Balance of payments:-

International trade involves the sale of goods and services to residents in other countries (exports) and purchases of goods and services from residents in other countries (imports). A country's BoP accounts keep track of the payments to and receipts from other countries for a particular time period. These includes payments to foreigners for imports of goods and services and receipts from foreigners for goods and services exported to them.

Any transaction resulting in a payment to other countries is entered in the BoP account as a debit and given a (-) negative sign. Any transaction resulting in a receipt from other countries is entered as a credit and given a (+) positive sign.

Fundamentals of BoP accounting

A basic fundamental rule is that BoP must balance. If it does not, something has not been counted properly. It is therefore improper to say that the BoP is in disequilibrium. It cannot be.

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The supply and demand for a country's currency may be imbalanced, but that is not the same thing. Sub-accounts of the BoP, such as the merchandise trade balance may be imbalanced but the entire BoP of a country is always balanced

There are three main elements to the process of measuring international economic activity -

(1) Defining International Economic Transactions
(2) BoP as a cash flow statement
The BoP is often misunderstood to be a balance sheet because of its name The BoP is actually a cash flow statement that records the flow of foreign exchange from all international transactions over a period of time. It is thus a record of the flow of foreign exchange and not a statement of the final value of all assets and liabilities of a country like Balance sheet of an individual firm.
There are two types of business transactions that dominate BoP -
1) Real Assets -
2) Financial Assets

(3) BoP Accounting - Double entry book keeping
The measurement of all international transactions in and out of a country over a year is a daunting task. Mistakes, errors and statistical discrepancies will occur. The primary problem is that although double-entry book keeping is employed in theory, the individual transactions are recorded independently. Current and capital account entries are recorded independent of one another and not together as double-entry bookkeeping would prescribe. It must then be recognised that there will be serious discrepancies b/w debits and credits, and the possibility in total that BoPs may not balance.

Types of BoPs Accounts:-
The BoP is composed of two primary sub-accounts, - the current account
- the capital account or financial account
In addition, the official reserves account tracks government currency transactions and a fourth statistical sub-account, the net errors and omissions is produced to create and keep the balance in BoP.

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Current Account

The current Account includes all international economic transactions with income or payment flows occuring within the current year. The current account consists of four subcategories :-

1) Goods - refers to the export or import of physical goods also known as merchandise trade.

2) Services - refers to the export and import of services such as banking & insurance services.

3) Income - This refers to receipts & payments i.e, income from foreign investments and payments that have to be made to foreigners investing in a country. for eg. The profit made by a Japanese Company will be repatriated back to Japan as dividend is the current income transfer. Wages and salaries paid to non-residents workers are also included in this category.

4) Current transfers :- These are unilateral current transfers such as U.S. govt. grants to foreigners including foreign aid. Any transfer b/w countries that is one way, a gift, or a grant is termed a current transfer.

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Note: (Transfers associated with the transfer of fixed assets are included in a new seperate account, the capital account, which follows the current account. The contents of what previously had been called the capital a/c are now included within the financial a/c)

The current a/c is typically dominated by the first component - the export and import of merchandise. For this reason, Balance of Trade (BOT) refers specifically to the balance of exports and imports of goods trade only.

BOT = Exports of Goods − Imports of Goods

A current account deficit occurs when a country imports more goods, services and income than it exports.

A current account surplus occurs when a country exports more goods, services and income than it imports.

Imbalances in the current a/c can be settled through a capital a/c which we discuss now.

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Capital and financial account

(Note:- The capital a/c records one-time changes in the stock of assets. As noted earlier, until recently this item was included in the current a/c but now is included within the financial a/c.)

The capital and financial a/c of the BOP measures all international economic transaction of financial assets. It is divided into two major components,
- the capital a/c
- the financial a/c

1) The capital a/c - The capital account includes capital transfers, such as debt forgiveness and migrant's transfers (the goods and financial assets that accompany migrants as they enter or leave the country). In the big scheme of things this is a relatively small figure. The capital a/c covers all transactions that involve receipts or payments of capital transfers and acquisition or disposal of non-produced non-financial assets.

2) The financial account - consists of three components: direct investment, portfolio investment and other asset investment. Here the financial assets is classified by the degree of control over the assets or operations the claim represents: portfolio investment - the investor

The financial a/c covers all transactions associated with changes of ownership in the foreign financial assets & liabilities of an economy.

has no control or direct investment where the investor exerts some explicit degree of control over the assets.

The three major sub-categories of India's capital a/c balance are
- Direct Investment - This is the net balance of capital flows into and out of the country for the purpose of exerting control over assets.
When the capital flows out of the country's BoP, it enters BoP as a negative cash flow. If, however foreign firms purchase firms in the country, it is a capital inflow and enters BoP as a positive cash flow.

- Portfolio Investment - It is that capital invested in activities that are purely motivated by returns, rather than control purposes. eg. purchases of debt securities, bonds etc.

- Other investment assets/liabilities - This category consists of various short-term and long-term trade credits, cross-border loans from all types of financial institutions, currency deposits and bank deposits, and other a/cs receivable & payable related

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to cross-border trade.

In current and financial a/c balance relationships there is an inverse relationship b/w the current and financial accounts of the BOP a/c. This inverse relationship is not accidental. The methodology of the BOP, double entry book-keeping requires that the current and financial a/cs be offsetting. Countries experiencing large current-a/c deficits finance these purchases through equally large surpluses in the financial a/c and vice-versa.

[Note:- A basic principle of BOP a/cing is double entry bookkeeping. Every international transaction automatically enters the BOP twice – once as a credit and once as a debit. Let us try and understand it with an example.
Imagine that you purchase a car produced in Japan by Toyota for $20,000. Because your purchase represents a payment to another country for goods, it will enter the BOP as a debit on the current account. Toyota now has the $20,000 and must do something with it. If Toyota deposits the money at US Bank, Toyota has purchased a US asset – a bank deposit worth $20,000

and the transaction will show up as a $20,000 credit on the financial a/c [OR] ~~the~~.
Thus any international transaction automatically gives rise to two offsetting entries in the BoP. Because of this the sum of the current a/c balance, the capital account and the financial a/c balance should always add up to zero.
In practice, this does always occur due to the ~~b~~ existence of statistical discrepancies.

Net Errors & Omissions
The net errors and omissions a/c makes sure that the BoP actually balances. Statistical discrepancies arise due to several reasons:-
1) Difficulties in Data Collection - different sources
2) Leads or Lags b/w actual transactions & their flow of funds
3) Unrecorded illegal transactions.

Official Reserves Account (ORA)
The ORA refers to the total currency and metallic reserves held by official monetary authorities within the country. These reserves usually composed of the major currencies

used in international trade and financial transactions and gold. The ORA is a part of financial a/c of BOP

The BoP in totality

The BoP current a/c and capital a/c add upto the total BoP a/c, which must always balance as it is prepared on double-entry principle. If debits on the current a/c exceed its credit-side transactions, a flow of funds on capital a/c is needed to wipe out the deficit. Thus, a deficit in the current a/c is always matched by a surplus in the capital a/c and vice-versa.

The BOP, is therefore, based on the concept of a/cing eqn, according to which:

Current A/c + Capital A/c = 0

Balance of Trade (BOT) = Export of Goods — Import of Goods

BOP = Balance on Current A/c + Balance on Capital A/c + Stastical Discrepancy.

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The BOP A/c may have either a surplus or a deficit. If it has a surplus, the money can be utilised for repaying past loans such as those taken from the IMF, and the balance amount to the official Reserves A/c.
However if the overall a/c has a deficit, the monetary authorities may transfer the funds from the official Reserves A/c or officially borrow from the IMF.
In other words, if capital inflows are meant for meeting the BOP deficit and getting it to balance, they are termed as accomodating flows. These are in the nature of OR transactions.

On the other hand, if capital inflows take place on their own, they are termed as autonomous flows.
Thus accomodating capital flows go "above the line" and autonomous capital flows go "below the line".

Does the current a/c deficit matter? — Refer Charles Hills Page - 222

DOES THE CURRENT ACCOUNT DEFICIT MATTER?

As discussed earlier, there is some concern when a country is running a deficit on the current account of its balance of payments.[47] In recent years, a number of rich countries, including most notably the United States, have run persistent and growing current account deficits. When a country runs a current account deficit, the money that flows to other countries can then be used by those countries to purchase assets in the deficit country. Thus, when the United States runs a trade deficit with China, the Chinese use the money that they receive from U.S. consumers to purchase U.S. assets such as stocks, bonds, and the like. Put another way, a deficit on the current account is financed by selling assets to other countries; that is, by a surplus on the financial account. Thus, the persistent U.S. current account deficit is being financed by a steady sale of U.S. assets (stocks, bonds, real estate, and whole corporations) to other countries. In short, countries that run current account deficits become net debtors.

For example, as a result of financing its current account deficit through asset sales, the United States must deliver a stream of interest payments to foreign bondholders, rents to foreign landowners, and dividends to foreign stockholders. One might argue that such payments to foreigners drain resources

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from a country and limit the funds available for investment within the country. Since investment within a country is necessary to stimulate economic growth, a persistent current account deficit can choke off a country's future economic growth. This is the basis of the argument that persistent deficits are bad for an economy.

However, things are not this simple. For one thing, in an era of global capital markets money is efficiently directed toward its highest value uses, and over the past quarter of a century many of the highest value uses of capital have been in the United States. So even though capital is flowing out of the United States in the form of payments to foreigners, much of that capital finds its way right back into the country to fund productive investments in the United States. In short, it is not clear that the current account deficit chokes off U.S. economic growth. In fact, notwithstanding the 2008–2009 recession, the U.S. economy has grown substantially over the past 30 years, despite running a persistent current account deficit and despite financing that deficit by selling U.S. assets to foreigners. This is precisely because foreigners reinvest much of the income earned from U.S. assets, and from exports to the United States, right back into the United States. This revisionist view, which has gained in popularity in recent years, suggests that a persistent current account deficit might not be the drag on economic growth it was once thought to be.[48]

Having said this, there is still a nagging fear that at some point the appetite that foreigners have for U.S. assets might decline. If foreigners suddenly reduced their investments in the United States, what would happen? In short, instead of reinvesting the dollars that they earn from exports and investment in the United States back into the country, they would sell those dollars for another currency, European euros, Japanese yen, or Chinese yuan, for example, and invest in euro-, yen-, and yuan-denominated assets instead. This would lead to a fall in the value of the dollar on foreign exchange markets, and that in turn would increase the price of imports, and lower the price of U.S. exports, making them more competitive, which should reduce the overall level of the current account deficit. Thus, in the long run, the persistent U.S. current account deficit could be corrected via a reduction in the value of the U.S. dollar. The concern is that such adjustments may not be smooth. Rather than a controlled decline in the value of the dollar, the dollar might suddenly lose a significant amount of its value in a very short time, precipitating a "dollar crisis."[49] Because the U.S. dollar is the world's major reserve currency, and is held by many foreign governments and banks, any dollar crisis could deliver a body blow to the world economy and at the very least trigger a global economic slowdown. That would not be a good thing.

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