

# Balance of Payment

Unit-II

# Introduction

- Balance of payments (BOP) of a country is a systematic summary statement of a Country's international economic transactions during a given period of time, usually a year.
- *It presents a summarized and classified record of all receipts on account of goods exported, services rendered, and capital received by residents and payments made by them on account of goods imported, and services received from rest of the world and capital transferred to the non-residents or foreigners.*

**-Reserve Bank of India**

- The International Monetary Fund (IMF) defines the term Balance of Payments more precisely as follows –

*“the balance of payments is a statistical statement that systematically summarizes for a specific time period, the economic transactions of an economy with the rest of the world. Transactions, for the most part between residents and nonresidents, consist of those involving goods, services, and income; those involving financial claims on, and liabilities to, the rest of the world; and those (such as gifts) classified as transfers, which involve offsetting entries to balance – in an accounting sense - one sided transaction.”*

- In a general sense, Balance of Payments (BOP) of a country is records all the economic transactions that take place between the residents of a particular country and the residents of all the other countries of the world during a particular period of time which is usually taken to be a year.
- Thus, it covers all types of transactions that a country transact such as export and import of goods and services, sale and purchase of foreign assets, FDI and portfolio investment as well as borrowing from and lending to the rest of the world.

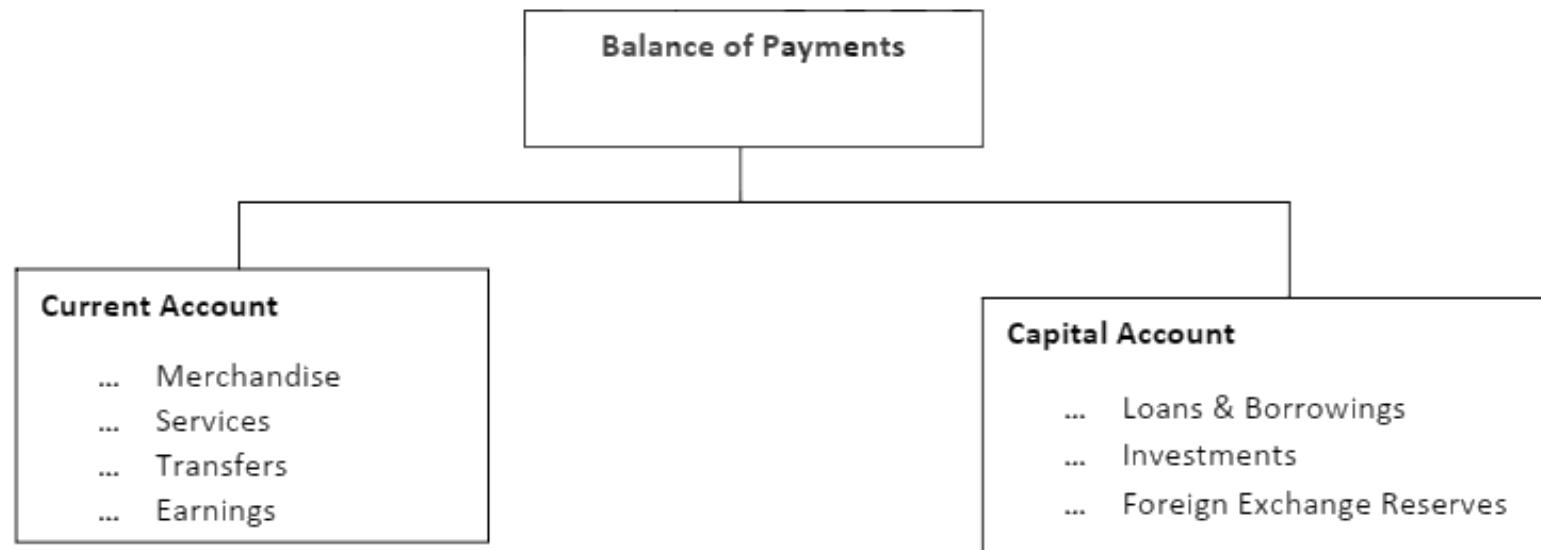
# Significance of Balance of payments

- The study of Balance of Payments of a country serves the following purposes:
- It indicates the changing international economic or financial position of a country.
- It helps in formulation of a country's monetary, fiscal and trade policies.
- It helps in determining the influence of foreign trade & transactions on the level of national income of a country.
- It is useful to banks, firms, financial institutions and individuals which are directly or indirectly involved in international trade and finance.
- It is an economic barometer of nation's progress vis-à-vis rest of the world.

# Components/Structure of BOP

There are two main components of Balance of Payments (BoP):

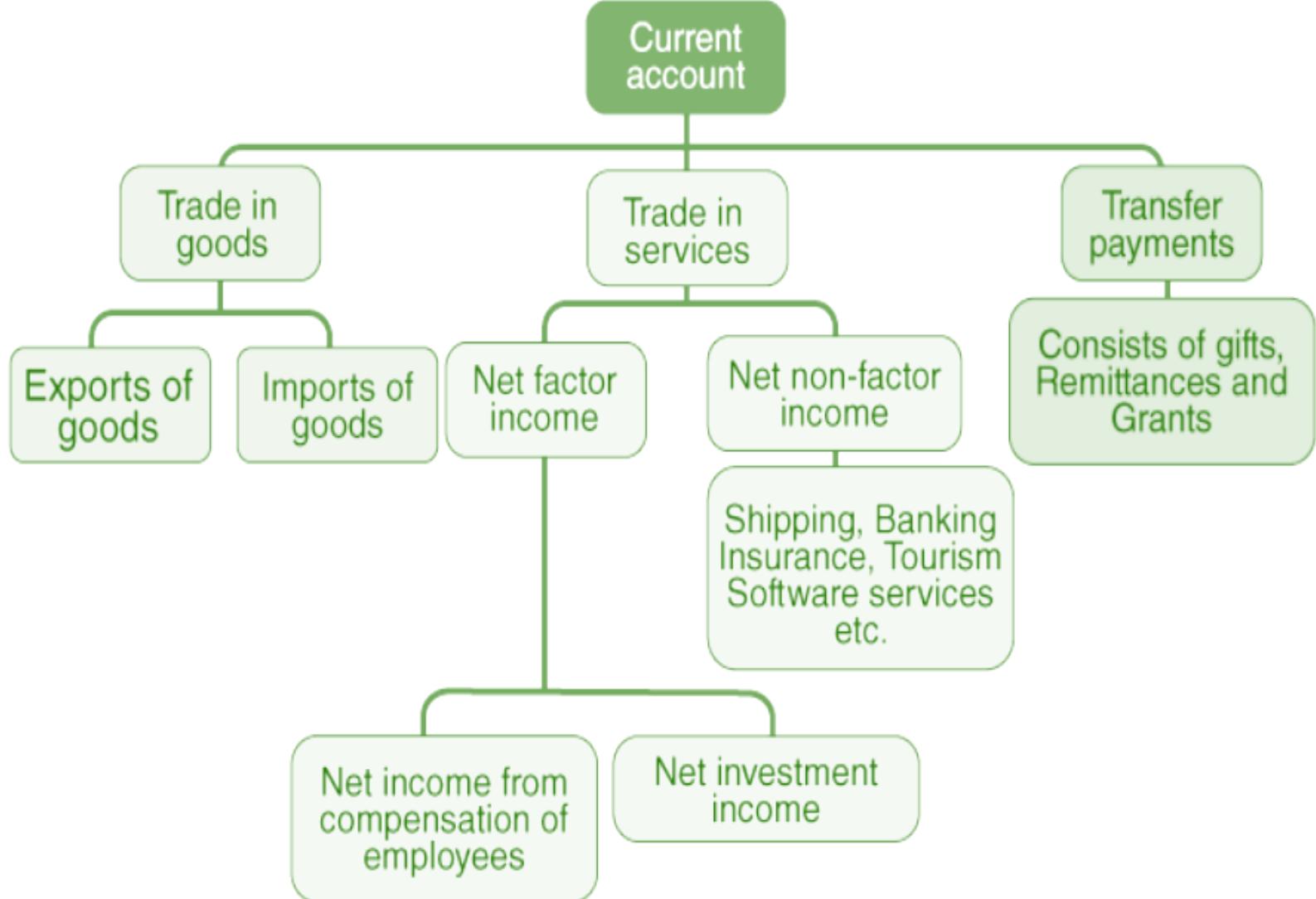
- Current Account
- Capital Account



# Current Account

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- The current account in the BoP, comprises of the transactions in goods and services, alongside transfers during the current time period.
- The current account of the BOP can be broken in three parts:
  - (a ) balance of trade and,
  - (b) balance of trade in services
  - (c) Unilateral Payments/ Transfer payments



# Balance of Trade (BOT)

- The BOT deals only with exports and imports of merchandise (or visible items).
- Merchandise exports and imports are the most significant items of the current account. In general, it accounts for a substantial portion of total transactions entered in a country's BOP.
- Usually, exports are estimated on free on board (f.o.b.) basis signifying that the transportation costs, costs of insurance etc. are not included and imports are estimated on carriage, insurance and freight (c.i.f.) basis which signifies that the transportation costs, costs of insurance and freight get included.
- The net balance in the BOT will show the monetary value of the difference in exports and imports of a country. Thus, three types of net BOT can be visualized:
  - i) Deficits in BOT; these will occur. When  $X < M$  ;
  - ii) Surplus in BOT; these will occur. When  $X > M$ ; and
  - iii) Balance of BOT; these will occur. When  $X = M$ .

# Balance of Trade in Services (BOS)

- The BOS shows net receipts on account of trade in services, (or what are also called invisibles).
- We can broadly classify invisibles into three groups:
  - (i) Services, such as banking, insurance, shipping civil aviation, royalty, consultancy services, postal services, etc.
  - (ii) Investment income, which includes profits and dividends on direct, portfolio and other investments as well as interest charges on bilateral and multilateral loans.
  - (iii) Travel both business and tourist.
- All of these transactions are two-way transactions; i.e. during any year these services would be provided by Indians to the rest-of-the- world, and foreigners would be providing these services to India.
  - i) Deficits in BOS; these will occur. When  $R < P$  ;
  - ii) Surplus in BOS; these will occur. When  $R > P$ ; and
  - iii) Balance in BOS; these will occur. When  $R = P$

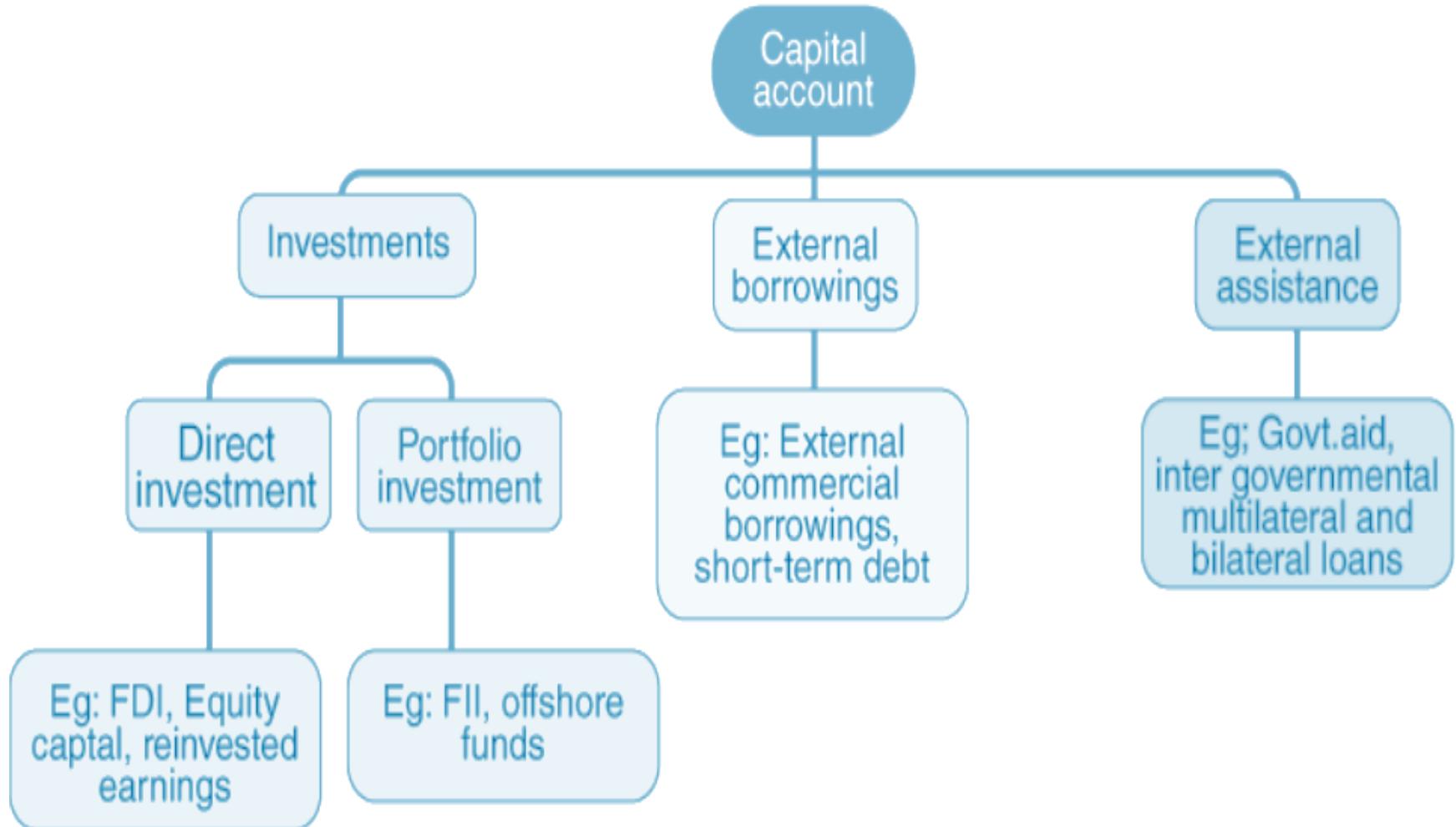
Where, R=receipt and P=payment

# Unilateral Transfers

- The third component of the current account is unilateral transfers or transfer payments. Unilateral transfers include grants, gifts etc. either received from abroad (credits) or given abroad (debits).
- They are one sided transactions, without a quid pro quo that has a measurable value. The unilateral transfers could be official or private.

# Capital Account

- The capital account of a country's BOP comprises of all those transactions that are related to financial assets in the form of short-term and long-term borrowing and lending and the transactions related to private and official investments.
- To state it otherwise, the capital account records international movement of loans and investments and depicts a change in a country's position regarding the foreign assets and liabilities.



- If a country is having a deficit on its current account BOP it need borrow from the rest of the world to square of its current excess liabilities.
- Likewise, if it has a surplus, it can lend to the rest-of-the world. These transactions are recorded on its capital account.
- All the borrowings of a country constitute the credits (cr.) in the capital account, while all lendings by it constitute its debits (dr.) in the capital account. Likewise, all repayments of old debts constitute debits, while receipts from the rest-of-the-world constitute its credits.
- Thus, if a country has been borrowing over a long period of time, during a particular year it would be contracting new loans (cr.) as well as paying of earlier debts (dr.) .
- The net of these debits and credits constitutes the capital account of the BOP.

# Borrowing from & Lending to Foreign Countries

- Borrowing from foreign countries are credit entries since they signify receipts from foreign nations.
- Lending to foreign nations are debit entries since they signify payments to foreign nations.
- This lending or borrowing could be of short term i.e. up to one year or long term i.e. more than one year.
- Borrowing from & lending to foreign countries could be also called as net sale of assets to foreigners and net purchases of assets from foreigners.





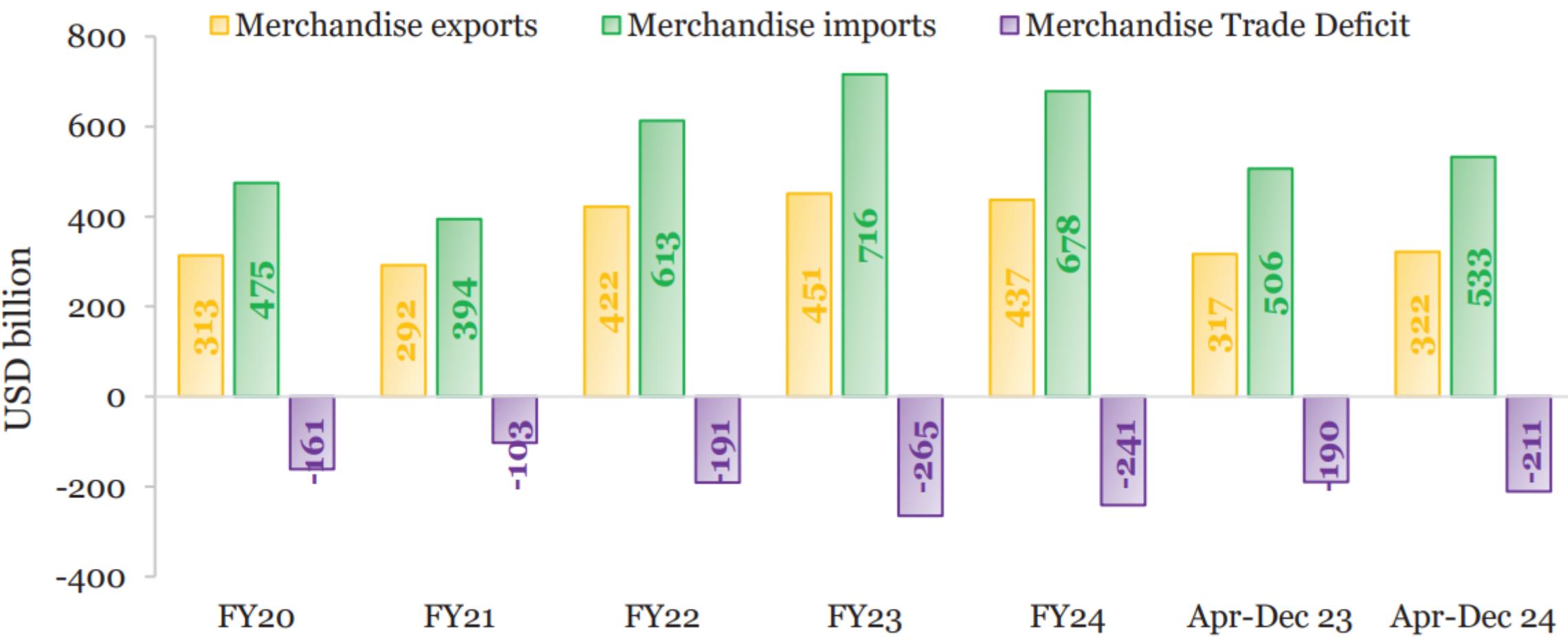
# Direct Investment & Portfolio Investment

- Direct investment is investment in enterprises located in one country but effectively controlled by residents of another country.
- Mostly direct investment takes place in the form of investment in subsidiaries or branches by parent companies situated in some other country.
- Portfolio investment signifies buying foreign securities which do not involve any claim on ownership or control of foreign companies.
- In other words, borrowing from foreign countries and direct & portfolio investment by foreign countries represent capital inflows.
- Whereas lending to foreign nations and direct & portfolio investment in foreign nations represent capital outflows.

# Other Components

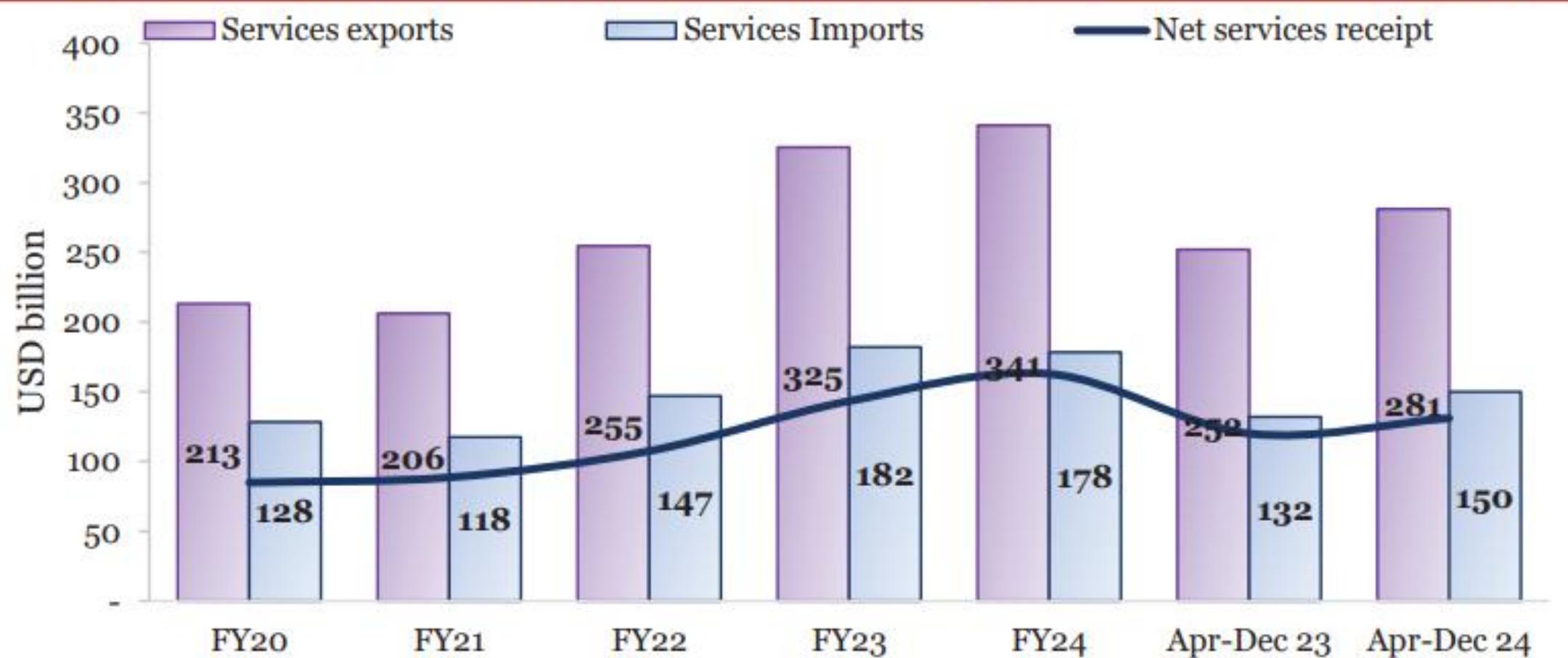
- Apart from the above mentioned two main accounts, a country's BOP also records
- some other transactions like-
- Transactions with IMF
- SDR allocations
- Errors & Omissions and
- Official settlements / Reserve account.

### Chart III.5: Trends in merchandise trade



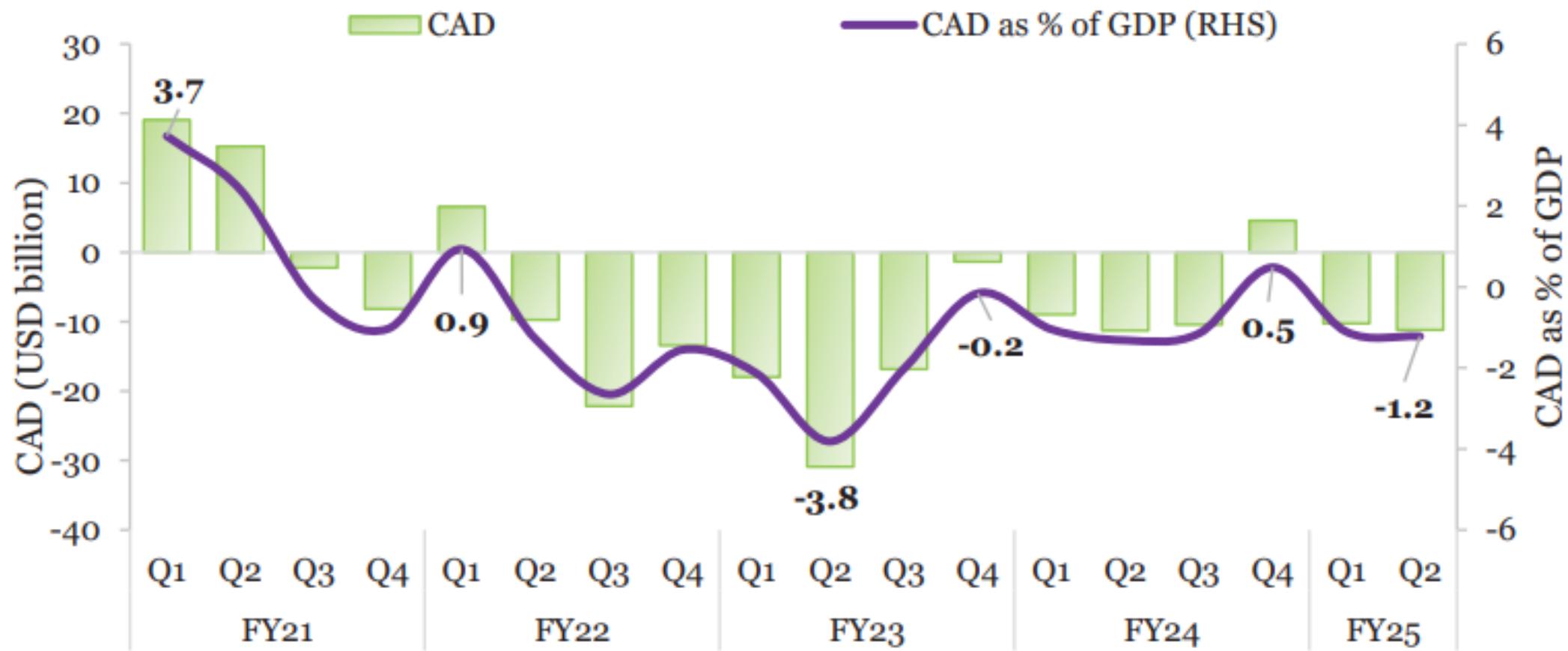
Source: DGCIS, M/o Commerce & Industry

**Chart III.10: Rise in net services receipts in the first nine months of FY25**



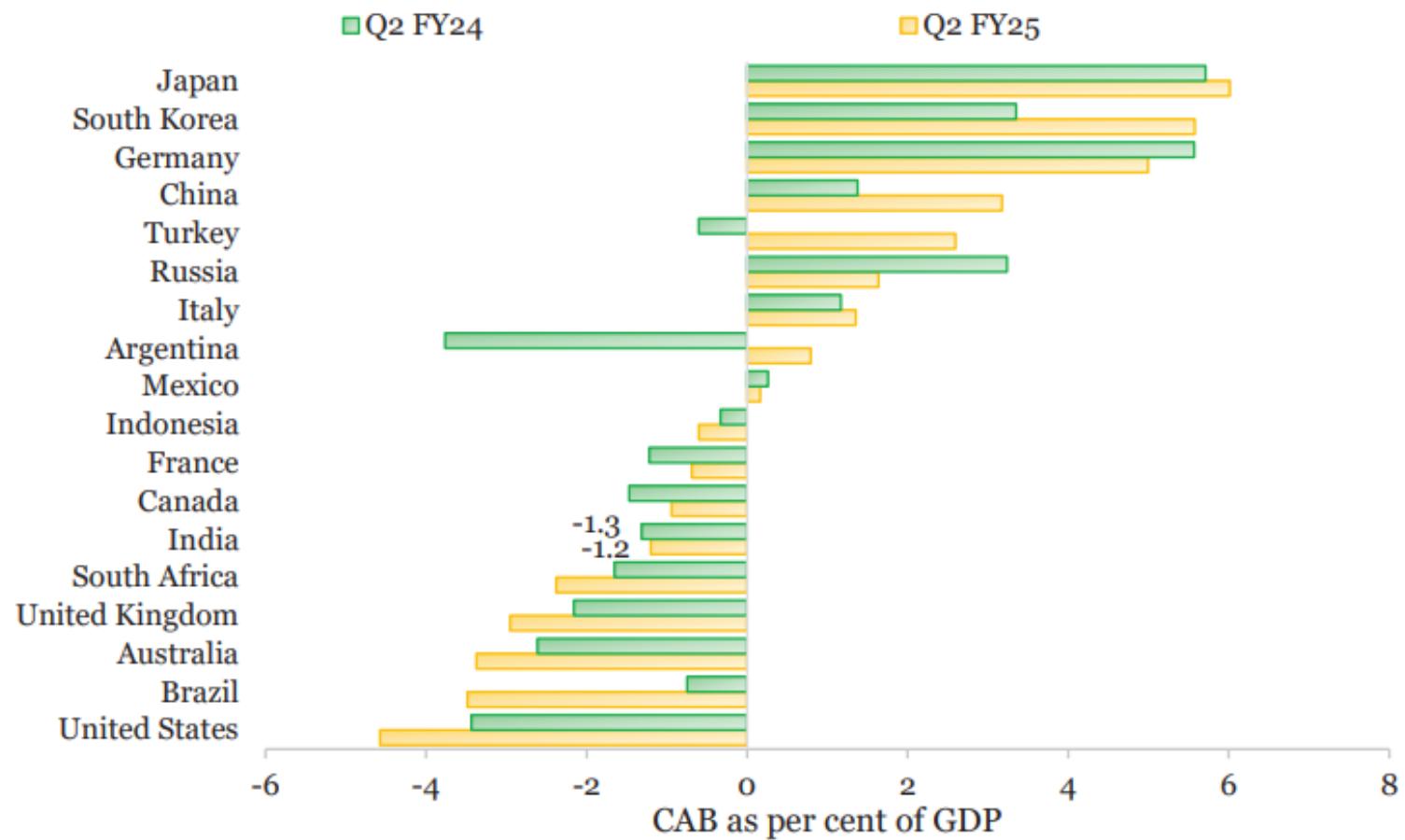
Source: RBI

### Chart III. 11: Trend in current account deficit



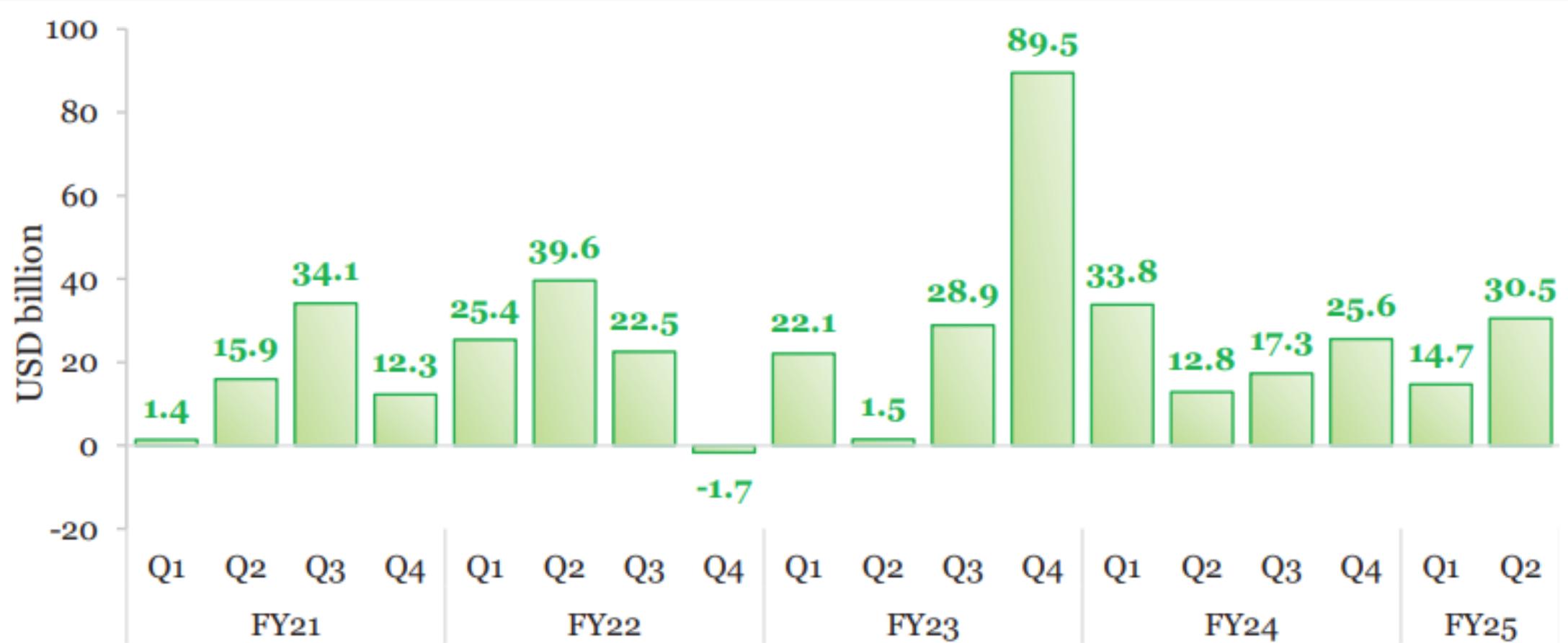
Source: RBI press release on developments in India's Balance of Payments during the second quarter (July-September) of 2024-25

### Chart III. 12: Current account balance (CAB) as a per cent of GDP (India vs select countries)



Source: CEIC Data

### Chart III.13: Quarterly trends in net capital inflows



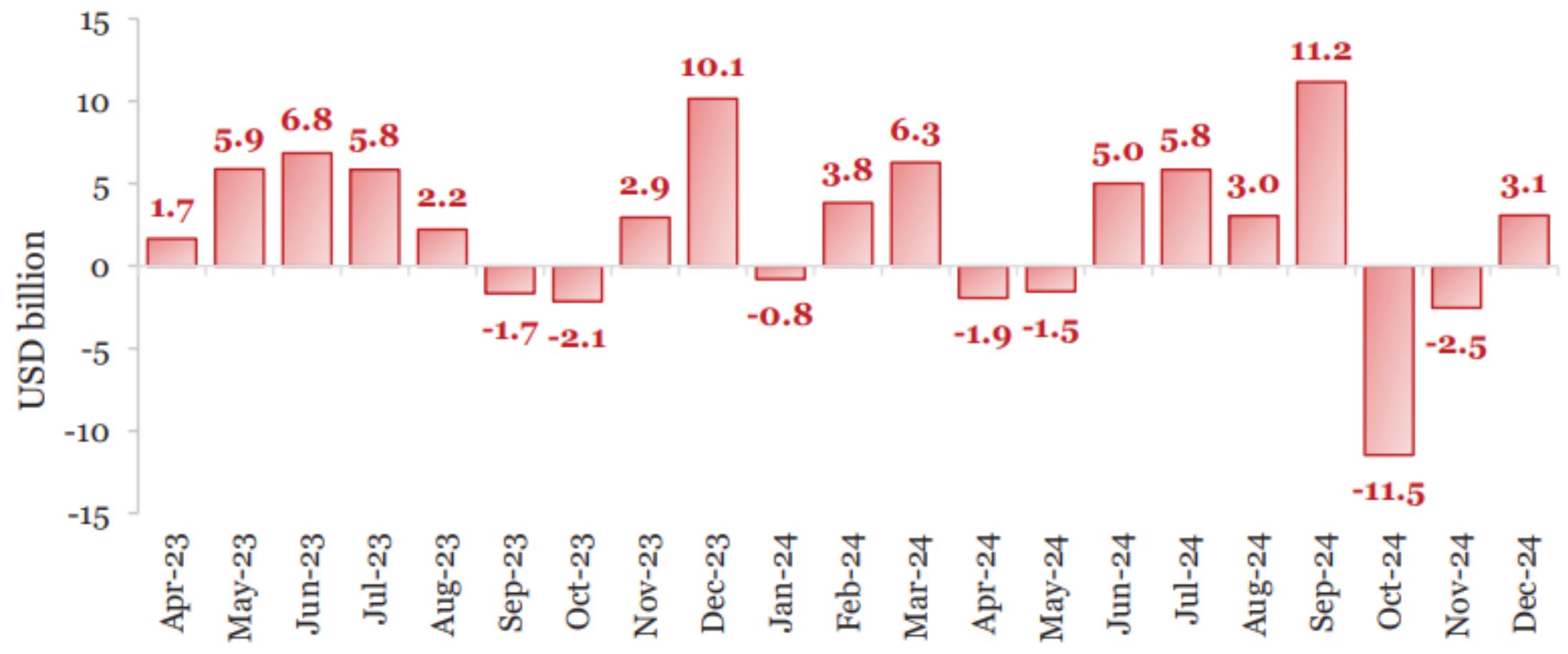
Source: RBI press release on developments in India's Balance of Payments during the second quarter (July-September) of 2024-25

### Chart III.15: Sectoral trends in FDI (H1 of FY25)-share in total FDI equity inflows



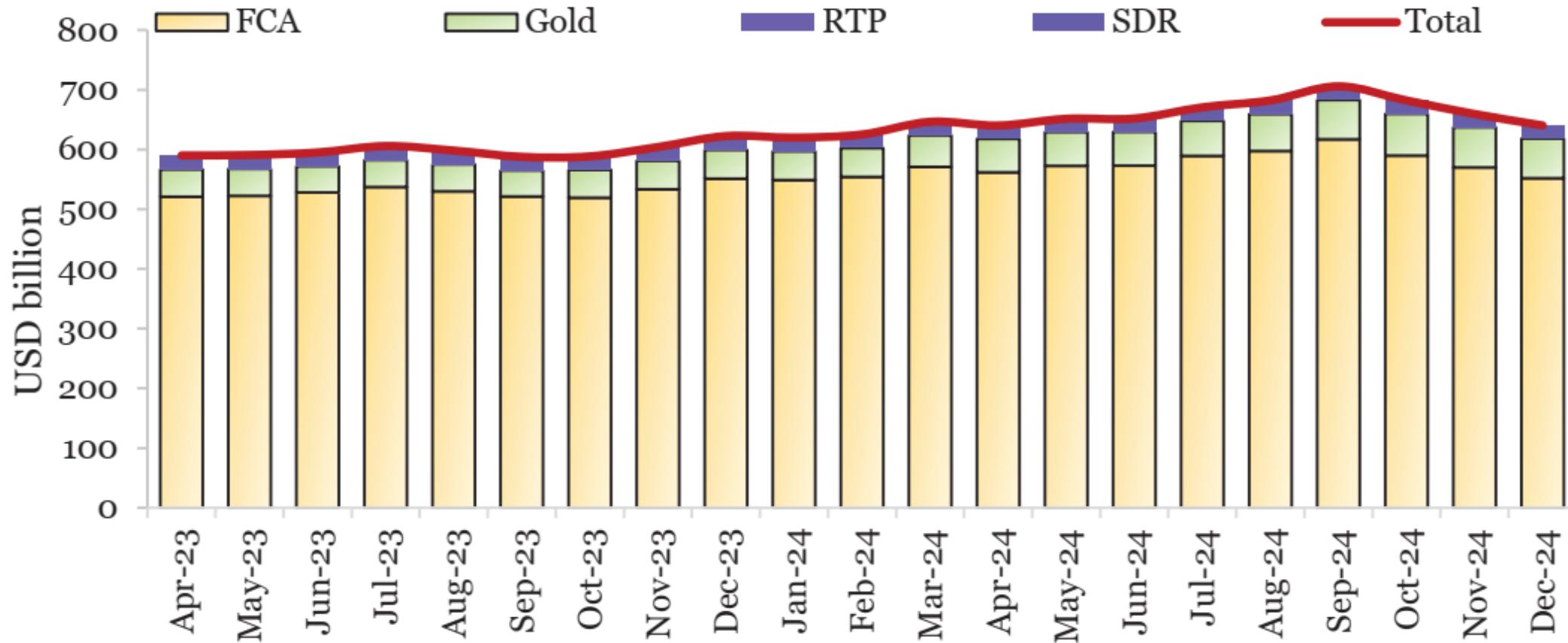
Source: DPIIT

### Chart III.16: Trends in foreign portfolio investment flows



Source: NSDL

### Chart III.19: Movements in foreign exchange reserves



Source: RBI

# Disequilibrium in Balance of Payments

Albeit the credit and debit sides are written balanced in the BOP, it may not always remain balanced.

Very often, either the debit side exceeds the credit side (referred to as deficit) or the credit side exceeds the debit side (referred to as surplus) which engenders an imbalance in the BOP account which is referred to as disequilibrium.

# Surplus in BOP



When the autonomous receipts (credits) are greater than autonomous payments (debits), the balance of payments will be in surplus or favorable.



To state it otherwise, if total credits exceed total debits in the current and capital account (including errors & omissions), the balance of payments will said to be in surplus.



This surplus is settled with an equal amount of net debit in the official reserves account.

# Deficit in BOP

- When the autonomous receipts (credits) are smaller than autonomous payments (debits), the balance of payments will be in deficit or unfavorable or adverse.
- To state it differently, when total debits exceed total credits in the current and capital accounts (including errors & omissions), the BOP is said to be in deficit.
- This deficit is settled with an equal amount of net credits in the official reserve account.

# Types of Disequilibrium

- i. Cyclical Disequilibrium
- ii. Secular Disequilibrium
- iii. Structural Disequilibrium
- iv. Fundamental Disequilibrium



# Measures to correct Disequilibrium in BOP

- Monetary Measures of Correcting the BOP
  - a) Deflation
  - b) Change in the Exchange Rate
    - (i) Under Fixed Exchange Rate – Devaluation
    - (ii) Under Flexible Exchange Rate – Depreciation
  - c) Exchange Control



# Measures to correct Disequilibrium in BOP

- Non-monetary measures of correcting BOP
  - a) Tariffs
  - b) Quantitative Restrictions/Quotas
  - c) Export Promotion
  - d) Import Substitution

Item/Year	(US \$ Million)			
	2021-22	Credit	Debit	Net
1		17	18	19
A. Current account				
1. Merchandise	429164	618623	-189459	
2. Invisibles (a+b+c)	369600	218906	150694	
a) Services	254527	147011	107516	
b) Transfers	89322	8875	80447	
c) Income	25751	63020	-37269	
Total Current account (1+2)	798764	837529	-38766	
B. Capital account				
1. Foreign investment	478000	456191	21809	
2. Loans	105457	71851	33605	
3. Banking capital	102886	96217	6669	
4. Rupee debt service	0	71	-71	
5. Other capital	75059	51265	23794	
Total capital account (1 to 5)	761402	675595	85807	
C. Errors & omissions	1433	974	459	
D. Overall balance	1561599	1514098	47501	
E. Monetary movements (i+ii)	16024	63524	-47501	
i) I.M.F.	0	0	0	
ii) Foreign exchange reserves (Increase- / Decrease+)	16024	63524	-47501	
G.n.i.e.: Government not included elsewhere.				
Notes: 1. Data for 2021-22 are preliminary estimates				
2. Total may not tally due to rounding off.				

Source: The Handbook of Statistics on the Indian Economy 2021-22, RBI, Mumbai