BALANCE OF PAYMENT

Q1. Define the meaning of balance of payment.

Ans. It is an accounting statement that provides a systematic record of all the economic transactions between the resident of a country and the rest of the world in a given period of time.

Q2. What is the structure of BOP?

Ans. BOP uses double entry system for recording the transactions with the rest of the world. So it has two sides.

1. **CREDIT SIDE:-** All inflows or sources of foreign exchange are recorded on the credit side.
2. **DEBT SIDE:-** All outflow or uses of foreign exchange are recorded on debt side.

However, in economic sense BOP need not be always equal. It can be:

- **BALANCED BOP:-** Where receipt and payment are equal.
- **SURPLUS:-** BOP is surplus when receipts are more than the payment.
- **DEFICIT BOP:-** When receipts are less than payment.

Q3. Explain the meaning of balance of trade.
Ans. It refers to difference between the amount of export and import of visible item goods.
Balance of Trade = Export – Import
Exports are entered on credit side while imports are entered on debt side. If BOT is not balanced it can be surplus BOT or deficit BOT.

Q4. Difference between BOP and BOT.
Ans.

Basis	Balance of Trade	Balance of Payment
Meaning	It refers to difference between the amount of export and import of visible item goods.	It is an accounting statement that provides a systematic record of all the economic transactions between the resident of a country and the rest of the world in a given period of time.
Component	It includes only visible items.	It includes visible items, invisible items, unilateral transfers, capital transfer.
Capital transactions	It does not record any transaction of capital nature.	It records all transactions of capital nature.
Scope	It is a narrow concept as it is only a part of BOP account.	It is wider concept and it includes BOT.
Settlement	Unfavourable BOT can be met out of favourable BOP.	Unfavourable BOP cannot met out of favourable BOT.

Q5. What are the components of BOP?

Ans. There are two components of BOP.

- **CURRENT ACCOUNT:-** It refers to an account which records all the transactions relation to export and import of goods and services and unilateral transfers during a given period of time. It shows the net income generated in the foreign sector.

❖ **COMPONENTS;-**

1. **EXPORTS AND IMPORTS OF GOODS;-** A major part of transactions in foreign trade is in the form of export and import of goods. Payment for imports of goods is written on the –ve side and receipt from exports is shown on credit side. Balance of these visible exports and imports is known as BOT.

2. **EXPORTS AND IMPORTS OF SERVICES;-** It includes are large variety of non factor services sold & purchased by the residents of a country to and from the rest of the world. Payments are either received or made to the other countries for use of these services. Services are of three kinds i.e. shipping, banking and insurance. Payments for these services are recorded on debt side and receipt on credit side.

3. **UNILATERAL TRANSFERS:-** These include gifts, donations, personal remittances and other one way transactions. These refer to those receipts and payments which take place without any service in returns. Receipts of these transfers record on credit side and payments on debt side.

- **BALANCE ON CURRENT ACCOUNT:-** The net value of credit and debt balance is the balance on current account.
- **SURPLUS IN CURRENT ACCOUNT:-** It arises when credit items are more than debit items.
- **DEFICIT CURRENT ACCOUNT:-** When debt side is more than the credit side.

- **CAPITAL ACCOUNT:-** It records all the transactions between the residents of a country and the rest of the world which cause a change in the assets or liabilities of the residents of the country or its govt.

1. **BORROWINGS AND LENDINGS TO AND FROM ABROAD:-** It includes:-

✓ All transactions related to borrowings from abroad by private sector, govt., etc. Receipts of such loans and repayments of such loans by the foreigners are recorded on the credit side.

✓ All the transactions of lending to abroad by private sector and govt. lending aboard and repayment of loan to abroad is recorded on debt side.

- **INVESTMENT TO AND FROM ABROAD:-** It includes:-

✓ Investment by the rest of the world in shares of Indian companies real estate in India Etc. Such investments from abroad are recorded on the +ve side and they bring foreign exchange.

✓ Investment by Indian residents in shares of foreign companies real estate in abroad will be recorded on –ve side as they lead to outflow of foreign exchange.

There are two types of investments:-

1. **FOREIGN DIRECT INVESTMENT:-** It refers to purchase of an asset such that gives direct control to the purchase over the asset.
2. **PORTFOLIO INVESTMENT:-** It refers to purchase of an asset such that it doesnot give direct control over the asset to the purchases.

- **CHANGE IN FOREIGN EXCHANGE RESERVE:-** A change in reserves serves as the financing item in India's BOP. So any withdraw from the reserves is recorded on the credit side and any addition to these reserves is recorded on the debit side.

❖ **CURRENT ACCOUNT SHOWS THE NET INCOME;-** Current accounts records all the actual transactions of goods and services which affect the income, output and employment of a country. So, it shows the net income generated in the foreign sector.

❖ **DIFFERENCE BETWEEN BALANCE OF TRADE AND CURRENT ACCOUNT;-**

Basis	Balance of trade	Current account
Components	Balance of trade includes only visible items.	Current account records both visible and invisible items.
Scope	It is a narrow concept as it is only a part of current account.	It is a wider concept and it includes BOT.

❖ **COMPONENTS OF CURRENT ACCOUNT;-**

Credit items	Debit items	Net credit (credit – debit)
1. **Visible trade** Exports of good	Imports of goods	Net exports of goods (balance of trade)

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2. **Invisible trade** Exports of services	Imports of services	Net exports of services
3. **Unilateral transfers** Transfer receipts	Transfer payments	Net transfer receipts
4. **Income receipts and payments** Income receipts	Income payments	Net income receipts
Current receipts (1+2+3+4)	**Current payments**	**Current account balance**

Investments to and from abroad includes two types of investments

1. **Foreign direct investment:-** It refers to purchase of an asset, such that it gives direct control to the purchase over the asset. **For example**, purchase of land and building.
2. **Portfolio investment:-** It refers to purchase of an asset, such that it does not give any direct control over the asset to the purchase. **For example,** purchase of shares. It also includes foreign institutional investment (FII).

❖ **BALANCE ON CAPITAL ACCOUNT;-** The transactions, which lead to inflow of foreign exchange (like receipt of loan from abroad, sale of assets or shares in foreign countries, etc.) are recorded on the credit or positive side of capital account. Similarly, transactions, which lead to outflow of foreign exchange (like repayment of loans, purchase of assets or shares in foreign countries, etc.) are recorded on the debit or negative side. The net value of credit and debit balances is the balance on capital account.

- Surplus in capital account arises when credit items are more than debit items. It indicates net inflow of capital.
- Deficit in capital account arises when debit items are more than credit items. It indicates net outflow of capital.

❖ **COMPONENTS OF CAPITAL ACCOUNT;-**

Credit items	Debit items	Net credit (credit – debit)
1. **Borrowings and lendings to and from abroad** Borrowings from abroad	Lendings to abroad	Net borrowings from abroad
2. **Investment from abroad** Investment from abroad	Investments to abroad	Net investments from abroad
3. **Change in foreign exchange reserves** Decreases in foreign exchange reserves	Increases in foreign exchange reserves	Net change in foreign exchange reserves
Capital receipts (1+2+3)	**Capital payments**	**Capital account balance**

❖ **BALANCE ON CURRENT ACCOUNT Vs BALANCE ON CAPITAL ACCOUNT;-** Balance on current account and balance on capital account are interrelated.

- A deficit in the current account must be settled by a surplus on the capital account.
- A surplus in the current account must be matched by a deficit on the capital account.

❖ **DIFFERENCE BETWEEN CURRENT ACCOUNT AND CAPITAL ACCOUNT;-**

Basis	Current account	Capital account
Influence on the economy	Current account transactions bring a change in the current level of a country's income.	Capital transactions bring about a change in the capital stock of a country.
Concept	It is a flow concept as it includes all items of flow nature.	It is a stock concept as it includes all items expressing changes in stock.

Components	Current account = Visible trade + Invisible trade + unilateral transfers + income receipts and payments	Capital account = Borrowings and lendings to and from abroad + investments to and from abroad + change in foreign exchange reserves

- On the current account, merchandise exports and imports of goods are autonomous transactions.
- On the capital account, receipts and repayments of long term loans by private individuals are autonomous transactions.

❖ **ACCOMMODATING ITEMS;-** Accommodating items refers to the transactions that are undertaken to cover deficit or surplus in autonomous transactions, i.e. such transactions are determined by net consequences of autonomous transactions. These items are also known as below of line items.

❖ **CAUSES OF DEFICIT (DISEQUILIBRIUM) IN BOP;-** Deficit in the balance of payments may be caused due to number of factors. These factors can be divided into three groups:

1. **ECONOMIC FACTORS;-**

a. **DEVELOPMENT ACTIVITIES;-** Developing countries depend on developed nations for supply of machines, technology and other equipment. This leads to increased levels of imports, thereby, resulting in a deficit in the BOP account.

b. **HIGH RATE OF INFLATION;-** When there is inflation in the domestic economy, foreign goods become relatively cheaper as compared to domestic goods. It increases imports which causes a deficit in the BOP.

c. **CYCLICAL FLUCTUATIONS;-** When the domestic economy is going through a phase of boom, then domestic production may be unable to satisfy the domestic demand. It leads to a deficit in BOP, due to increase in imports.

d. **CHANGE IN DEMAND;-** Fall in demand for country's goods in the foreign markets leads to fall in exports and it adversely affects the balance of payments.

e. **IMPORT OF SERVICES;-** Underdeveloped countries import services from developed countries for which, they have to pay huge amounts of money. It leads to a deficit in the BOP.

2. **POLITICAL FACTORS;-**

a. **POLITICLA INSTABILITY;-** Political instability may lead to large capital outflows and reduce the inflows of foreign funds, thus, creating disequilibrium in the BOP.

b. **POLITICAL DISTURBANCES;-** Frequent changes in the government, inadequate support to the government in parliament also discourage inflows of capital. This leads to a deficit due to higher outflows than inflows.

3. **SOCIAL FACTORS;-**

a. **DEMONSTRATION EFFECT;-** When the people of underdeveloped countries come in contact with those of advanced countries, they start adopting the foreign pattern of consumption. Due to this reason, their imports increase and it leads to an adverse balance of payments for underdeveloped country.

b. **CHANGE IN TASTES, PREFERENCE, FASHION AND TRENDS;-** An unfavourable change for the domestic goods lead to a deficit in the balance of payments.

❖ **AUTONOMOUS ITEMS;-** Autonomous items refers to those international economic transactions, which take place, due to some economic motive such as profit maximisation. These items are also known as above the line items.

Autonomous transactions are independent of the state of BOP account. For example, if a foreign company is making investments in India with the aim of earning profit, then such a transaction is independent of the country's BOP situation. Autonomous transactions take place on both current and capital account.

❖ **AUTONOMOUS ITEMS Vs ACCOMMODATING ITEMS;-**

Basis	**Autonomous items**	**Accommodating items**
Meaning	Autonomous items refer to those international economic transactions, which take place due to some economic motive such as profit maximisation.	Accommodating items refer to the transactions that are undertaken to cover deficit or surplus in autonomous transactions.
Effect on Bop account	Autonomous transactions are independent of the state of Bop account.	Accommodating transaction are undertaken to maintain the balance in BOP account.
Current /capital account	Autonomous transactions take place on both current and capital account.	Accommodating transactions take place only on capital account.t
Alternate name	These items are lasso known as above the line items.	These items are also known as below of line items.