BALANCE OF PAYMENT

- ✓BOP
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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, corporate and the government and helps in monitoring the flow of funds to develop the economy.

- 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.

- 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.

Definition of 'Balance Of Payment'

Definition: According to the RBI, balance of payment is a statistical statement that shows

1. The transaction in goods, services and income between an economy and the rest of the world,
2. Changes of ownership and other changes in that economy's monetary gold, special drawing rights (SDRs), and financial claims on and liabilities to the rest of the world, and
3. Unrequited transfers.

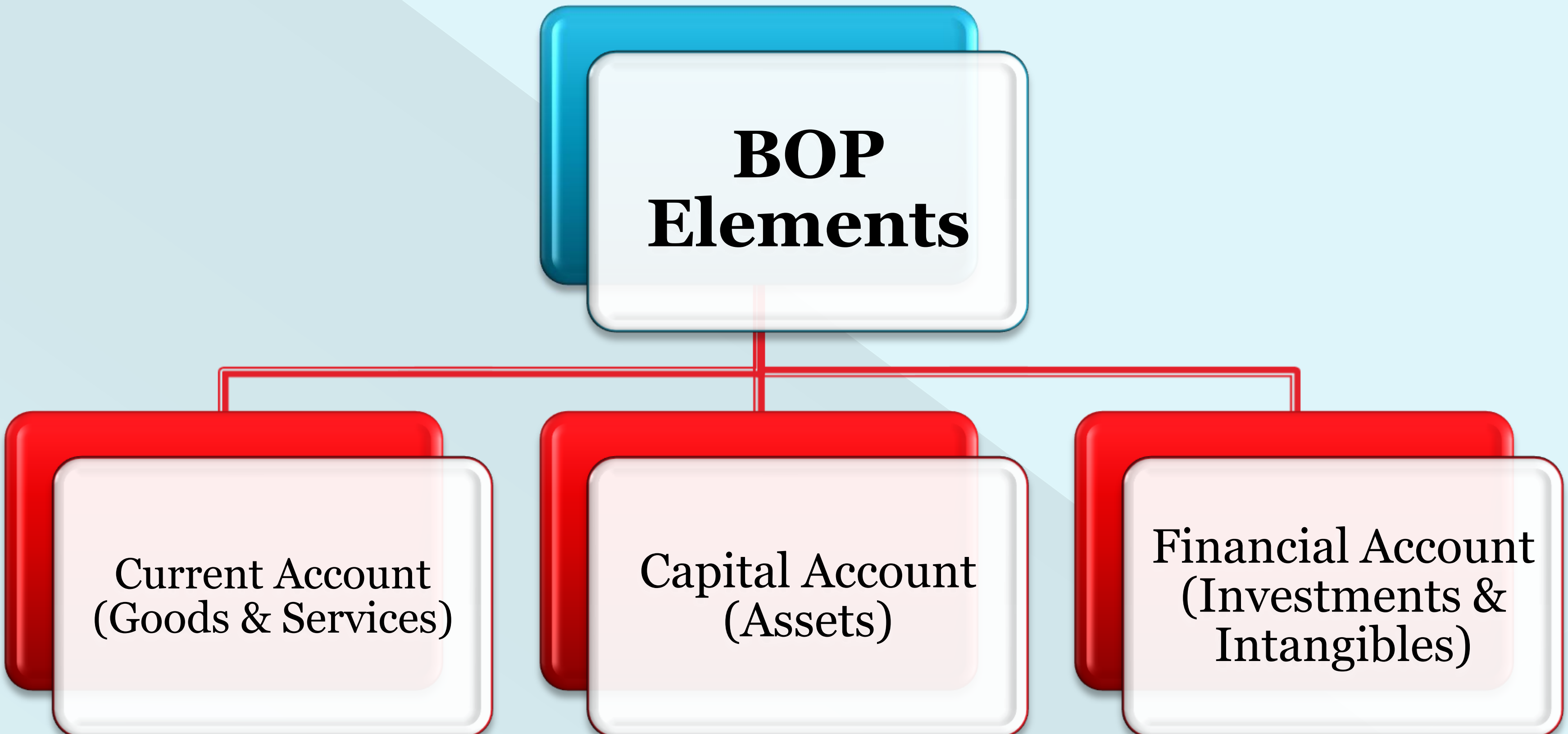
Why balance of payment is vital for a country?

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.

Elements of balance of payment



BALANCE OF PAYMENT

CURRENT ACCOUNT

Trade in Goods
(Balance of Trade = Export - Import

Net Visible

Factor Trade Services
(Compensation-Investment Income, i.e., Dividends, profits, interest, etc)

Non- Factor Trade in Services
(shipping, banking, software, etc)

Private Transfer Payments
(gifts, remittances, grants, etc)

Official Transfer Payments
(gifts, remittances, grants, etc)

Net Transfer

Net Invisibles

CAPITAL ACCOUNT

Foreign Investment
(FDI, FII. Euro Equities etc)

External Assistance

Commercial Borrowings

IMF

NR Deposits

Rupee Debt Services

Other Flow

The transactions in BOP

- **Current Account**: This account scans all the incoming and outgoing of goods and services between countries. All the payment made for raw materials and constructed goods is covered under this account. Few other deliveries that include in this category are from tourism, engineering, stocks, business services, transportation, and royalties from license and copyrights, all these combined together make a BOP of a country.

- **Capital Account**: Capital transaction like purchase and sale of assets (non-financial) like land and properties are monitored under this account. This account also records the flow of taxes, acquisition and sale of fixed assets by immigrants moving into the different country. The shortage or excess in the current account is governed by the finance from capital account and vice versa.

- **Finance Account**: The funds that flow to and from other countries through investments like real estate, foreign direct investments, business enterprises, etc is recorded in this account. The account calculates the foreign proprietor of domestic asset and domestic proprietor of foreign assets and analyses if it's acquiring or selling more assets like stocks, gold, equity etc.

Balance of Payments Disequilibrium

- Equilibrium state is when
  DEMAND = SUPPLY (of Foreign Exchange)

- Disequilibrium states are of two types

DEFICIT	SURPLUS
Demand High	Supply High
When the central bank buys domestic currency	When the central bank sells domestic currency
When the central bank sells the foreign reserve currency	When the central bank buys foreign currency in the FOREX

Balance of Payment Deficit

- The country imports more goods, services & capital than its exports.
- It must borrow from other countries to pay for its imports.
- In the short-term, this fuels economic growth.
- In the long-term, it will have to go into debt to pay for consumption.

Balance of Payments Surplus

- The country exports more than its imports.
- Country provides enough capital to pay for all domestic production,
- A surplus boosts economic growth in the short term.
- In the long run, it becomes too dependent on export-driven growth.

Causes of disequilibrium in BOP

There are several factors which cause disequilibrium in the BOP indicating either surplus or deficit.

1) **Economic Factors:**

(a) Imbalance between exports and imports.

(b) Large scale development expenditure which causes large imports,

(c) High domestic prices which lead to imports,

(d) Cyclical fluctuations (like recession or depression) in general business activity,

(e) New sources of supply and new substitutes.

2) **Political Factors:** Experience shows that political instability and disturbances cause large capital outflows and hinder Inflows of foreign capital.

3) **Social Factors:**

a) Changes in fashions, tastes and preferences of the people bring disequilibrium in BOP by influencing imports and exports;

b) High population growth in poor countries adversely affects their BOP because it increases the needs of the countries for imports and decreases their capacity to export.

Measures to correct disequilibrium in BOP

- **Export promotion:** Exports should be encouraged by granting various bounties to manufacturers and exporters. At the same time, imports should be discouraged by undertaking import substitution and imposing reasonable tariffs.

- **Import:** Restrictions and Import Substitution are other measures of correcting disequilibrium.

- **Reducing inflation:** Inflation (continuous rise in prices) discourages exports and encourages imports. Therefore, government should check inflation and lower the prices in the country.

- **Exchange control:** Government should control foreign exchange by ordering all exporters to surrender their foreign exchange to the central bank and then ration out among licensed importers.

Measures to correct disequilibrium in BOP

- **Devaluation of domestic currency:** It means fall in the external (exchange) value of domestic currency in terms of a unit of foreign exchange which makes domestic goods cheaper for the foreigners. Devaluation is done by a government order when a country has adopted a fixed exchange rate system. Care should be taken that devaluation should not cause rise in internal price level.

- **Depreciation:** Like devaluation, depreciation leads to fall in external purchasing power of home currency. Depreciation occurs in a free market system wherein demand for foreign exchange far exceeds the supply of foreign exchange in foreign exchange market of a country (Mind, devaluation is done in fixed exchange rate system.)

THANKS