Balance of Payment

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Balance of Payment

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.

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

Balance of Trade V/s Balance of Payment

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 = Current Account + Capital Account + or - 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 = Net Earning on Export - 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

The various components of a BOP statement

1. Current Account

2. Capital Account

3. Reserve Account

4. Errors & Omissions

Current Account

- 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

Capital Account

- 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

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 repurchase (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.

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**, BOP= CREDIT>DEBIT**

A Deficit in the BOP occurs when Total Payments exceeds Total Receipts.

Thus, **BOP= CREDIT<DEBIT**

Causes of Disequilibrium In The BOP

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

Trends in Balance of Payment in India

❖ **BOP Position in the 50s**

1. In the early 1950s when India launched its economic planning, the balance of payments position was more or less comfortable. India witnessed surplus in the current account and surplus in BOP position in the year 1952-53 and 1953-54. As a result India experienced an increase in the official reserves position.

2. During the second five year plan, trade deficit was much more than the net surplus on invisible transfers and surplus on capital account. India experienced an outflow from the official reserves account towards meeting the balance of payments requirements. The foreign exchange reserves of the country declined sharply during this period. The basic reason of the significant deficit in the BOP was that the country embarked upon the planned development in the fifties.

Trends in Balance of Payment in India

BOP Position in the 60s

1. During the decade of 60's the balance on current account was unfavorable mainly because of steep rise in imports of food grains, machinery and equipments and sluggish exports.
2. Heavy trade deficits, debt obligations and a sharp fall in foreign exchange reserves led to the devaluation of the rupee in 1966.

BOP Position in the 70s

1. In the early 70s, though exports grew more significantly, the larger increase in imports led to continued trade deficits and India had deficits even in terms of invisible transfers.
2. In the year 1973-74, country faced pressure on the balance of payments as the import bill rose dramatically. As a result, India went for huge external assistance to tide over the balance of payment problems that become a regular feature thereafter.

Trends in Balance of Payment in India

❖ **BOP Position in the 80s**

1. In the year 1979-80 India faced second oil shock that had a far more severe impact on the economy's balance of payment than that of the first shock. Increase in oil prices substantially increased the import bill while exports failed to cope up with the rising imports. Export performance was depressed by the severe international recession of 1980-83.
2. Exports grew by about 3 percent, in terms of volume. As a result trade deficit widened during the entire decade of 1980 barring three years 1982-85.
3. However, during the latter half of 1980's trade deficit reached new highs that put strains on BOP. The volume of imports rose sharper than the volume of exports.
4. During 1981-90, the current account deficit averaged 2.4 percent of GDP. The repayments to the I.M.F during the period put added pressure on the balance of payments.

Trends in Balance of Payment in India

❖ **BOP Position in the 90s**

1. In the year 1991, India experienced the worst ever BOP crisis since independence. The year 1990-91 witnessed three major developments which contributed to this crisis-

i) substantial increase in oil price following Gulf war that led to substantial increase in the import's bill of the country. Further the remittances from Indian workers employed in Kuwait also stopped;

ii) decline in exports due to disintegration of USSR and

iii) problems on the domestic front (like fiscal imbalance, double digit inflation, political uncertainty etc.).

2. By June 1991, the level of foreign exchange reserves dropped to the extent that they were barely sufficient to finance imports for a fortnight. The Government of India was on the verge of default on payment of external borrowings in June1991.

Trends in Balance of Payment in India

❖ **BOP Position in the 1992-95**

1. During 1991 the economic reforms and macro-economic stabilization measures were introduced to tide over the BOP crisis of 1991.
2. During 1993-94, the balance of payments position improves significantly due to growth in exports, fall in international prices of crude oil and the slack in the growth of non-oil imports. The trade deficit reduced dramatically.
3. During 1994-95, both exports and imports grew significantly: exports grew by 18.4 percent, in US dollar terms and imports by 22.9 percent. Invisible payments also rose considerably. As a result, the current account deficit widened.

Trends in Balance of Payment in India

❖ **BOP Position in the 1995-2007**

1. In the year 1995-96 the surge in exports and imports continued. However the current account deficit grew tremendously to 1.7 percent of GDP.
2. The balance of payments (BOP) has been in an overall surplus since 1996-97, with reserves rising .
3. India witnessed surplus in the current account for three consecutive years i.e. 2001-02, 2002-03, and 2003-04. This surplus was accompanied by strong net capital inflows.
4. The current account recorded deficit since 2004-05 that is increasing. The deficit was caused by a burgeoning excess of merchandise imports over exports, which was left uncompensated by the net surplus in invisibles. The increase in imports occurs due to increase in the international price of crude and other major items of imports like gold.
5. The trade and current account deficit widened to 7.7 per cent and 1.5 percent of GDP in 2007-08

Measures To Correct Disequilibrium in the BOP

1. **Policy 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 curb on consumption and 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 amount if fixed by monetary authority.

Measures To Correct Disequilibrium in the BOP

2. **Non- Monetary measures** :-

a) Export Promotion To control export promotions the country may adopt measures to stimulate exports like:

i. export duties may be reduced to boost exports

ii. cash assistance, subsidies can be given to exporters to increase exports

iii. 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