BALANCE OF PAYMENT

What is 'Balance of Payment'?

Balance of Payment (BOP) is a statement which records all the monetary transactions made between residents of a country and the rest of the world during any given period. This statement includes all the transactions made by/to individuals, corporates and the government and helps in monitoring the flow of funds to develop the economy. When all the elements are correctly included in the BOP, it should sum up to zero in a perfect scenario. This means the inflows and outflows of funds should balance out. However, this does not ideally happen in most cases.

BOP statement of a country indicates whether the country has a surplus or a deficit of funds i.e when a country's export is more than its import, its BOP is said to be in surplus. On the other hand, BOP deficit indicates that a country's imports are more than its exports. Tracking the transactions under BOP is something similar to the double entry system of accounting. This means, all the transaction will have a debit entry and a corresponding credit entry.

Why balance of payment is vital for a country?

A country's BOP is vital for the following reasons:

BOP of a country reveals its financial and economic status.

BOP statement can be used as an indicator to determine whether the country's currency value is appreciating or depreciating.

BOP statement helps the Government to decide on fiscal and trade policies.

It provides important information to analyze and understand the economic dealings of a country with other countries.

By studying its BOP statement and its components closely, one would be able to identify trends that may be beneficial or harmful to the economy of the county and thus, then take appropriate measures.

Illustration

if for the year 2018 the value of exported goods from India is Rs. 80 lakhs and the value of imported items to India is 100 lakhs, then India has a trade deficit of Rs. 20 lakhs for the year 2018.

BOP statement acts as an economic indicator to identify the trade deficit or surplus situation of a country. Analyzing and understanding the BOP of a country goes beyond just deducting the outflows of funds from inflows. As mentioned above, there are various components of BOP and fluctuations in these accounts which provide a clear indication about which sector of the economy needs to be developed.

Components of B.O.P

Now let's understand the different components of the B.O.P. The B.O.P consists of three main components—current account, capital account, and financial account. As mentioned earlier, the B.O.P should be zero. The current account must balance with the combined capital and financial accounts.

Current Account

The current account monitors the flow of funds from goods and services trade (import and export) between countries. Now this includes money received or spent on manufactured goods and raw materials. It also includes revenue from tourism, transportation receipts, revenue from specialized services (medicine, law, engineering), and royalties from patents and copyrights. In addition, the current account includes revenue from stocks.

Capital Account

The capital account monitors the flow of international capital transactions. These transactions include the purchase or disposal of non-financial assets (for example, land) and non-produced assets. The capital account also includes money received from debt-forgiveness and gift taxes. In addition, the capital account records the flow of the financial assets by migrants leaving or entering a country and the transfer, sale, or purchase of fixed assets.

Financial Account

The financial account monitors the flow of funds pertaining to investments in businesses, real estate, and stocks. It also includes government-owned assets such as gold and Special Drawing Rights (SDRs) held with the International Monetary Fund (IMF). In addition, it includes foreign investments and assets held abroad by nationals. Similarly, the financial account includes a record of the assets owned by foreign nationals.

Importance of Balance of Payment

A balance of payment is an essential document in the finance department or transaction as it gives the status of a country and its economy. The importance of the balance of payment can be calculated from the below points:

- It examines the transaction of all the export and import of goods and services for a given period
- It helps the government to analyze the potential of a particular industry export growth and formulate policy to support that growth
- It gives the government a broad perspective on a different range of import and export tariff. The government then takes measure to increase and decrease the tax to discourage import and encourage export respectively and be self-sufficient
- If the economy urges support in the mode of import, the government plan according to the BOP and divert the cash flow and technology to the unfavorable sector of the economy, and seek future growth
- The Balance of Payment also indicates the government to detect the state of the economy, and plan expansion, monetary, and fiscal policy establish on that