BALANCE OF PAYMENT[BOP]

Class 17

What Is the Balance of Payments (BOP)?

- **It is , also known as the balance of international payments**
- It is a statement of all transactions made between entities in one country and the rest of the world over a defined period, **such as a quarter or a year.**
- These entites are a country's individuals, companies, and government bodies' completed transactions with individuals, companies, and government bodies outside the country.

Definition of BOP:

- The balance of payments is a comprehensive and systematic record of a country's economic transactions with the rest of the world, encompassing goods, services, and capital flows within a specified time frame.
- It comprises the current, capital, and financial accounts, each reflecting different types of transactions.

The General Rule in BOP Accounting

- a. If a transaction earns foreign currency for the nation, **it is a credit and is recorded as a plus item.**

- b. If a transaction involves spending of foreign currency **it is a debit and is recorded as a negative item.**

Contd.

- It thus records how much money is going in and out of a country.
- **If a country has received money**, this is known as a **credit**, and **if a country has paid or given money**, the transaction is counted as a **debit**.
- Debit items include imports, foreign aid, domestic spending abroad and domestic investments abroad.
- Credit items include exports, foreign spending in the domestic economy and foreign investments in the domestic economy.

Double-entry accounting system

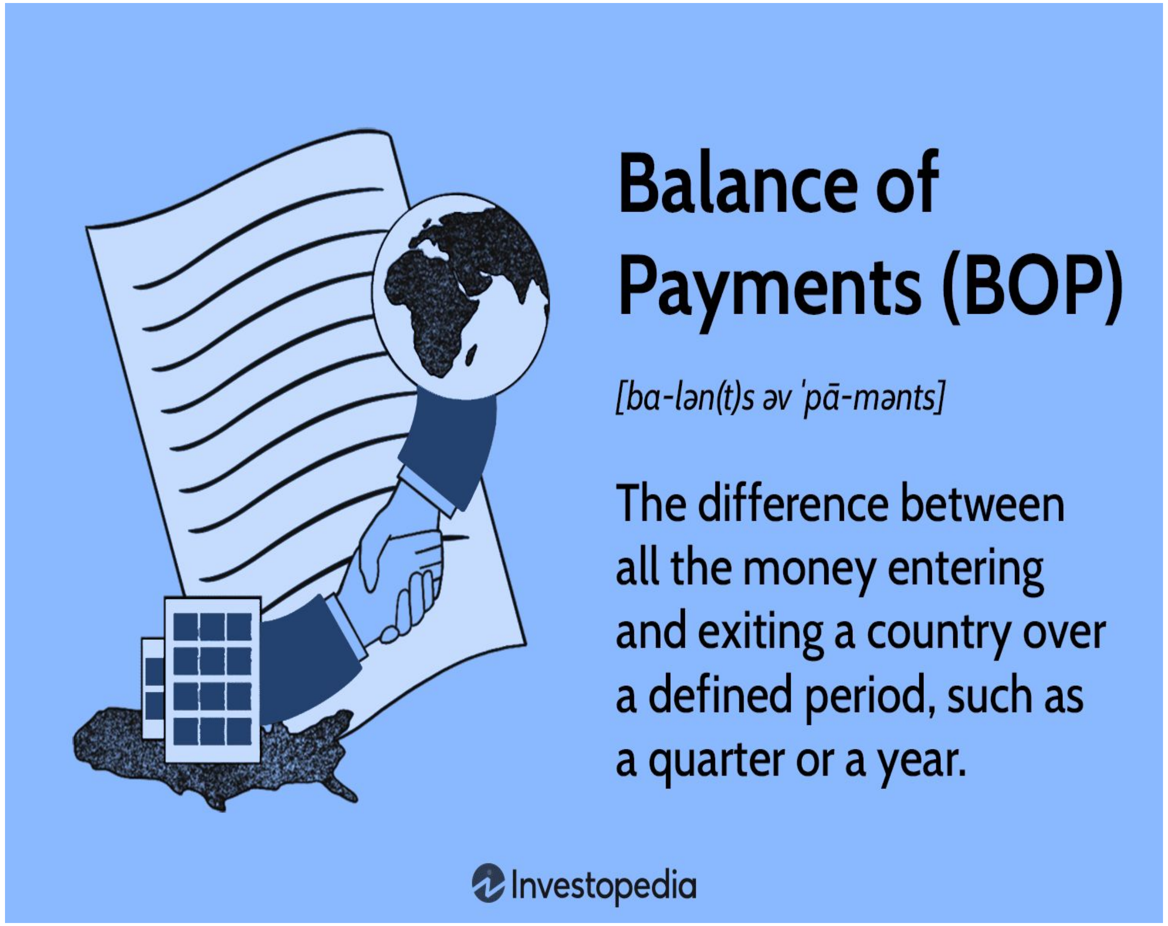
- **Tracking the transactions under BOP is similar to the double-entry accounting system.**
- **All transactions will have a debit entry and a corresponding credit entry.**
- **For example:**
- Funds entering a country from a foreign source are booked as credit and recorded in the BOP. Outflows from a country are recorded as debits in the BOP.
- **Let's say India exports 100 cars to USA.**
- The value of these exported 100 cars is entered as a debit in the BOP, while the amount of payment received from USA for these exports is entered as a credit in the BOP.
- Similarly, when India imports some commodities, its value will enter as a Credit item,while the payment made for these will enter as Debit item.

Thus, BOP always balances Theoretically.

- Theoretically, the BOP should be zero, meaning that assets (credits) and liabilities (debits) should balance, because every entry is entered twice.
- But in practice, this is rarely the case.
- Factors like fluctuating exchange rates, inflation rate, timing of transactions and payments etc and thus the change in the value of money can all add to BOP discrepancies.

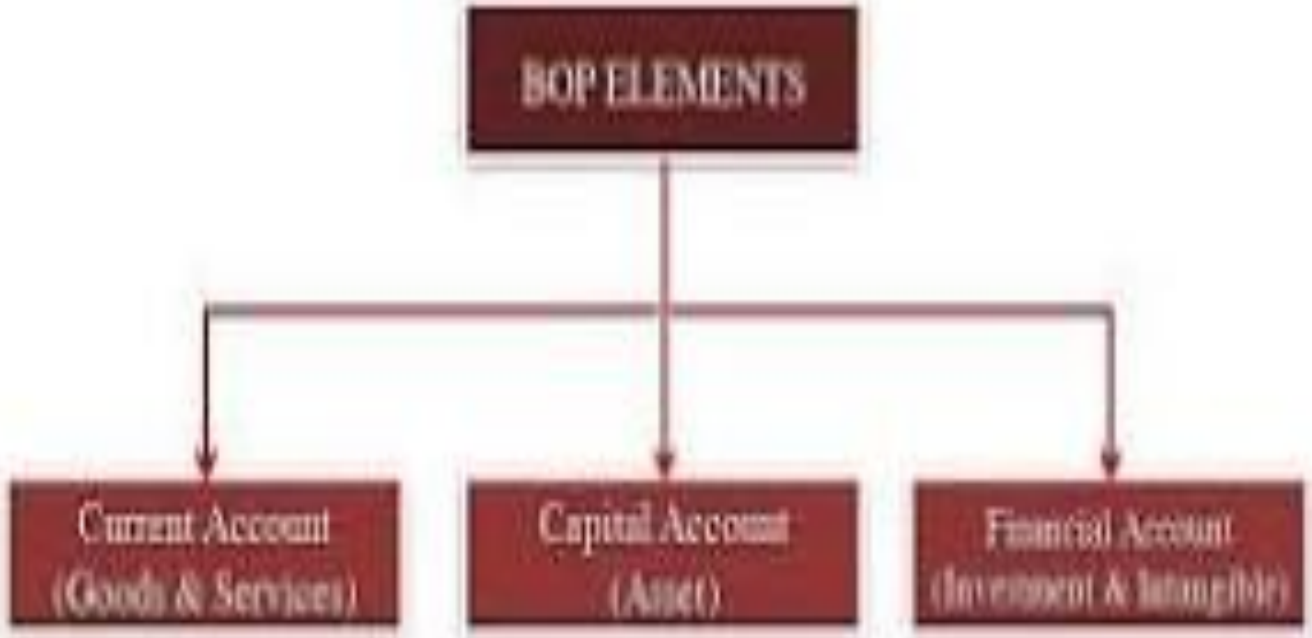
Thus, the balance of payments (BOP) is like a country's financial report card, tracking its international transactions over time.

- It shows how much a nation earns, spends, and invests globally through three main components: current, capital, and financial accounts.



STRUCTURE OR COMPONENTS OF THE BOP

- The BOP comprises three components which are the >>
- **current account, capital account and financial account.**



The various components of a BOP statement

- 1. Current Account
- 2. Capital Account
- 3. Reserve Account
- 4. Errors & Omissions

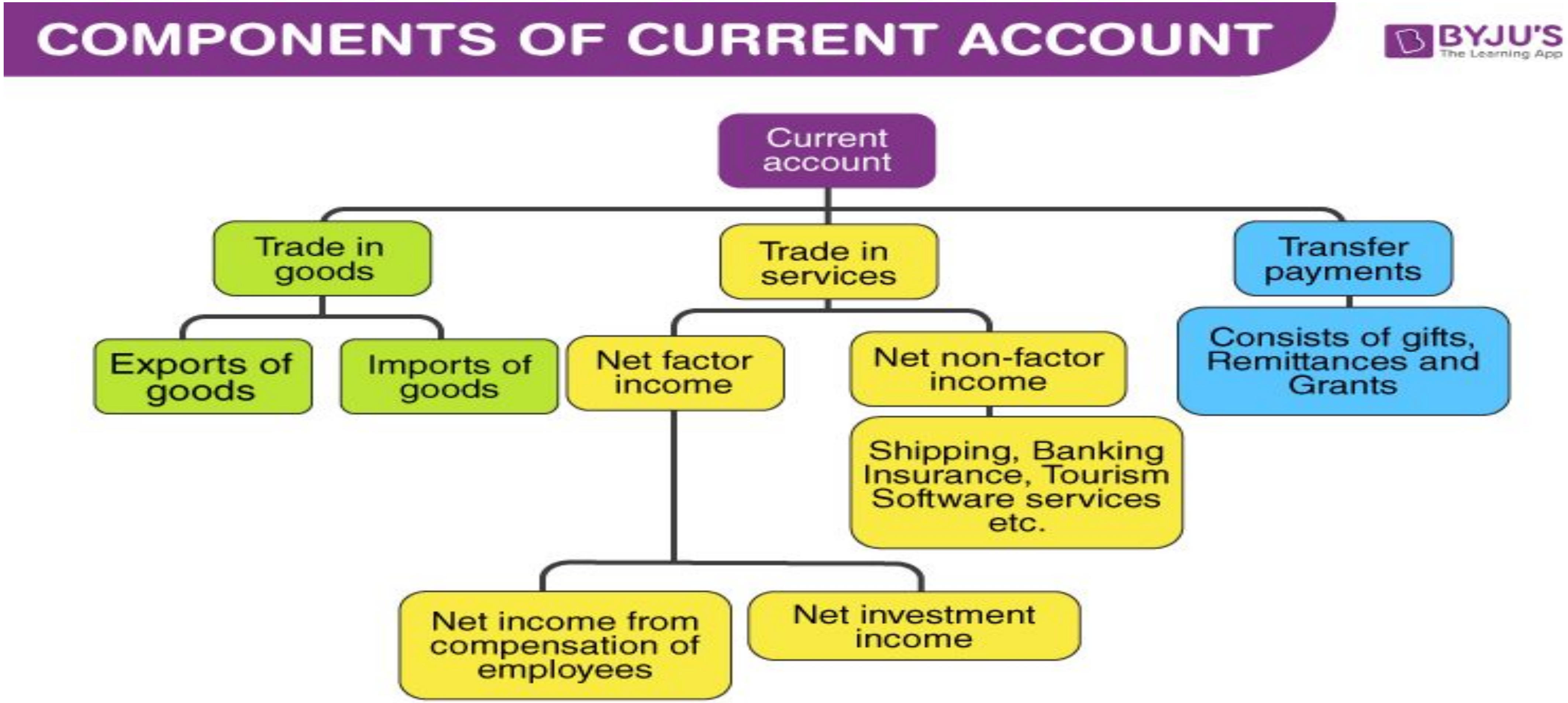
1. Current account

- The current account indicates the country’s economic activity.
- The current account is divided into four main components, which record the transactions of a country's industries, services, and governments.

The Three components of the Current account are:

- 1. **Balance of trade in goods.** Tangible items(goods) are recorded here.
- 2. **Balance of trade in services.** Intangible items like Net income flows, income from tourism,banking.insurance,shippingetc are recorded here.
- Receipts from income-generating assets such as stocks (in the form of dividends) are also recorded in the current account
- **3. Transfer Payments:** Remittances, gifts , grants, foreign aid and all short of unilateral transfers etc would be recorded here.
- Remitances: These are credits that are mostly workers' remittances, which are salaries sent back into the home country of a national working abroad.

Current account(contd.)



Balance of Trade[BOT]

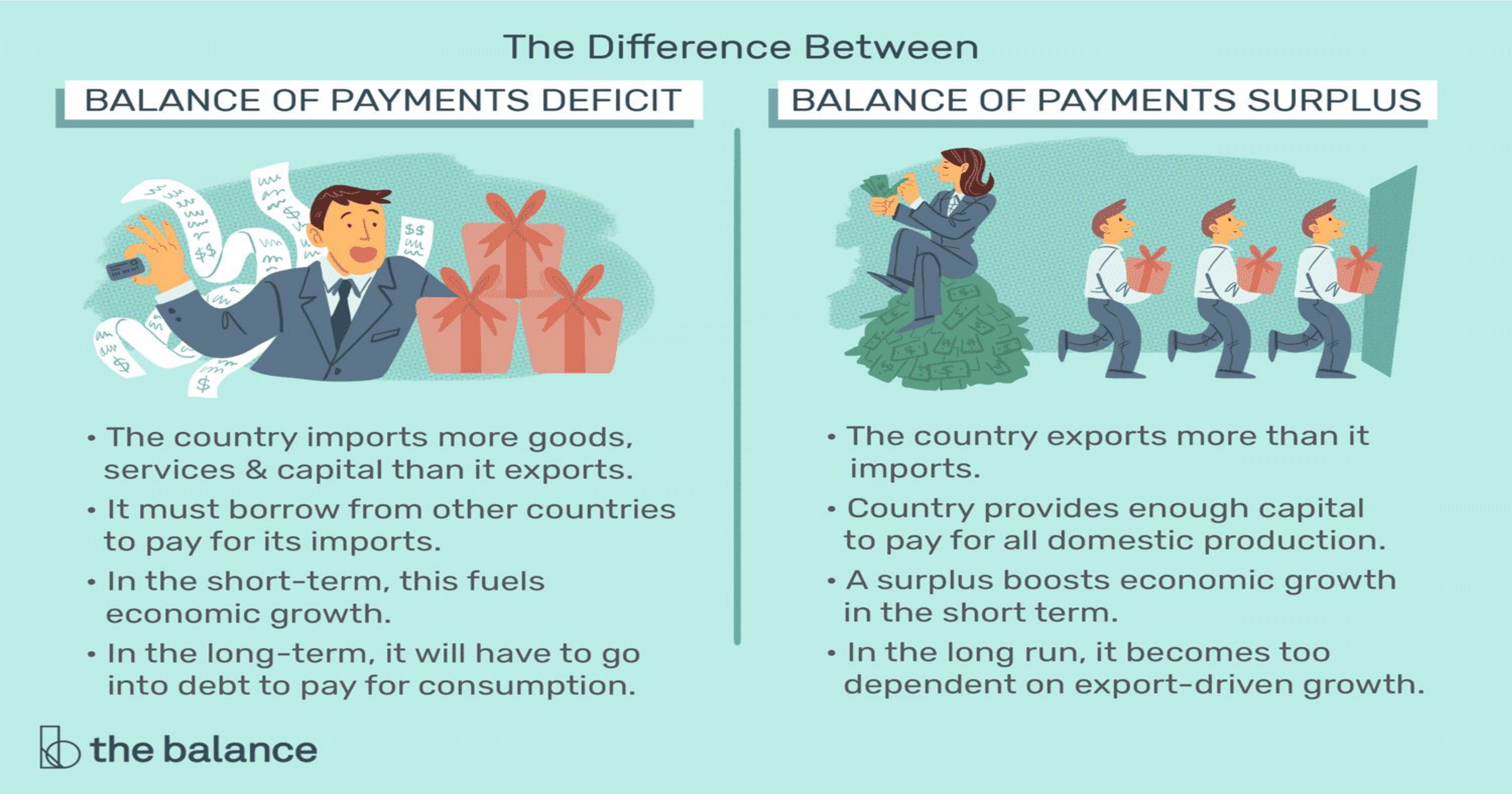
- It is the difference between a country's imports and its exports i.e., [X-M]
- BOT is the largest component of a country's balance of payments.
- When X > M, exports are greater than imports than the **BOT is favourable**, and
- if M > X, imports are greater than exports then **BOT is unfavourable.**

Formula to calculate the current account balance :

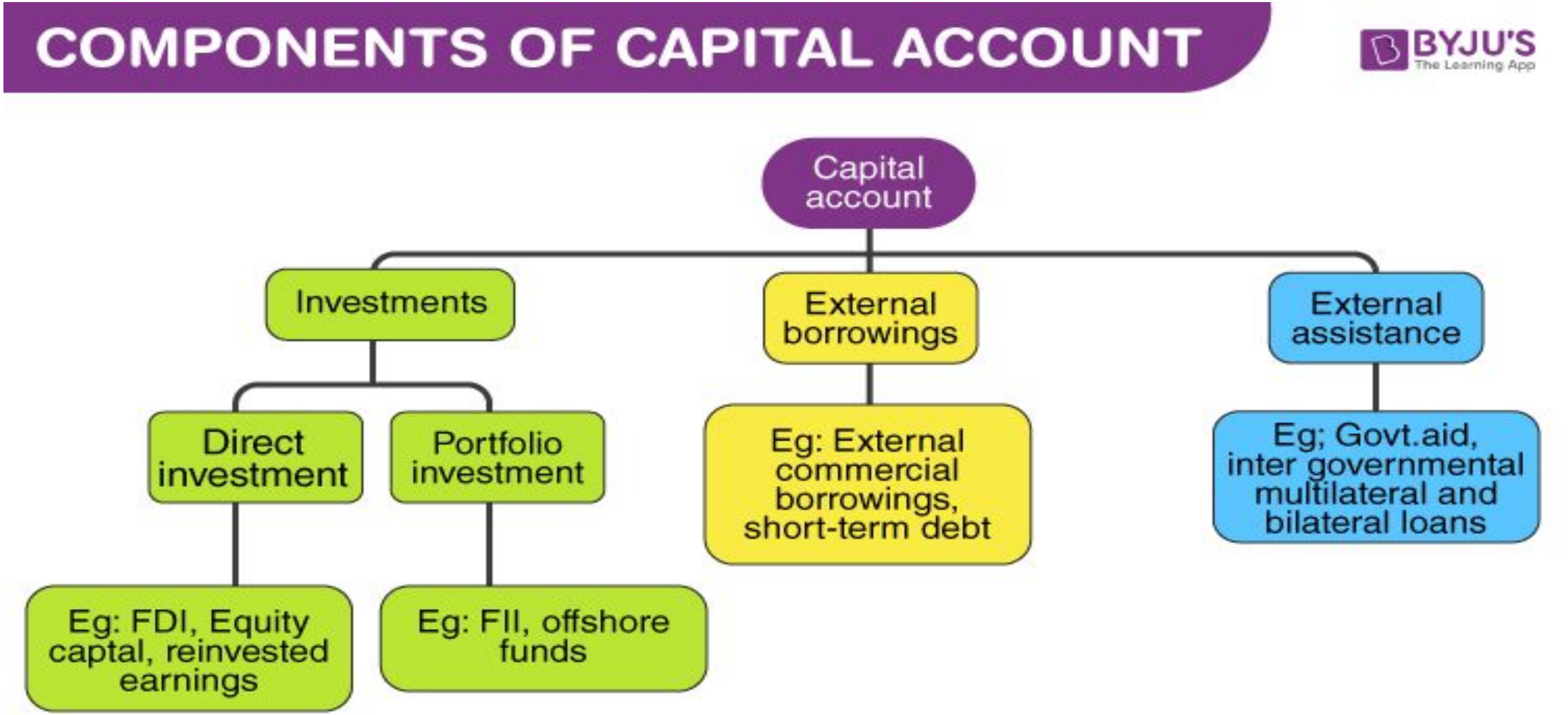
- Current Account = Balance in trade + Balance in services + Net income flows + Net current transfers
- The current account can either be in a surplus or deficit.

BOT IS A SUBSET OF THE BOP

Deficit and Surplus >>



COMPONENTS OF CAPITAL ACCOUNT



1. Capital account

A country's capital account records all international **capital transfers.**

>>The income and expenditures are measured **by the inflow and outflow of funds in the form of investments and loans.**

>>A deficit shows more money is flowing out, while a surplus indicates more money is flowing in.

The Capital Account includes: Along with non-financial and non-produced asset transactions, the following:

- ✔ Debt forgiveness by the Government
- ✔ The transfer of goods and financial assets by migrants leaving or entering a country
- ✔ Gift and inheritance taxes
- ✔ Death levies, patents, copyrights, royalties
- ✔ Uninsured damage to fixed assets.

3. Financial account

- It has two sub-accounts.
- One is the domestic ownership of foreign assets. The other is the foreign ownership of domestic assets.
- If the sub-account for the domestic ownership of foreign assets increases, the overall financial account increases.
- If the sub-account for the foreign ownership of domestic assets increases, the overall financial account decreases.
- **Thus, the overall financial account increases when the foreign ownership of domestic assets sub-account decreases.**
- Together, these two sub-accounts of the financial account measure a country's ownership of international assets.

The financial account deals with money related to:

- Foreign reserves
- Private investments in businesses, real estate, bonds, and stocks(Portfolio Investments)
- Government-owned assets such as special drawing rights(SDRs) at the International Monetary Fund (IMF).
- Private sector assets held in other countries
- Local assets held by foreigners (government and private)
- Foreign direct investment(FDI)

4. Errors and Omissions: The balancing item in the balance of payments

- As its name states, the balance of payments should balance: the flows into the country should equal the flows out of the country.
- If the BOP records a surplus or a deficit, **it is called a balancing item**, and they represents that transactions that were somehow failed to be recorded in the BOP.
- **The errors and omissions amount is equal to the amount required to balance both the sides.**

So,

- The capital account measures the capital transfers between the domestic residents and foreign residents.
- The financial account reflects increases or decreases in a country's ownership of international assets

Formula To Calculate:

- The balance on capital account = Surpluses or Deficits of Net Non-Produced + Non-Financial assets + Net Capital Transfers.

- Balance of financial account = Net direct investment + Net portfolio investment + Assets funding + Errors and Omissions.

Disequilibrium In The Balance Of Payments

- 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**

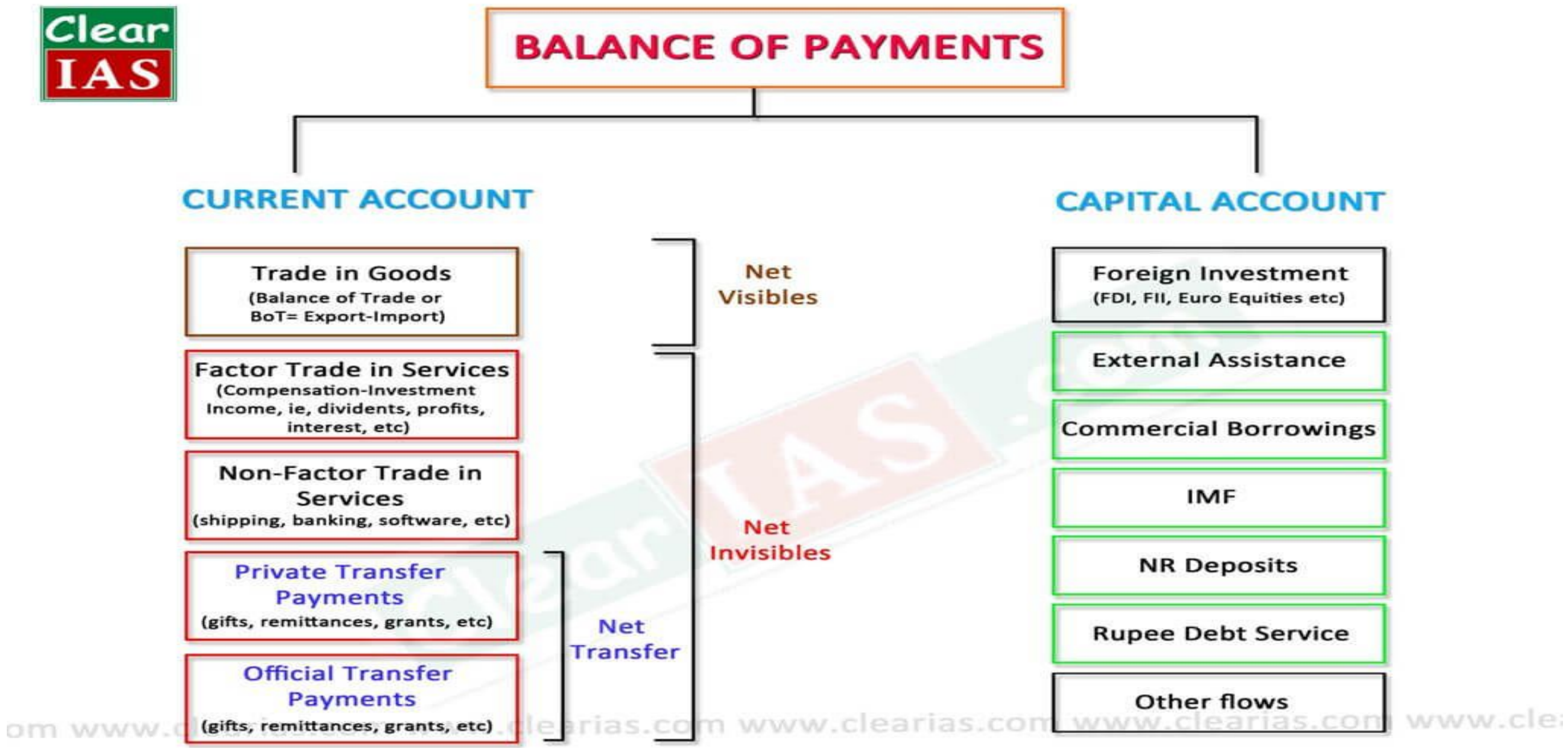
>> A **Deficit** in the BOP occurs when Total Payments exceeds **Total Receipts. Thus, BOP= CREDIT<DEBIT**

How the Two Accounts >> Capital and Financial Accounts Work

- Capital transferred out of a country for the purpose of investing in a foreign country is recorded as a **debit** in both capital and Financial accounts.
- Specifically, **if it's a portfolio investment, it's recorded as a debit in the financial account.**
- **If it's a direct investment, it's recorded as a debit in the capital account.**

- Since these transfers involve investments, there's an implied return.
- **In the BOP, this return is recorded as a credit in the Capital account.** The opposite is true when a foreign country earns a return. **Paying a return on an investment would be noted as a debit in the current account.**

Balance of Payments at a view



1. Exports	250.5
2. Imports	-381.1
3. Trade balance (2 – 1)	**-130.6**
4. Invisibles (net)	84.6
(a)Non-factor income	48.8
(b)Income	-17.3
(c)Pvt. Transfers	53.1
5. Current account balance (3 + 4)	**-45.9**
6. External assistance (net)	4.9
7. Commercial borrowing (net)	12.5
8. Short-term debt	11.0
9. Banking Capital of which NR deposits (net)	4.9 3.2
10. Foreign investment (net)	39.7
Of which: (i) FDI (net)	9.4
(ii)Portfolio	30.3
11. Other flows (net)	-11.0
12. Capital account total (net)	**62.0**
13. Errors and Omissions	-3.0
14. Balance of payments [5 + 12+13]	**13.1**
15. Reserve use (- increase)	-13.1

An example of Balance of Internatinal Payments with respect to India

Importance of Balance of Payment

1. It examines **the transaction of all the exports and imports of goods and services for a given period.**

2. It helps the government to **analyse the potential of a particular industry** export growth and formulate policy to support that growth.

3. It gives the government a broad **perspective on a different range of import and export tariffs.** The government then takes measures to increase and decrease the tax to discourage import and encourage export, respectively, and be self-sufficient.

4. The balance of payment also indicates the government **to detect the state of the economy, about surplus , deficit etc.**

5. **Monetary and fiscal policy,trade policies etc** are established on the basis of balance of payment status of the country.

Importance of Balance of Payment(contd.)

- The BOP statement can be an indicator to determine whether the currency of a country is **appreciating or depreciating.**
- Thus, it provides important information to understand and analyze the economic dealings of one country with the other.

Q. Based on the balance of payment, which of the following terms constitute the current account?

- A. Balance of invisible
- B. Balance of trade
- C. Both A and B
- D. None of the above

Answer:

- C. Both A and B

Q. What are official reserve transactions and their importance in the balance of payments?

- Official reserve transactions mean running down the country's foreign exchange reserves in case of a deficit in the balance of payments by selling foreign currency in the foreign exchange market.
- In surplus, the country can buy foreign exchange and increase its official reserves.
- A country is said to be having its balance of payment in equilibrium when the sum of its current account and non-reserve capital account equals zero, which means the current account deficit is financed entirely by international borrowings without any movement in the country's official reserves.

Q. What are some of the sources of supply of foreign exchange to our country ?

- ✔ Purchase of goods and services by foreigners
- ✔ Foreign Direct Investment (FDI) into our country
- ✔ Inflow by the NRIs settled in foreign countries
- ✔ Speculative purchase of home currency by foreigners

Q. What is the difference between the balance of trade and Balance of Current Account?

- Balance of trade is the difference between exports and imports of goods. Only the visible items are considered in the balance of trade. The exchange of services between countries is not considered.
- The current account of the balance of payment comprises exports and imports of goods, services and unilateral transfers like remittances, gifts, donations, etc. The net value of all these constitutes the balance of the current account. Thus, the balance of trade is a part of the current account of the balance of payments.

Q. What is the difference between Balance of Trade and Balance of Payments?

- >> Balance of Trade or BoT is a financial statement that captures the nation's import and export of commodities with the rest of the world.
- Balance of Payment or BoP is a financial statement that keeps track of all the economic transactions by the nation with the rest of the world.
- >>Net effect of Balance of Payment is always zero. Net effect of Balance of Trade can be zero, positive or negative.

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