluation. Consequently, the foreigners start importing more goods from that country. This gives an incentive to the exports of the country. It was to remove the deficit in her balance of payments that India resorted to the devaluation of the Rupee in September, 1949. The Rupee was devalued for the second time on 6th June, 1966. The objective again was to eliminate or reduce the deficit in the country's balance of payments.

(ii) *Money Contraction.* If the Government of a country does not look upon currency devaluation as a proper measure, it may resort to currency contraction to remove the disequilibrium in the balance of payments. The prices of goods and services automatically go down as a result of currency contraction. This gives the much needed incentive to exports. But the imports are discouraged as a result of the fall in the internal price level. The increase in exports and the decline in imports helps the country to remove the disequilibrium in the balance of payments. But currency contraction as a method to remove the disequilibrium in the balance of payments is not looked upon with favour by certain economists. If the price level in the country is deliberately brought down with the help of currency contraction, it may pose a serious economic problem for the country. It may even lead to a slump in the economy. The producers may suffer heavy losses consequent upon the fall in prices. Ultimately, they may be compelled to close down their businesses rather than to suffer heavy financial losses. Hence the method of currency contraction should be used with a good deal of caution to bring about an improvement in the balance of payments.

(iii) *Exchange Control.* Sometimes, the government prefers exchange control to other methods for bringing about an equilibrium in the balance of payments. Currently devaluation, it is said, adversely affects the self-respect and reputation of the country. Currency contraction may likewise result in a slump or depression in the economy. Similarly, if the imports are cut down by imposing various types of restrictions by the government, this may lead to retaliation on the part of other countries. They may likewise impose the same restrictions on the exports of the country concerned. Keeping in view the limitations of the above methods, the governments often resort to the system of exchange control to eliminate the deficit in the balance of payments. Under this system, the exporters have to surrender their earnings of foreign exchange to the government in exchange for domestic currency. Likewise, the government allocates foreign exchange to the importers to enable them to make payments for imported goods. Thus, the government comes to have full control over foreign exchange. It utilizes the exchange control system to effect a cut in the volume of imports. Unnecessary imports are altogether stopped by the government by denying foreign exchange to the importers. Many developing countries like India, Kenya, Sudan, Nigeria and others have been restricting imports by not releasing foreign exchange for non-essential goods.

(iv) *Foreign Loans.* The government can also secure loans from foreign banks or foreign governments to reduce the deficit in the balance of payments. Since the repayment of these loans is spread over a long period, this helps the government to remove the deficit in the balance of payments. During the currency of the loans, the government takes steps to improve its foreign exchange position.

(v) *Encouragement to Foreign Investment.* The government induces the foreigners to make investment in the country offering them all sorts of incentives and concessions. This provides the government with extra foreign exchange which is utilized to reduce the deficit in the balance of payments. But while inviting the foreign capitalists to invest their capital within the country, the government sees to it that this does not produce any adverse repercussions on the economy.

(vi) *Incentives to Foreign Tourists*. The government may also encourage the foreign tourists to visit the country in increasing numbers by offering them various facilities and concessional travel. This increases the foreign exchange earnings of the country with the help of which the deficit in the balance of payments can be reduced.

To sum up, the deficit in the balance of payments is not a desirable phenomenon for a country. The methods discussed above aim at reducing imports and stimulating exports. Of these, the first method, trade measures, is obviously the best, and the most effective. It produces immediate results. The government of a country may use this method in combination with other methods to eliminate or reduce a chronic deficit in its balance of payments.

SUGGESTED READINGS

1. Charles P. Kindleberger, *International Economics*, Chapter 2.
2. Gottfried Von Haberler, *The Theory of International Trade*, Chapter 4.
3. P. T. Ellsworth, *International Economy*, Chapters 15 and 16.
4. J. E. Meade, *The Balance of Payments*, Chapters 1 to 3.