

UNIT – III

Balance of Payment: Meaning – Components of BOP
–Importance of BOP–BOT and BOP–
Disequilibrium in BOP - Causes of Disequilibrium –
Measures to Correct Disequilibrium in BOP.

BALANCE OF PAYMENT (BOP)

A country has to deal with other countries in respect of the following

1. **Visible items** which include all types of physical goods exported and imported.
2. **Invisible items** which include all those services whose export and import are not visible. e.g. transport services, medical services etc.
3. **Capital transfers** which are concerned with capital receipts and capital payment.

Balance of Payments

According to Kindle Berger, "The balance of payments of a country is a systematic record of all economic transactions between the residents of the reporting country and residents of foreign countries during a given period of time".

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

when we say “a country’s balance of payments” we are referring to the transactions of its citizens and government.

Balance Of Payment : Definition

The balance of payments of a country is a systematic record of all economic transactions between the residents of a country and the rest of the world. It presents a classified record of all receipts on account of goods exported, services rendered and capital received by residents and payments made by them on account of goods imported and services received from the capital transferred to non-residents or foreigners.

- **Reserve Bank of India**

Features

- It is a systematic record of all economic transactions between one country and the rest of the world.
- It includes all transactions, visible as well as invisible.
- It relates to a period of time. Generally, it is an annual statement.
- It adopts a double-entry book-keeping system. It has two sides: credit side and debit side. Receipts are recorded on the credit side and payments on the debit side.

Balance of Trade

The difference between a country's imports and its exports. Balance of trade is the largest component of a country's balance of payments.

Debit items include imports, foreign aid, domestic spending abroad and domestic investments abroad.

Credit items include exports, foreign spending in the domestic economy and foreign investments in the domestic economy.

When exports are greater than imports then the BOT is **favourable** and if imports are greater than exports then it is **unfavourable**

Balance of Trade V/s Balance of Payment

The Balance of Payment takes into account all the transaction with the rest of the worlds

The Balance of Trade takes into account all the *trade* transaction with the rest of the worlds

BOP

1. It is a broad term.
2. It includes all transactions related to visible, invisible and capital transfers.
3. It is always balances itself.
4. $BOP = \text{Current Account} + \text{Capital Account} + \text{or} - \text{Balancing item (Errors and omissions)}$
5. Following are main factors which affect BOP
 - a) Conditions of foreign lenders.
 - b) Economic policy of Govt.
 - c) all the factors of BOT

BOT

1. It is a narrow term.
2. It includes only visible items.
3. It can be favourable or unfavourable.
4. $BOT = \text{Net Earning on Export} - \text{Net payment for imports.}$
5. Following are main factors which affect BOT
 - a) cost of production
 - b) availability of raw materials
 - c) Exchange rate
 - d) Prices of goods manufactured at home

Importance of Balance Of Payments

1. BOP records all the transactions that create demand for and supply of a currency.
2. Judge economic and financial status of a country in the short-term
3. BOP may confirm trend in economy's international trade and exchange rate of the currency. This may also indicate change or reversal in the trend.
4. This may indicate policy shift of the monetary authority (RBI) of the country.
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The General Rule in BOP Accounting

- a. If a transaction earns foreign currency for the nation, it is a credit and is recorded as a plus item.
- b. If a transaction involves spending of foreign currency it is a debit and is recorded as a negative item.

The various components of a BOP statement

1. Current Account
2. Capital Account
3. Reserve Account
4. Errors & Omissions

Current Account Balance

- BOP on current account is a statement of actual receipts and payments in short period.
- It includes the value of export and imports of both visible and invisible goods. There can be either surplus or deficit in current account.
- The current account includes:- export & import of services, interests, profits, dividends and unilateral receipts/payments from/to abroad.
- BOP on current account refers to the inclusion of three balances of namely – Merchandise balance, Services balance and Unilateral Transfer balance

Types of Balances

Trade Balance

Merchandise: exports - imports of goods

Services: exports - imports of services

Income Balance

Net investment income: net income receipts from assets

Net international compensation to employees: net compensation of

Employees

Net Unilateral Transfers

Gifts from foreign countries minus gifts to foreign countries

Capital Account Balance

- The capital account records all international transactions that involve a resident of the country concerned changing either his assets with or his liabilities to a resident of another country. Transactions in the capital account reflect a change in a stock – either assets or liabilities.
- It is difference between the receipts and payments on account of capital account. It refers to all financial transactions.
- The capital account involves inflows and outflows relating to investments, short term borrowings/lending, and medium term to long term borrowing/lending.

Capital Account Balance

- There can be **surplus or deficit** in capital account.
- It includes: - private foreign loan flow, movement in banking capital, official capital transactions, reserves, gold movement etc.
- These are classified into two categories-
 - Direct foreign investments
 - Portfolio investments
 - Other capital

The Reserve Account

Three accounts: **IMF, SDR, & Reserve and Monetary Gold** are collectively called as The Reserve Account.

The IMF account contains purchases (credits) and re-purchase (debits) from International Monetary Fund.

Special Drawing Rights (SDRs) are a reserve asset created by IMF and allocated from time to time to member countries. It can be used to settle international payments between monetary authorities of two different countries.

Errors & Omissions

- The entries under this head relate mainly to leads and lags in reporting of transactions
- It is of a balancing entry and is needed to offset the overstated or understated components.

<i>Receipts (Credits)</i>	<i>Payments (Debits)</i>
1) Exports of goods	1) Imports of goods
<i>Trade Account Balance</i>	
2) Exports of services	2) Imports of services
3) Interests, profits and dividends received	3) Interests, profits and dividends paid
4) Unilateral receipts	4) Unilateral Payments
<i>Current Account Balance</i> <i>(1 to 4)</i>	
5) Foreign Investments	5) Investments abroad
6) Short term borrowing	6) Short term lending
7) Medium and long term borrowing	7) Medium and long term lending
8)	Statistical discrepancy (Errors and omission)
<i>Capital Account Balance</i> <i>(5 to 8)</i>	
9) Change in reserves (+)	9) Change in reserves
<i>Total Receipts = Total payments</i>	

Disequilibrium In The Balance Of Payments

A disequilibrium in the balance of payment means its condition of Surplus Or deficit

- ✓ A **Surplus** in the **BOP** occurs when Total Receipts exceeds Total Payments. Thus,

$$\text{BOP} = \text{CREDIT} > \text{DEBIT}$$

- ✓ A **Deficit** in the **BOP** occurs when Total Payments exceeds Total Receipts. Thus,

$$\text{BOP} = \text{CREDIT} < \text{DEBIT}$$

Causes of Disequilibrium In The Bop

- Cyclical fluctuations
- Short fall in the exports
- Economic Development
- Rapid increase in population
- Structural Changes
- Natural Calamities
- International Capital Movements

Measures To Correct Disequilibrium in the BOP

1. Monetary Measures :-

a) Monetary Policy

The monetary policy is concerned with money supply and credit in the economy. The Central Bank may expand or contract the money supply in the economy through appropriate measures which will affect the prices.

b) Fiscal Policy

Fiscal policy is government's policy on income and expenditure. Government incurs development and non - development expenditure,. It gets income through taxation and non - tax sources. Depending upon the situation governments expenditure may be increased or decreased.

Measures To Correct Disequilibrium in the BOP

c) Exchange Rate Depreciation

By reducing the value of the domestic currency, government can correct the disequilibrium in the BoP in the economy. Exchange rate depreciation reduces the value of home currency in relation to foreign currency. As a result, import becomes costlier and export become cheaper. It also leads to inflationary trends in the country,

d) Devaluation

devaluation is lowering the exchange value of the official currency. When a country devalues its currency, exports becomes cheaper and imports become expensive which causes a reduction in the BOP deficit.

Measures To Correct Disequilibrium in the BOP

e) Deflation

Deflation is the reduction in the quantity of money to reduce prices and incomes. In the domestic market, when the currency is deflated, there is a decrease in the income of the people. This puts a curb on consumption and the government can increase exports and earn more foreign exchange.

f) Exchange Control

All exporters are directed by the monetary authority to surrender their foreign exchange earnings, and the total available foreign exchange is rationed among the licensed importers. The license-holder can import any good but the amount is fixed by the monetary authority.

Measures To Correct Disequilibrium in the BOP

II. Non- Monetary measures :-

a) Export Promotion

To control export promotions the country may adopt measures to stimulate exports like:

- ✓ export duties may be reduced to boost exports
- ✓ cash assistance, subsidies can be given to exporters to increase exports
- ✓ goods meant for exports can be exempted from all types of taxes.

b) Import Substitutes

Steps may be taken to encourage the production of import substitutes. This will save foreign exchange in the short run by replacing the use of imports by these import substitutes.

Measures To Correct Disequilibrium in the BOP

c) *Import Control*

Import may be kept in check through the adoption of a wide variety of measures like quotas and tariffs. Under the quota system, the government fixes the maximum quantity of goods and services that can be imported during a particular time period.

1. Quotas – Under the quota system, the government may fix and permit the maximum quantity or value of a commodity to be imported during a given period. By restricting imports through the quota system, the deficit is reduced and the balance of payments position is improved.
2. Tariffs – Tariffs are duties (taxes) imposed on imports. When tariffs are imposed, the prices of imports would increase to the extent of tariff. The increased prices will reduced the demand for imported goods and at the same time induce domestic producers to produce more of import substitutes

INDIA'S BALANCE OF PAYMENT

INDIA'S BALANCE OF PAYMENT

- ❖ A country, like India, which is on the path of development generally, experiences a deficit balance of payments situation.
- ❖ This is because such a country requires imported machines, technology and capital equipment's in order to successfully launch and carry out the programme of industrialization

Table 1: Major Items of India's Balance of Payments

(US\$ Billion)

	Apr-Jun 2015 P			Apr-Jun 2014 PR		
	Credit	Debit	Net	Credit	Debit	Net
A. Current Account	126.6	132.7	-6.2	139.2	147.0	-7.8
1. Goods	68.0	102.2	-34.2	81.7	116.3	-34.6
<i>Of which:</i>						
POL	8.2	24.7	-16.5	16.8	40.4	-23.6
2. Services	38.0	20.6	17.4	37.6	20.6	17.0
3. Primary Income	3.2	8.8	-5.6	2.3	9.0	-6.7
4. Secondary Income	17.3	1.1	16.2	17.6	1.1	16.4
B. Capital Account and Financial Account	140.3	133.6	6.6	144.6	136.6	8.0
<i>Of which:</i>						
Change in Reserve (Increase (-)/Decrease (+))	0.0	11.4	-11.4	0.0	11.2	-11.2
C. Errors & Omissions (-) (A+B)	0.0	0.5	-0.5	0.0	0.1	-0.1

P: Preliminary; PR: Partially Revised

Note: Total of subcomponents may not tally with aggregate due to rounding off.

BOP OF INDIA

- ❑ India's current account deficit (CAD) narrowed to US\$ 6.2 billion (1.2 per cent of GDP) in Q1 of 2015-16 from US\$ 7.8 billion (1.6 per cent of GDP) a year ago.
- ❑ This improvement was mainly on account of the merchandise trade deficit (US\$ 34.2 billion during Q1 of 2015-16) which contracted on a year-on-year (y-o-y) basis due to a larger absolute decline in merchandise imports relative to merchandise exports.
- ❑ The reduction in the CAD was also enabled by higher net earnings through services and lower outflow on account of primary income (profit, dividend and interest).
- ❑ Private transfer receipts, mainly representing remittances by Indians employed overseas, amounted to US\$ 16.2 billion, a marginal decline from their level a year ago.

BOP OF INDIA

- In the financial account, net inflows of foreign direct investment were higher on a y-o-y basis, however, portfolio investment declined sharply.
- Non-resident Indian (NRI) deposits received by commercial banks during the quarter at US\$ 5.9 billion were more than double the net inflow into these accounts in Q1 of last year.
- Net loans availed by banks witnessed an inflow of US\$ 5.4 billion, mainly on account of a fall in foreign currency assets held abroad by banks.
- In April-June 2015 there was net accretion of US\$ 11.4 billion to India's foreign exchange reserves on a BoP basis; which was marginally higher than the accretion in the corresponding quarter of last year .

REASONS FOR POOR PERFORMANCE OF INDIA'S EXPORT TRADE

There are Several reasons for India's Poor performance. Some off them are:

I. Export - Related Problems :-

1. High Prices :-

As compared to other Asian Countries the price of Indian goods is high. Prices are high due to documentation formalities, high transaction costs & also to make higher profits.

2. Poor - Quality :-

Many Indian exporters do not give much importance to quality control, so their products are of poor quality. Due to low quality many times Indian goods are rejected & sent back to India by foreign buyers.

REASONS FOR POOR PERFORMANCE OF INDIA'S EXPORT TRADE

- 3.Poor Negotiation Skills** :- Indian exporters lack Negotiation Skills due to poor training in Marketing. They fail to Convince & induce the foreign buyers to place orders.
- 4.Inadequate Promotion** :-For Export Marketing, Promotion is important. Many Indian Exporters do not give much importance to promotion. A good no. of Indian exporters are not professional in advertising & Sales promotion. They do not take part in trade fairs & exhibitions.
- 5.Poor follow-up of sales** :-Indian exporters are ineffective in providing after-sale-service. They do not bother to find out the reactions of buyers after sale. This results in poor performance of India's export trade.

REASONS FOR POOR PERFORMANCE OF INDIA'S EXPORT TRADE

II. General Causes

1. **Good Domestic Market**

Sellers find a ready market for their goods within the country, so they do not take pains to get orders from overseas markets.

2. **Number of formalities**

There are number of documentation & other formalities due to which the some marketers do not enter the export field. So there is a need to simplify formalities.

REASONS FOR POOR PERFORMANCE OF INDIA'S EXPORT TRADE

3. Problem of Trading Blocs

Trading blocs reduce trade barriers on member nations, but they impose trade barriers on non-members. As India is not a member of some powerful trading blocs, it has to face some problems.

4. Negative Attitude

Some of the overseas buyers have a negative attitude towards Indian goods. They feel that Indian goods are inferior goods. Thus there is a need to correct this attitude.

5. Poor Infrastructure

Indian infrastructure is poor. Indian exporters find it difficult to get orders & also to deliver them at time.