UNIT 4

Balance of Payments – Unit 4 A

Foreign Exchange Market and Exchange Rate Determination – Unit 4 B

Balance of trade (BOT)

BOT is the difference between the value of exports and imports of goods i.e. visible items only. Thus,

Balance of Trade = Export of visible items – Import of visible items

Balance of Payments (BOP)

In the words of Kindleberger, "*The balance of payment of a country is a systematic record of all economic transactions between the residents of the reporting country and the residents of foreign countries during a given period of time.*"

It is a statement of account recording all international receipts and payment of a country with the rest of the world. It measures all international economic transactions between residents & foreign residents.

Difference between BOP & BOT

Balance of Payments (BOP) is the summary of all the 'economic' transactions India has had with the rest of the world (ROW) in a financial year.

Balance of Trade (BOT) is just the summary of the total exports and the total imports of India in a financial year.

Balanced BOP is when forex payment and receipts are equal. Surplus BOP is when the forex receipts are more than the payments. Deficit BOP is when the forex payments are more than the receipts.

Surplus BOT is when the exports are more than imports – it is a 'favourable BOT'. Deficit BOT is when the imports are more than the exports – it is 'unfavourable BOT'.

BOP summarizes all the inter-country transactions (ALL international transactions) and is a wider term which includes BOT. So, BOT forms a part of BOP. Whereas BOT is a narrower term, and includes only the summary of export and import of Visible Items.

BOP is a wider term and includes:

1. *Visible Items*: Those items which are visible/ touchable/ tangible/ physical – i.e., they can be seen and measured and touched! BOP includes the export and import of such physical goods.

2. *Invisible Items*: Are those which cannot be seen (and hence invisible) or touched but can be felt mainly services. The import and export of services is included like banking/consultancy services of IT/ Legal/ Architecture/ Management/ CA etc./ insurance and logistics services.

3. *Unilateral Transfers*: As the name suggests are transactions which are one way.

4. *Capital Transfers*: Are transfer of title or ownership of capital assets across borders. It includes purchase/ sale of capital assets like land, building, plant and machinery etc. but across borders.

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.

The balance-of-payments accounts of a country record the payments and receipts of the residents of the country in their transactions with residents of other countries. If all transactions are included, the payments and receipts of each country are, and must be, equal. *Any apparent inequality simply leaves one country acquiring assets in the others*.

For example, if India buys mobile phones from China, and has no other transactions with China, the Chinese must end up holding INR, which they may hold in the form of bank deposits in the India or in some other Indian investment. The payments Indians make to China for mobile phones are balanced by the payments Chinese make to Indian individuals and institutions, including banks, for the acquisition of Indian assets. Put another way, China sold India mobile phones , and India sold China INR or INR-denominated assets such as treasury bills.

Many different definitions of the balance-of-payments deficit or surplus have been used in the past. Each definition has different implications and purposes.

Until about 1973 attention was focused on a definition of the balance of payments intended *to measure a country's ability to meet its obligation to exchange its currency for other currencies or for gold at fixed exchange rates.* To meet this obligation, countries maintained a stock of official reserves, in the form of gold or foreign currencies, that they could use to support their own currencies. A decline in this stock was considered an important balance-of-payments deficit because it threatened the ability of the country to meet its obligations.

After 1973, interest in official reserve positions as a measure of balance of payments greatly diminished as the major countries gave up their commitment to convert their currencies at fixed exchange rates. This reduced the need for reserves and lessened concern about changes in the size of reserves. *Since 1973, discussions of "the" balance-of-payments deficit or surplus usually refer to what is called the current account. This account contains trade in goods and services, investment income earned abroad, and unilateral transfers. It excludes the capital account, which includes the acquisition or sale of securities or other property.*

Components of BOP

- Current Account
- Capital Account
- The Official Reserve Account

The General Rule in BOP Accounting

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

COMPONENTS OF BOP

- Current Account: Records flows of exports, imports, investment income, and international financial transfers.
  - Merchandise trade export and import of tangible goods
  - Services payments and receipts for legal and consulting fees, royalties, tourist expenditures
  - Investment income payments and receipts of interest, dividends, and other income on foreign investments
  - Unilateral Transfers “unrequited” payments (e.g. Foreign aid).
- If the debits exceed the credits, then a country is running a trade deficit.
- If the credits exceed the debits, then a country is running a trade surplus.

- Capital account: Records sales to foreigners of a country’s financial assets and a country’s purchases of foreign financial assets.
  - The capital account is composed of Foreign Direct Investment (FDI), portfolio investments, and other investment.
  - Direct investment involves acquisitions of controlling interests in foreign businesses.
  - Portfolio investment represents investment in foreign shares and bonds that does not involve acquisition of control.
  - Other investment includes bank deposits, currency investment, trade credit and the like.

- The Reserve Account: The Reserve Account of BOP records changes in the amount of “official” reserve assets held by the Central Bank of that country.

  - Official reserves assets include gold, foreign currencies, SDRs, reserve positions in the IMF.

  - If a country must make net payment to foreigners because of BOP deficit, the country could either run down its official reserve assets or borrow a new from foreigners.

BOP

A. Current Account

A. Net exports/imports goods & services (Balance of Trade)

B. Net Income (investment income from direct portfolio investment plus employee compensation

C. Net transfers (sums sent home by migrant abroad)

B. Capital Account

Capital transfers related to purchase and sale of fixed assets such as real estate

C. Financial Account

A. Net foreign direct investment

B. Net portfolio investment

C. Other financial items

D. Net Errors and Omissions

Missing data such as illegal transfers

E. Reserves and Related Items

Changes in official monetary reserves including gold and foreign exchange reserves

Σ (A:E) = Overall Balance