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Balance of Payments

BALANCE OF PAYMENT

The Balance of payments of a country is a systematic record of all economic transaction (i.e. transaction in goods, services and assets) between the residents of a country, and the rest of the world, during the year.

DOUBLE ENTRY SYSTEM OF ACCOUNTING

Balance of payments has two sides: debit and credit. Payments recorded on the debit side and receipts are recorded on the credit side. The balance of payments accounts are prepared on the double entry system. That is why it is said that balance of payments in the accounting sense, it is always balance.

SIGNIFICANCE OF BALANCE OF PAYMENT

The important uses of the balance of payment are as follows

1. It yield necessary information on the strength and weakness of the Country in the international economic transactions.

2. By analysing balance of payment accounts of past years, we can find out overall gains and losses from the international mode of economic transaction.

3. Balance of payments accounts caution us and provides signals for future policy formulation.

4. With the help of balance of payments accounts, we are able to come know about the manner in which national economy affects and is affected by the transaction with the rest of the world markets.

Accounts of Balance of Payments and their Components

The balance of payments accounts are classified into two main groups

(i) Current account and

(ii) Capital account

CURRENT ACCOUNT

MEANING

Transaction relating to trade of goods and services and transfer payments constitute the current account.

COMPONENTS OF CURRENT ACCOUNT

The components of current account of the balance of payment can be further divided into three broad categories:

1. Visible Trade (or Trade in goods) **It includes exports and imports of all physical goods. The difference in the value of export and import of goods is called trade balance.**

2. Invisible Trade (or Trade in Services) **Trade in services is called invisible trade because they cannot be seen to cross national borders. It can be divided into two following sub groups:**

(i) Factor income (or investment Income): - Investment income consists of interest, profits, dividend and royalty income from foreign

countries.

(ii) Non - Factor Income - It mainly covers transportation services (shipping), financial services such as insurance, banking, software services and service provided to the foreign tourists, services etc. and government current expenditure in foreign countries such as expenditure on embassies and other organisations.

3. Transfer Payment This Category includes unilateral transfers like foreign gifts, donations, military aid, and technical assistance and so on. There is no repayment obligation for such items.

Current Account = Visible Trade + Invisible Trade + Transfer payment or

Current Account = Export - Import of goods + Investment income + Non - factor income + Transfer payments

CAPITAL ACCOUNT

MEANING

Capital account represents international Capital transactions which includes sales and purchase of assets such as bonds, equities, lands, loan bank accounts etc.

COMPONENTS OF CAPITAL ACCOUNT

1. FOREIGN INVESTMENT

It includes foreign direct investment and portfolio investment.

Foreign Direct Investment

Foreign direct investment refers to the purchase of fixed capital asset like factories, residential structures etc. by the foreigners which gives control over assets.

Portfolio Investment

Portfolio investment refers to the purchase of financial assets by the foreigners that does not give the purchaser Control over the assets. A Foreign institutional investor is also a part of portfolio investment.

2. LOANS

Borrowing and lending of funds is an important component of India's Capital account. This takes two forms: -

(a) External assistance: - It means borrowing from foreign countries under concessional rate of interest.

(b) Commercial borrowings to the funds borrowed by the Indian Government and the private sector from world money market at higher market rate of interest.

3. BANKING CAPITAL TRANSACTION

Banking capital essentially covers movements in the external financial assets and liabilities of commercial and Co - operative banks authorised to deal in foreign exchange.

BALANCE OF TRADE (OR TRADE BALANCE)

Balance of Trade of a country means the systematic record of visible imports and exports in a given year. The balance of exports and imports of goods is termed as the trade balance.

Balance of Trade or Trade balance = Visible Export - Visible Import

BALANCE OF PAYMENTS ON CURRENT ACCOUNT OR CURRENT ACCOUNT BALANCE

Current account balance is more comprehensive in scope than the balance of trade, as it includes not only the visible items but also invisible ones.

Current Account Balance = (visible Export + Invisible Export) - (visible Import + Invisible Import)

OR = Trade Balance + Invisibles (net)

CAPITAL ACCOUNT BALANCE

International sale and purchase of assets are recorded in the capital account. Hence, when we deduct spending on buying foreign assets from the receipt from the sale of domestic assets.

Thus, Capital Account Balance = Receipt from the sale of domestic assets - Spending on buying foreign assets

BALANCE OF PAYMENT - SURPLUS AND DEFICIT

The basic rule of Balance of payment accounting is that "Any transaction that give rise to a payment by a country to foreigners is a deficit (debit) item in that country's balance of payment account. On the other hand, any transaction leading to receipt from foreigners is a surplus (credit) items in that country's balance of payment account.

We know that,

Overall Balance of payment = Current Account + Capital Account

Balance of payment (BOP) is in surplus (deficit) if the combined Current and Capital account have surplus (deficit). Thus, deficit in current account by itself does not create BOP deficit.

The central point of international payment is that a country has to pay for what it buys abroad. For instance, person spends more than his income, his deficit needs to be financed by selling asset or by borrowing. This selling of assets or borrowing implies that country is running a capital account surplus.

Thus any current account deficit is necessarily be financed by an offsetting capital account (surplus).

Capital account can be classified into two separate parts: (i) Private Capital transactions and (ii) official reserve transactions. Thus there can be two ways to finance a current account deficit:

(i) A current account deficit can be financed by private resident selling assets abroad or borrowing abroad.

(ii) A Current account deficit can also be financed by government by running down its reserves of foreign exchange. In this case, central government sells foreign currency in the foreign exchange market on the other hand, in the case of current a/c surplus, the central bank can purchase the foreign currency in the foreign market that adds to its foreign exchange reserve.

Balance of Payment Surplus = Increase in official foreign exchange reserve
= Current a/c surplus + Net private Capital inflow

Balance of Payment deficit = Decrease in official foreign exchange reserve
= current a/c deficit + Net private Capital out flow.

The balance of payment is in equilibrium, when the sum of current a / c and non - reserve Capital a/c of a country become equal to zero. In this situation, the current account balance is entirely financed by international lending and there is no official reserve movement.