Balance of Payment

- We now begin our examination of the monetary aspects of international economics, or international finance, and the commodity prices are expressed in terms of domestic and foreign currency units.
- The balance of payments of a country is a systematic record of all economic transactions between the residents of a country and the rest of the world.
- It presents a classified record of all receipts on account of goods exported, services rendered and capital received by residents and payments made by theme on account of goods imported and services received from the capital transferred to non-residents or foreigners.
- BOP records all the transactions that create demand for and supply of a currency. This can drive changes in exchange rate of the currency with other currencies.
- BOP may confirm trend in economy's international trade and exchange rate of the currency. This may also indicate change or reversal in the trend.
- This may indicate policy shift of the monetary authority (RBI) of the country.

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.

Features of BOP

- **Comprehensiveness:** The BoP covers a wide range of transactions, including trade in goods and services, financial investments, income flows, and transfers.
- **Double-Entry Accounting:** Like any accounting system, the BoP follows the principles of double-entry accounting. This means that every international transaction is recorded as both a credit (inflow) and a debit (outflow) to ensure that the BoP equation remains balanced.
- **Balance of Payments Identity:** The BoP follows the principle of the balance of payments identity, which states that the sum of the current account, capital account, and financial account balances must equal zero.
- **Data Source:** BoP data is typically collected and compiled by a country's central bank or statistical agency.
- **Use for Policy Analysis:** The BoP is a crucial tool for policymakers, economists, and analysts to assess a country's external economic position, monitor trade imbalances, evaluate the impact of trade policies, and make informed decisions regarding economic and monetary policies.

The various components of a BOP statement

- Current Account
- Capital Account
- IMF
- SDR Allocation
- Errors & Omissions
- Reserves and Monetary Gold

Current Account

- BOP on current account refers to the inclusion of three balances of namely – Merchandise balance, Services balance and Unilateral Transfer balance.
- It includes several sub-components:
- **Goods Balance:** This accounts for the value of physical goods (exports and imports) traded between a country and its trading partners. It is often referred to as the trade balance.
- **Services Balance:** This component includes international transactions in services, such as tourism, transportation, financial services, and business services.
- **Income Balance:** The income balance reflects earnings from investments, including income received by residents from foreign investments (such as dividends and interest) and income earned by foreign residents from investments within the country.
- **Current Transfers:** This sub-component includes unilateral transfers of money or goods between countries, such as foreign aid, remittances from overseas workers, and grants.
- The current account, therefore, provides information about a country's trade balance (whether it has a trade surplus or deficit) and its net income from international transactions.

Table 23.1 ***Current account summaries for four countries, 1989 ($US billion)***

	United States	*Japan*	*West Germany*	*United Kingdom*
A: Merchandise exports	360.46	269.59	324.48	151.31
B: Merchandise imports	−475.33	−192.74	−247.77	−189.26
C: Visible trade balance ($A + B$)	−114.87	76.85	76.71	−37.96
D: Exports of services	242.71	143.91	98.31	172.01
E: Imports of services	−223.14	−159.53	−101.13	−157.79
F: Invisible trade balance ($D + E$)	19.57	−15.62	−2.82	14.22
G: Private unrequited transfers (net)	−1.33	−0.99	−6.17	−0.49
H: Official unrequited transfers (net)	−13.43	−3.30	−12.24	−6.93
I: Current account balance ($C + F + G + H$)	−110.06	56.94	55.48	−31.16

Source: Based on Table 2.3 in Pilbeam (1992), which is derived from

Capital Account

- The capital account records all international transactions that involve a resident of the country concerned with changing either his assets or his liabilities to a resident of another country.
- Transactions in the capital account reflect a change in a stock – either assets or liabilities.
- It includes:
- **Foreign Direct Investment (FDI):** The purchase or sale of physical assets, like factories or businesses, by foreign entities in the country and vice versa.
- **Portfolio Investment:** Transactions involving financial assets like stocks and bonds, typically involving non-controlling ownership.
- **Other Investments:** Transactions in financial assets and liabilities that do not fall into the categories of FDI or portfolio investment, including loans and currency deposits.
- **Capital Transfers:** These are one-time transfers of ownership, such as debt forgiveness or the transfer of ownership of fixed assets.

(net)				
M: Long-term capital balance (J + K + L)	87.93	−93.61	−11.65	−34.98
N: Short-term capital balance (net)	16.32	45.86	−56.75	27.53

Source: Based on Table 2.3 in Pilbeam (1992).

reserves and in official liabilities that are part of the reserves of other countries.

Errors and omissions (or the balancing item) reflect the difficulties involved in recording accurately, if at all, a wide variety of transactions that occur within a given period (usually 12 months). In some cases there is such a large number of transactions that a sample is taken rather than recording each transaction, with the inevitable errors that occur when samples are used. In others problems may arise when one or other of the

- The export of goods and services, as well as primary income, secondary income, and capital transfers receivable from abroad are classified as **credit transaction.**
- whereas imports of goods and services, as well as primary income, secondary income, and capital transfers payable to foreign residents are classified as **debit transactions**.
- **Net lending (+)** from **current-** and **capital-account transactions** occurs when the total credits exceed the total debits in the nation's current and capital accounts.
- **Net borrowing (−)** from **current-** and **capital- account transactions** occurs when the total debits exceed the total credits in the nation's current and capital accounts.

Table 23.3 Balance of payments summaries for four countries, 1989 ($US billion)

	United States	Japan	West Germany	United Kingdom
I: Current account balance	−110.06	56.94	55.48	−31.16
M: Long-term capital balance	87.93	−93.61	−11.65	−34.98
N: Short-term capital balance	16.32	45.86	−56.75	27.53
O: Other recorded items	1.55	−0.01	0.12	−0.54
P: Net errors and omissions	22.60	−21.95	2.33	24.55
R: Exceptional financing	—	—	—	−1.94
S: Liabilities constituting other authorities' reserves	8.48	—	13.43	7.19
T: Total change in reserves	−26.81	12.77	−2.95	9.34

Source: Based on Table 2.3 in Pilbeam (1992).

BOP is always in Balances

- The BoP is essentially a structured accounting system that ensures that the accounting equation remains balanced at all times.

1. **Double-Entry Accounting:** The BoP follows the principles of double-entry accounting, which is a fundamental accounting concept. In double-entry accounting, every financial transaction has two equal and opposite entries—one on the credit side and one on the debit side. This system ensures that the accounting equation stays in balance.
2. **Recording of International Transactions:** When international transactions occur, they are recorded in the BoP in a way that reflects their economic impact on a country. These transactions are categorized into the current account, capital account, depending on their nature. For example, exports are recorded as a credit entry in the current account, while imports are recorded as a debit entry.

3. **Balance of Payments Identity:** The BoP is governed by the balance of payments identity, which is an accounting identity stating that the sum of the current account balance, the capital account balance, must always equal zero.
4. **International Economic Equilibrium:** From an economic perspective, the BoP always balances because, in the absence of errors and omissions, all international transactions involve an exchange of economic value between countries. For every credit (inflow) recorded in the BoP, there is a corresponding debit (outflow) that represents the reciprocal transaction in another country.
5. **Errors and Omissions:** In practice, there may be some minor discrepancies in the BoP due to data collection and reporting issues, but these discrepancies are typically categorized as "errors and omissions." These discrepancies are relatively small and do not significantly affect the overall balance of the BoP.

India’s BOP

Table 5.2. Balance of Payments as per IMF Balance of Payments Manual 5									
	Items	2019-20		2020-21		2021-22		2022-23 (Apr-Sep)^{P}	
		₹ crore	US$ million	₹ crore	US$ million	₹ crore	US$ million	₹ crore	US$ million
		(18)	(19)	(20)	(21)	(22)	(23)	(24)	(25)
1	Imports (c.i.f.)	3385822	477937	2946318	398452	4613049	618623	2994669	381366
2	Exports (f.o.b.)	2270919	320431	2193253	296300	3199115	429164	1841576	234801
3	Trade Balance (2-1)	-1114902	-157506	-753065	-102152	-1413934	-189459	-1153093	-146565
4	Invisibles								
	a) Receipts	2281179	321712	2278625	307253	2755292	369600	1737220	221238
	b) Payments	1338706	188862	1343490	181188	1632174	218906	1014821	129242
	(of which: Interest & Service Payments on Loans and Credits)	132007	18629	114374	15413	112739	15128	68187	8679
	c) Net	942474	132850	935135	126065	1123118	150694	722399	91997
5	Current Account Balance	-172429	-24656	182070	23912	-290816	-38766	-430693	-54569

Disequilibrium in BOP

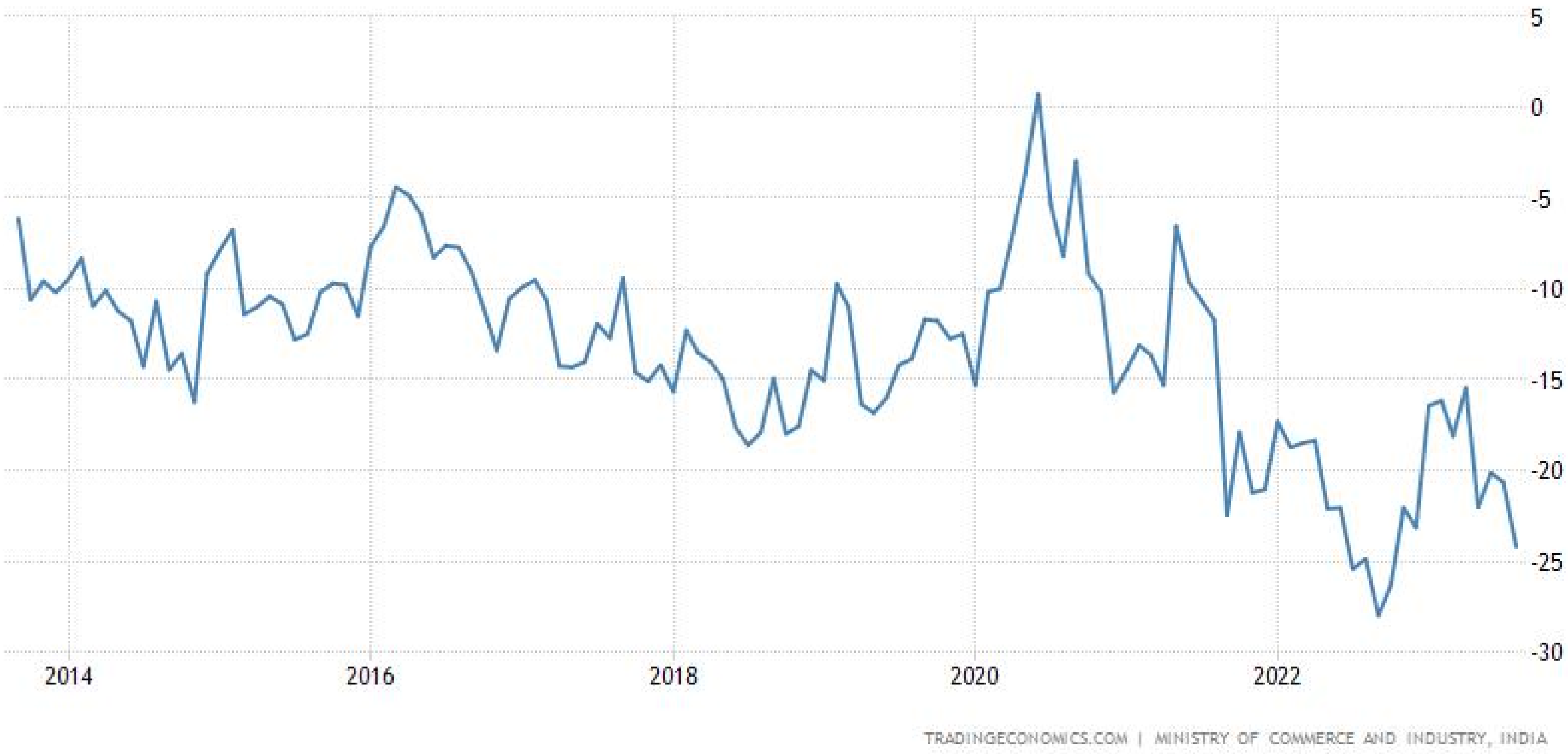
- Balance of Payments (BOP) disequilibrium refers to a situation where a country's international transactions result in an imbalance between its receipts and payments.

1. **Trade Disequilibrium**: A trade deficit occurs when a country imports more than it exports, and a trade surplus occurs when it exports more than it imports.
2. **Current Account Disequilibrium**: The current account includes the trade balance along with income from abroad (such as interest, dividends, and remittances) and unilateral transfers (gifts, grants, and foreign aid).
3. **Capital Account Disequilibrium**: Disequilibrium in the capital account can result from fluctuations in capital flows, such as a sudden outflow of foreign investment.

Types of Disequilibrium in BOP

5. **Structural Disequilibrium**: This type of disequilibrium is characterized by long-term imbalances in a country's BOP, often stemming from structural issues such as a lack of competitiveness in the export sector, inadequate infrastructure, or overreliance on imports.
6. **Cyclical Disequilibrium**: Economic cycles, both domestically and internationally, can impact a country's trade balance and financial flows.
7. **Speculative Disequilibrium**: Speculative capital flows can lead to short-term imbalances in a country's BOP. These flows are often driven by expectations of currency depreciation or appreciation, rather than underlying economic fundamentals.
8. **Policy-Induced Disequilibrium**: Government policies, such as exchange rate interventions or trade barriers, can influence a country's BOP. If these policies are not well-coordinated or effective, they can lead to BOP disequilibrium.
9. **Sudden Stops and Capital Flight**: These phenomena occur when capital flows suddenly reverse, leading to a rapid depletion of foreign exchange reserves. This is often associated with financial crises and can result in severe BOP problems.

India’s Trade Deficit in last 10 years



Causes of Disequilibrium

Balance of Payments (BOP) disequilibrium can be caused by a variety of factors, both internal and external to a country's economy.

- **Trade Imbalances**: various reasons, of trade imbalances including differences in production costs, changes in exchange rates, and shifts in global demand and supply.
- **Exchange Rate Movements**: Exchange rate fluctuations can affect a country's BOP. A depreciation of the domestic currency can make exports more competitive but can also increase the cost of imports, potentially affecting the trade balance.
- **Global Economic Conditions**: Changes in the global economy can impact a country's BOP. For example, a global recession can reduce demand for a country's exports, leading to a trade deficit. Conversely, a strong global economy can boost demand for exports, resulting in a trade surplus.
- **Domestic Economic Factors**: A country's domestic economic conditions, such as inflation, interest rates, and income levels, can affect its BOP. High inflation, for instance, may reduce a country's competitiveness by raising production costs.
- **Interest Rates**: Higher interest rates in one country may attract foreign capital, causing a capital account surplus.

- **Government Policies**: Government policies related to trade, fiscal spending, and monetary policy can impact a country's BOP.
- **Speculative Capital Flows**: Sudden inflows or outflows of speculative capital can affect exchange rates and the financial account.
- **External Shocks**: External shocks such as natural disasters, geopolitical events, or global financial crises can disrupt a country's BOP by affecting its trade, investment, and financial flows.
- **Terms of Trade**: A decline in the terms of trade, where export prices fall relative to import prices, can lead to a trade deficit.
- **Capital Flight**: Political instability or economic uncertainty can lead to capital flight, where residents and foreign investors withdraw their capital from a country, causing a sudden BOP crisis.
- **Government Interventions**: Central bank interventions in foreign exchange markets to maintain a fixed exchange rate or defend the currency can impact the BOP by affecting foreign exchange reserves.
- **Structural Factors**: Long-term structural issues within an economy, such as inadequate infrastructure, an aging population, can contribute to persistent BOP imbalances.

Method of correction of BOP disequilibrium

- Correction of BOP disequilibrium
  - Automatic correction
  - Deliberate measures
    - Monetary measures
      1. Monetary contraction/ expansion
      2. Exchange control
    - Miscellaneous
      1. Foreign loans
      2. Incentives for foreign investments
      3. Tourism development
      4. Incentives for foreign remittances
      5. Import substitution
    - Trade measures
      - Export promotion
        1. Abolition/reduction of export duties
        2. Export subsidies
        3. Export incentives
      - Import control

Monetary Policy:

- **Interest Rate Changes (for Deficit or Surplus Correction):** Adjusting interest rates can influence capital flows. Raising interest rates can attract foreign capital and reduce imports, while lowering rates can stimulate domestic demand and potentially increase imports.

Exchange Rate Adjustment:

- **Currency Depreciation (for Deficit Correction):** A country with a BOP deficit can allow its currency to depreciate in the foreign exchange market. This can make its exports cheaper and imports more expensive, potentially boosting exports and reducing imports.
- **Currency Appreciation (for Surplus Correction):** Conversely, a country with a BOP surplus can allow its currency to appreciate. This can make imports cheaper and exports more expensive, potentially reducing exports and increasing imports.

- **2. Trade Policies:**

- **Tariffs and Import Restrictions (for Deficit Correction):** Imposing tariffs or other import restrictions can reduce the quantity of imports and promote domestic production, helping to correct a trade deficit.
- **Export Promotion (for Surplus Correction):** Governments can provide incentives to boost exports, such as export subsidies, tax breaks, or marketing support.

Miscellaneous Measure

- **Structural Reforms:**
  - **Long-term Measures (for Structural Disequilibrium Correction):** Addressing structural issues in the economy, such as improving infrastructure, enhancing competitiveness, and encouraging innovation, can help correct chronic BOP imbalances.
- **Negotiations and International Agreements:**
  - **Bilateral or Multilateral Agreements (for Surplus or Deficit Correction):** Negotiating trade agreements or currency arrangements with other countries can help rebalance the BOP. For example, a country with a surplus might agree to increase imports from its trading partners.
- **Foreign Aid and Assistance:**
  - **Foreign Aid (for Deficit Correction):** In the case of developing countries, foreign aid and assistance can help finance deficits by providing additional financial resources.
- **Foreign Direct Investment (FDI):**
  - **Encouraging FDI (for Deficit or Surplus Correction):** Attracting foreign direct investment can bring in capital and create jobs, potentially addressing BOP issues.