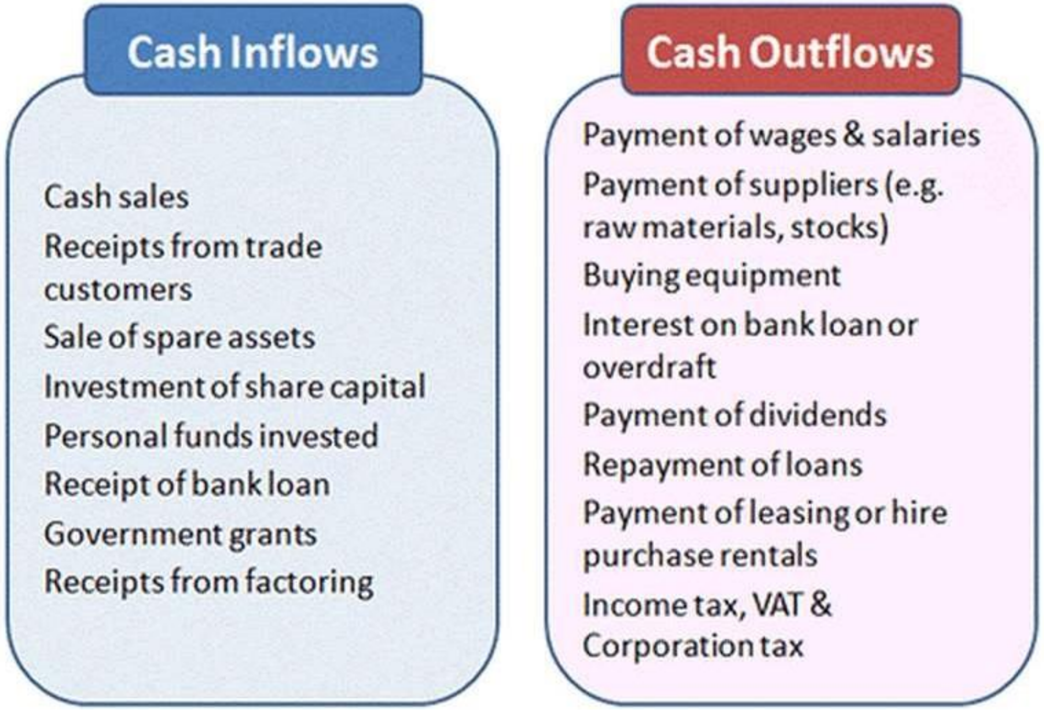
BALANCE OF PAYMENTS

Susmita Paul

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. It is a double entry system of all economic transactions between the residents of the country and the rest of the world carried out in a specific period of time.

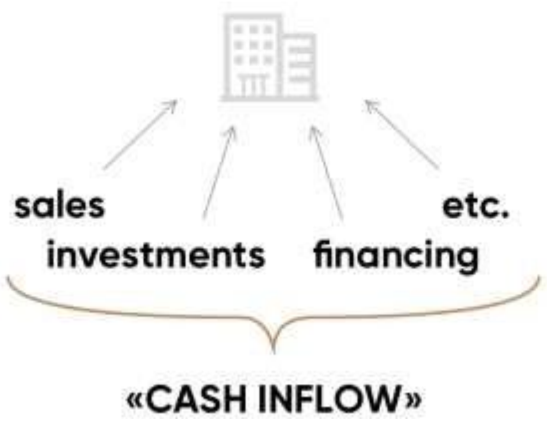
- The economic transactions of a country include all the inflows and outflows during a financial year. The inflows and outflows form the part of the balance of payment.



Inflow of money (foreign receipts)

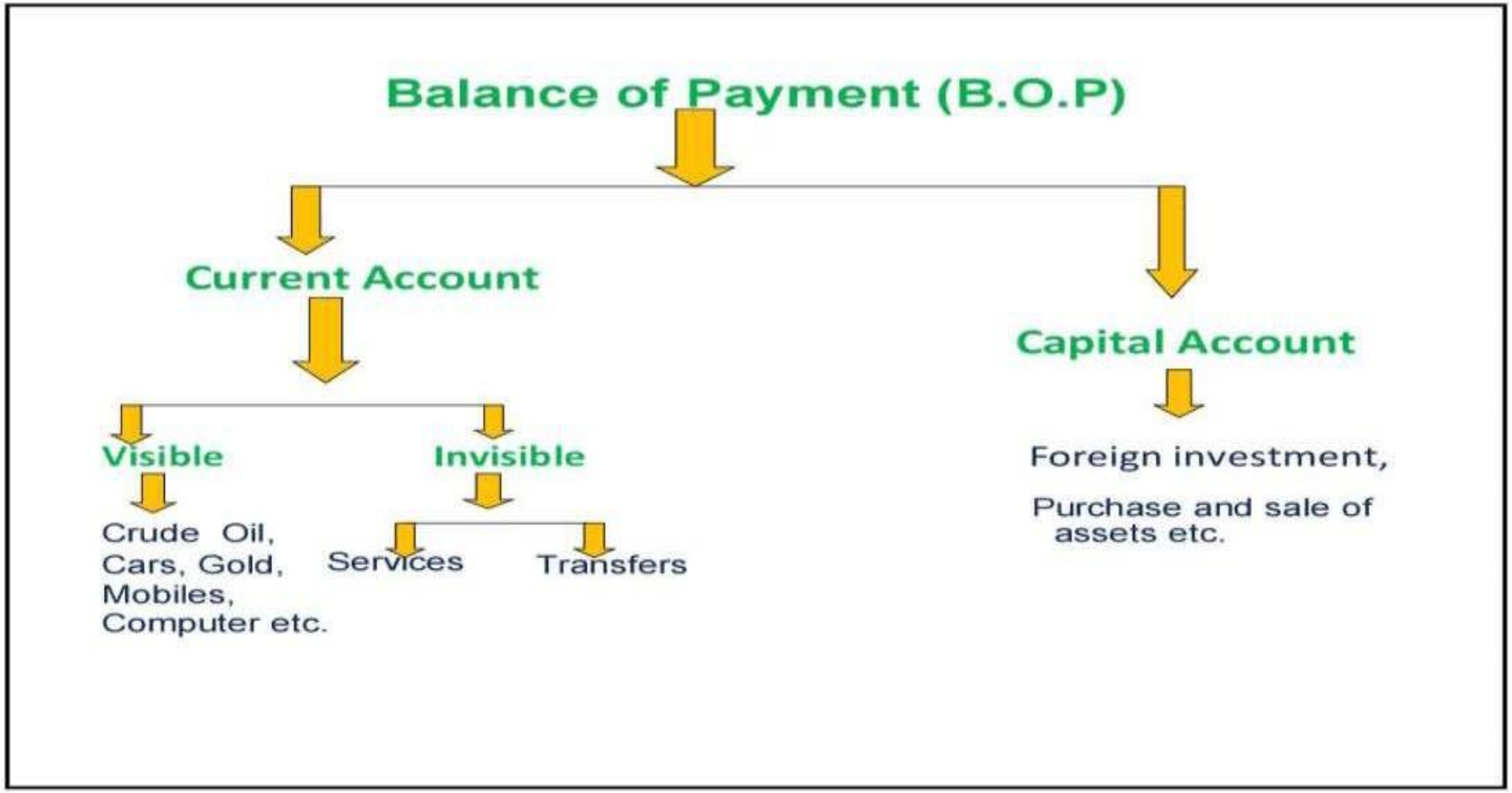
- The foreign receipts include the inflows from external earnings and external borrowings.

- **Source of earnings:** It includes the merchandise exports, services exports, private transfers and remittances, Gifts and Aids from foreign sources, money earned from interest, dividends, and royalties etc.
- **Source of borrowings:** the borrowings include Foreign Direct Investments (FDI), external commercial borrowings, loans taken by the government from external sources etc.



Outflow of money (foreign payments)

- **Spendings:** it includes spending on merchandise imports, service imports, remittances sent to their home countries by foreign nationals, gifts, and grants given to foreign countries, interest, dividends and royalties etc paid to the foreign countries etc.
- **Lendings:** it includes Foreign Direct Investment made by Indian companies in foreign countries, ,short term deposits made by Indian residents in foreign countries, the loans given by the Indian government to the foreign governments etc.


Balance of Payment (B.O.P)
Current Account
Capital Account
Visible
Invisible
Foreign investment,
Purchase and sale of assets etc.
Crude Oil, Cars, Gold, Mobiles, Computer etc.
Services
Transfers

Components of the current account

- **Merchandise transactions or the visible trade (export and import of goods):** the major part of foreign trade transaction include the export and import of a country. Payments made for the import of goods from other countries are shown as a negative side or debit items, and the receipts from the export of goods to other countries are shown as positive items. The balance of these exports and imports is called as the balance of trade or the merchandise trade balance. If the imports are more than exports, it will lead to trade deficit; while if the exports are more than imports, it will lead to a trade surplus. India has experienced consistent trade deficits except for the two years in the 1970s.
- **Invisible trade (the export and import of services):** it includes the export and import of services such as Information Technology services, banking, insurance and consultancy services offered to foreign countries, BPO, tourism, outsourcing etc. The export of services is shown as a credit in the current account, while the import of services is shown as a debit to the current account. Since the export and import of services are invisible, they are known as invisible trade.

- **Unilateral or unrequited transfers (one sided transactions):** the unilateral or unrequited transfers are one way transfer which include gifts and donations, personal remittances, foreign aid, charitable donations, withdrawal of NRI deposits locally etc. The inward transfers are shown as a credit to the current account and the outward remittances are shown as a debit to the current account.

Capital account transactions:

- Capital account refers to the record of all the transactions of the capital inflows and capital outflows which affect a country's foreign assets and liabilities. The capital account shows net the changes in the ownership of a country's assets and liabilities.

- For example, if an Indian citizen buys a property in a foreign country it will be shown as a debit in the capital account.

Components of capital account

- **Borrowing and lendings from foreign countries:** It includes the financial transactions related to borrowing money from foreign countries by the private sector companies or individuals, government etc. The receipts from abroad which include the repayment of loans from the foreign citizens etc are shown as a credit in the capital account. The financial transactions dealing with lending to abroad by the private sector companies, individuals and the government, and the repayment of loans taken from foreign countries is shown as a debit in the capital account.
- **Investments to and from the foreign countries:** The investments from the foreign countries in the Indian companies, government bonds, real estate etc in India are shown as a credit in the capital account as they lead to the inflow of foreign exchange. The investments made by the Indian residents in the stocks and shares of companies abroad, government bonds, real estate etc are shown as a debit in the capital account as they lead to the outflow of foreign exchange.

- **Foreign direct investment (FDI):** when the foreign residents buy Indian capital assets such as companies, industrial complexes, machines etc, it is shown as a credit to the capital account. The FDI investment made by Indians in the foreign countries is shown as a debit in the capital account.
- **Foreign portfolio investment (FPI):** when the foreign residents purchase stocks, government bonds, corporate securities etc, then these transactions are shown as a credit to the capital account. When the Indian residents purchase securities and bonds in foreign countries, it is shown as a debit in the capital account.

Current Account		Capital Account	
Import	Export	Debit	Credit
total		total	

Current Account

The current account records imports and exports of goods and services, transfers etc.

Capital Account

Capital account is that account which records all such transactions between residents of a country and rest of the world which cause a change in asset or liability status.

Current Account Surplus and Deficit

Current account surplus means an economy is exporting a greater value of goods and services than it is importing and current account deficit means an economy is importing a greater value of goods and services than it is exporting.

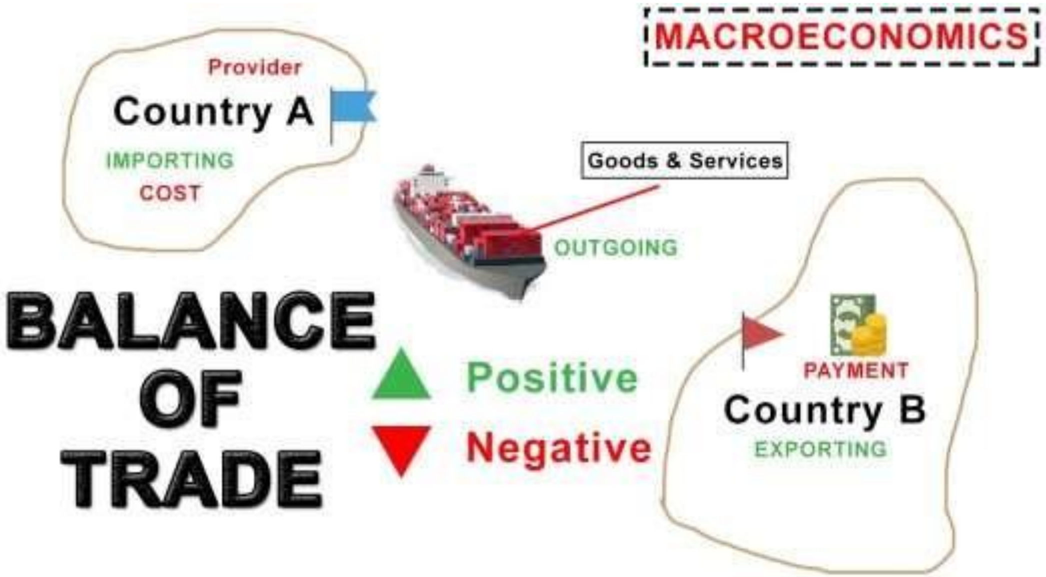
Capital Account Surplus and Deficit

A surplus in the capital account means there is an inflow of money into the country, while deficit indicates money moving out of the country.

Balance of Trade

- BOT is different from the balance of payment of a country. The balance of trade shows the difference between the country s monetary value of exports and imports (visible trade) for a given period of time. It is usually the largest component of any country's BOP.

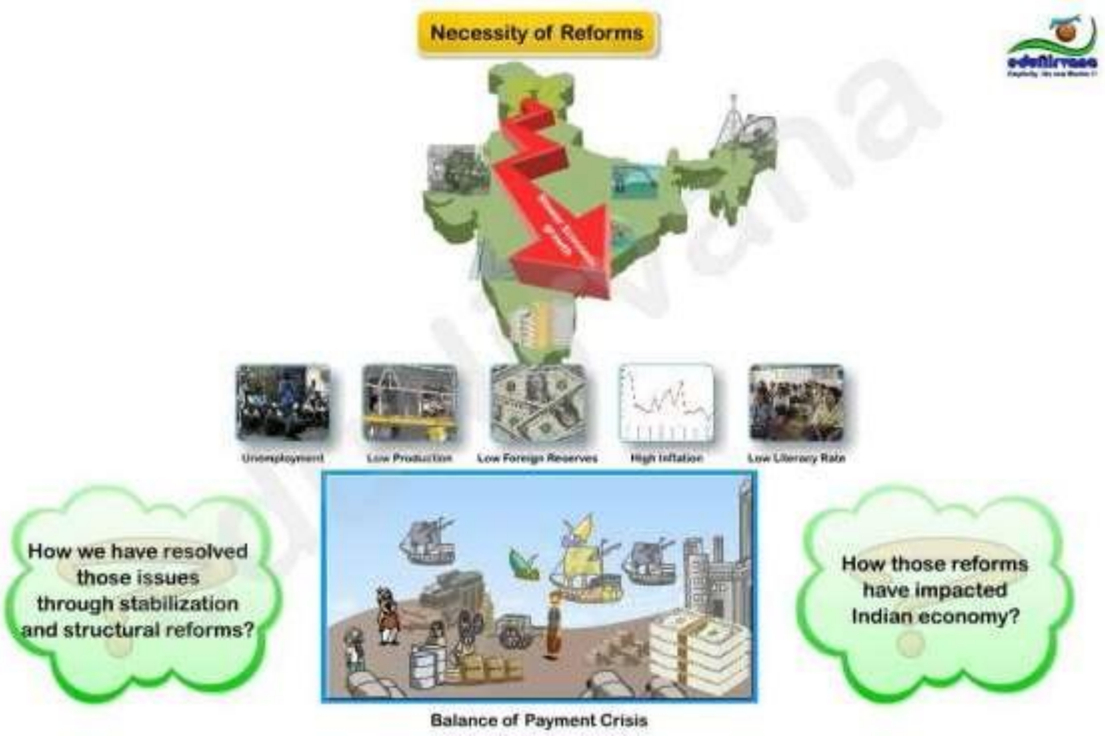
- The balance of trade is also known as trade balance, international trade balance, net exports or commercial balance etc. If a country exports more than its imports then it will have a positive balance or trade surplus. However, if imports are greater than its exports, the country will have a trade deficit or negative balance.



The balance of payment (BOP) crisis of 1991 in India

- The balance of payment crisis occurs when there are insufficient capital account surplus and foreign exchange reserves for financing the current account deficit.

- India faced the BOP crisis in 1991 due to factors such as the Gulf War which increased the oil prices. The disintegration of USSR also negatively impacted India's exports contributing to the BOP crisis.
- The value of Indian rupee fell and the Reserve Bank of India sold its forex reserves for making the balance of payment zero. Since the RBI did not had enough forex reserves, India had to pledge 65 tons of gold for getting foreign loans to make the balance of payment zero.
- India liberalized its economy after 1991, and now the Reserve Bank of India holds forex reserves of around $400 billion



Necessity of Reforms
Unemployment
Low Production
Low Foreign Reserves
High Inflation
Low Literacy Rate
How we have resolved those issues through stabilization and structural reforms?
How those reforms have impacted Indian economy?
Balance of Payment Crisis

THANK YOU !!

SAMPLE QUESTION

- Which of the following does not form part of current account under balance of payments?

a) Export and import of goods
b) Export and import of services
c) Income receipts and payments
d) Capital receipts and payments
Answer : d

- Which of the following pairs is not correctly matched with regard to balance of payment accounts?

a) Import of goods and services – Debit in the current account
b) Receipts of transfer payments – Credit in the current account
c) Direct investment receipt – Credit in the capital account
d) Portfolio investment payments – Debit in the current account
Answer : d

- A country is said to be in debt trap if

a) It has to abide by the conditionality imposed by the International Monetary Fund
b) It is required to borrow money to make interest payments on outstanding loans
c) It has been refused loans or aid by creditors
d) The World Bank charges a very high rate of interest on outstanding as well as new loans
Answer : b

- Balance in capital account refer to the

a) Nation's net exports of goods and services
b) Nation's net exports of financial claims
c) Nation's net exports of international official reserve assets
d) Nation's sum of net exports of goods, services and financial claims
Answer : b

- Which of the following are the components of balance of payments?

1. Financial capital transfer
2. External loan and investment
3. Foreign institutional investment
4. Issuing of external bonds
5. Export and imports of goods and services

Select the correct answer using the codes given below:

a) 1, 2, and 3 only

b) 2, 3, and 4 only

c) 1, 4, and 5 only

d) 1, 2, 3, 4, and 5

Answer : d

- Consider the following statements regarding post-liberalization India’s balance of payments position:

1. The current account deficit is on account of net import of services.
2. The capital account surplus is on account of large amount of external assistance received on bilateral basis.
3. The balance of payments situation has improved post-liberalization

Select the correct answer using the codes given below:

a) 3 only

b) 2 and 3

c) 1 and 2

d) 1 and 3

Answer : a

- Consider the following statements:

1. India’s net exports of goods have a negative balance
2. India’s net export of services have a positive balance
3. India is the largest receiver of remittances around the world

Select the correct answer using the codes given below:

a) 2 only

b) 2 and 3

c) 1 and 2

d) a, 2, and 3

Answer : d