BALANCE OF PAYMENTS

(Unit -2)

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Balance of Payments

Introduction:

Balance of payments (BoP) accounts are an accounting record of all monetary transactions between a country and the rest of the world. These transactions include payments for the country's exports and imports of goods, services, financial capital, and financial transfers. The BoP accounts summarize international transactions for a specific period, usually a year, and are prepared in a single currency, typically the domestic currency for the country concerned. Sources of funds for a nation, such as exports or the receipts of loans and investments, are recorded as positive or surplus items. Uses of funds, such as for imports or to invest in foreign countries, are recorded as negative or deficit items.

Balance of Payment

While the overall Balance of Payment accounts will always balance when all types of payments are included, imbalances are possible on individual elements of the BOP, such as the current account, the capital account excluding the central bank's reserve account, or the sum of the two. Imbalances in the latter sum can result in surplus countries accumulating wealth, while deficit nations become increasingly indebted. The term "balance of payments" often refers to this sum: a country's balance of payments is said to be in surplus (equivalently, the balance of payments is positive) by a certain amount if sources of funds (such as export goods sold and bonds sold) exceed uses of funds (such as paying for imported goods and paying for foreign bonds purchased) by that amount. There is said to be a balance of payments deficit (the balance of payments is said to be negative) if the former is less than the latter.

Under a fixed exchange rate system, the central bank accommodates those flows by buying up any net inflow of funds into the country or by providing foreign currency funds to the foreign exchange market to match any international outflow of funds, thus preventing the funds flows from affecting the exchange rate between the country's currency and other currencies. Then the net change per year in the central bank's foreign exchange reserves is sometimes called the balance of payments surplus or deficit. Alternatives to a fixed exchange rate system include a managed float where some changes of exchange rates are allowed, or at the other extreme a purely floating exchange rate (also known as a purely flexible exchange rate). With a pure float the central bank does not intervene at all to protect or devalue its currency, allowing the rate to be set by the market, and the central bank's foreign exchange reserves do not change.

Historically there have been different approaches to the question of how or even whether to eliminate current account or trade imbalances. With record trade imbalances held up as one of the contributing factors to the financial crisis of 2007–2010, plans to address global imbalances have been high on the agenda of policy makers since 2009.

The Balance of Payments Divided

The BOP is divided into three main categories: the current account, the capital account and the financial account. Within these three categories there are sub-divisions, each of which accounts for a different type of international monetary transaction.

- **The Current Account**

The current account is used to mark the inflow and outflow of goods and services into a country. Earnings on investments, both public and private, are also put into the current account. Within the current account are credits and debits on the trade of merchandise, which includes goods such as raw materials and manufactured goods that are bought, sold or given away (possibly in the form of aid). Services refer to receipts from tourism, transportation (like the levy that must be paid in Egypt when a ship passes through the Suez Canal), engineering, business service fees (from lawyers or management consulting, for example) and royalties from patents and copyrights. When combined, goods and services together make up a country's balance of trade (BOT). The BOT is typically the biggest bulk of a country's balance of payments as it makes up total imports and exports.

If a country has a balance of trade deficit, it imports more than it exports, and if it has a balance of trade surplus, it exports more than it imports. Receipts from income-generating assets such as stocks (in the form of dividends) are also recorded in the current account. The last component of the current account is unilateral transfers. These are credits that are mostly worker's remittances, which are salaries sent back into the home country of a national working abroad, as well as foreign aid that is directly received.

- **The Capital Account**

The capital account is where all international capital transfers are recorded. This refers to the acquisition or disposal of non-financial assets (for example, a physical asset such as land) and non-produced assets, which are needed for production but have not been produced, like a mine used for the extraction of diamonds. The capital account is broken down into the monetary flows branching from debt forgiveness, the transfer of goods, and financial assets by migrants leaving or entering a country, the transfer of ownership on fixed assets (assets such as equipment used in the production process to generate income), the transfer of funds received to the sale or acquisition of fixed assets, gift and inheritance taxes, death levies and, finally, uninsured damage to fixed assets

- **The Financial Account**

In the financial account, international monetary flows related to investment in business, real estate, bonds and stocks are documented. Also included are government- owned assets such as foreign reserves, gold, special drawing rights (SDRs) held with the International Monetary Fund (IMF), private assets held abroad and direct foreign investment. Assets owned by foreigners, private and official, are also recorded in the financial account.

Significance of balance of payments

A balance of payment is an essential document in the finance department or transaction as it gives the status of a country and it's economy. The importance of the balance of payment can be calculated from the below points:

- It examines the transaction of all the export and import of goods and services for a given period.
- It helps the government to analyse the potential of a particular industry export growth and formulate policy to support that growth.
- It gives the government a broad perspective on a different range of import and export tariff. The government then takes measure to increase and decrease the tax to discourage import and encourage export respectively and be self-sufficient.
- If the economy urges support in the mode of import, the government plan according to the BOP and divert the cash flow and technology to the unfavourable sector of the economy, and seek future growth.
- The Balance of Payment also indicates the government to detect the state of the economy, and plan expansion, monetary, and fiscal policy establish on that.

Balance of payments in the world

- **The Balancing Act**

The current account should be balanced against the combined-capital and financial accounts; however, as mentioned above, this rarely happens. We should also note that, with fluctuating exchange rates, the change in the value of money can add to BOP discrepancies. When there is a deficit in the current account, which is a balance of trade deficit, the difference can be borrowed or funded by the capital account. If a country has a fixed asset abroad, this borrowed amount is marked as a capital account outflow. However, the sale of that fixed asset would be considered a current account inflow (earnings from investments). The current account deficit would thus be funded. When a country has a current account deficit that is financed by the capital account, the country is actually foregoing capital assets for more goods and services. If a country is borrowing money to fund its current account deficit, this would appear as an inflow of foreign capital in the BOP.

- **Liberalizing the Accounts**

The rise of global financial transactions and trade in the late-20th century spurred BOP and macroeconomic liberalization in many developing nations. With the advent of the emerging market economic boom - in which capital flows into these markets tripled from USD$50 million to $150 million from the late 1980s until the Asian crisis - developing countries were urged to lift restrictions on capital and financial-account transactions in order to take advantage of these capital inflows. Many of these countries had restrictive macroeconomic policies, by which regulations prevented foreign ownership of financial and non-financial assets. The regulations also limited the transfer of funds abroad. With capital and financial account liberalization, capital markets began to grow, not only allowing a more transparent and sophisticated market for investors, but also giving rise to foreign direct investment (FDI).

- **Balance of payments crisis**

A BOP crisis, also called a *currency crisis*, occurs when a nation is unable to pay for essential imports and/or service its debt repayments. Typically, this is accompanied by a rapid decline in the value of the affected nation's currency. Crises are generally preceded by large capital inflows, which are associated at first with rapid economic growth. However a point is reached where overseas investors become concerned about the level of debt their inbound capital is generating, and decide to pull out their funds. The resulting outbound capital flows are associated with a rapid drop in the value of the affected nation's currency. This causes issues for firms of the affected nation who have received the inbound investments and loans, as the revenue of those firms is typically mostly derived domestically but their debts are often denominated in a reserve currency. Once the nation's government has exhausted its foreign reserves trying to support the value of the domestic currency, its policy options are very limited. It can raise its interest rates to try to prevent further declines in the value of its currency, but while this can help those with debts denominated in foreign currencies, it generally further depresses the local economy.

- **Balancing Mechanisms**

One of the three fundamental functions of an international monetary system is to provide mechanisms to correct imbalances. Broadly speaking, there are three possible methods to correct BOP imbalances, though in practice a mixture including some degree of at least the first two methods tends to be used. These methods are adjustments of exchange rates; adjustment of a nations internal prices along with its levels of demand; and rules-based adjustment. Improving productivity and hence competitiveness can also help, as can increasing the desirability of exports through other means, though it is generally assumed a nation is always trying to develop and sell its products to the best of its abilities.

Balance of Payments Accounts in India

The Reserve Bank of India (RBI) is responsible for compiling the balance of payments for India. The RBI obtains data on the balance of payments primarily as a by-product of the administration of the exchange control. In accordance with the Foreign Exchange Management Act (FEMA) of 1999, all foreign exchange transactions must be channeled through the banking system, and the banks that undertake foreign exchange transactions must submit various periodical returns and supporting documents prescribed under the FEMA. In respect of the transactions that are not routed through banking channels, information is obtained directly from the relevant government agencies, other concerned agencies, and other departments within the RBI. The information is also supplemented by data collected through various surveys conducted by the RBI.

- **Current Account Goods**

The RBI compiles data on merchandise transactions mainly as a by-product of the administration of exchange control. Data on exports are based on export transactions and the collection of export proceeds as reported by the banks. In the case of imports, exchange control records cover only those imports for which payments have been affected through banking channels in India. Information on payments for imports not passing through the banking channels is obtained from other sources, primarily government records and borrowing entities in respect of their external commercial borrowing. Since 1992-93, the value of gold and silver brought to India by returning travelers has been added to the imports data with a contra-entry under current transfers, other sectors.

- **Services**

Under the exchange control rules, authorized dealers (i.e., banks authorized to deal in foreign exchange) are required to report details in respect of transactions, other than exports, when the individual remittances exceed a stipulated amount. For receipts below this amount, the banks report only aggregate amounts without indicating the purpose of the incoming remittance. The balance of payments classification of these receipts is made on the basis of the Survey of Unclassified Receipts conducted by the RBI. This sample survey is conducted on a biweekly basis.

- **Transportation**

This category covers all modes of transport and port services; the data are based mainly on the receipts and payments reported by the banks in respect of transportation items. In addition to the exchange control records, the survey of unclassified receipts is also used as a source. These sources are supplemented by information collected from major airline and shipping companies in respect of payments from foreign accounts. A benchmark Survey of Freight and Insurance on Exports is also used to estimate freight receipts on account of exports.

- **Travel**

Travel data are obtained from exchange control records, supplemented by information from the surveys of unclassified receipts. The estimates of travel receipts also use the information on foreign tourist arrivals and expenditure, received from the Ministry of Tourism as a cross-check of the exchange control and survey data.

- **Other Services**

The insurance category covers all types of insurance (i.e., life, nonlife, and reinsurance transactions). Thus, the entries include all receipts and payments reported by the banks in respect of insurance transactions. In addition to information available from exchange control records, information in the survey of unclassified receipts is also used. The benchmark survey of freight and insurance is used to estimate insurance receipts on account of exports. Other services also cover a variety of service transactions on account of software development, technical know-how, communication services, management fees, professional services, royalties, and financial services. Since 1997-98, the value of software exports for onsite development, expenditure on employees, and office maintenance expenses has been included in other services. Transactions in other services are captured through exchange control records and the survey of unclassified receipts, supplemented by data from other sources.

- **Income Investment Income**

Information on investment income transactions is obtained from exchange control records and foreign investment surveys, supplemented by information available from various departments of the RBI. Interest payments on foreign commercial loans are also reported under the RBI Foreign Currency Loan reporting system. The data on reinvested earnings of foreign direct investment companies are based on the annual

Survey of Foreign Liabilities and Assets, conducted by the RBI. Details of investment income receipts on account of official reserves are obtained from the RBI's internal records. Interest accrued during the year and credited to nonresident Indian deposits is also included under this category.

- **Other Sectors**

Transactions relating to workers' remittances are based on the information furnished by authorized dealers regarding remittances received under this category, supplemented by the data collected in the survey of unclassified receipts regularly conducted by the RBI. Redemption, in India, of nonresident dollar account schemes and withdrawals from nonresident rupee account schemes has been included as current transfers, other sectors since 1996-97.

- **Direct Investment**

Basic data are obtained from the exchange control records, but information on noncash inflows and reinvested earnings is taken from the Survey of Foreign Liabilities and Assets, supplemented by other information on direct investment flows. Up to 1999/2000, direct investment in India and direct investment abroad comprised mainly equity flows.From 2000/2001 onward, the coverage has been expanded to include, in addition to equity, reinvested earnings, and debt transactions between related entities. The data on equity capital include equity in both unincorporated business (mainly branches of foreign banks in India and branches of Indian banks abroad) and incorporated entities.

- **Portfolio Investment**

Basic data are obtained from the exchange control records. These are supplemented with information from the Survey of Foreign Liabilities and Assets. In addition, the details of the issue of global depository receipts and stock market operations by foreign institutional investors are received from the Foreign Exchange Department, RBI.

- **Other Investment**

Most of the information on transactions in other investment assets and liabilities is obtained from the exchange control records, supplemented by information received from the departments of the RBI and various government agencies. Entries for transactions in external assets and liabilities of commercial banks are obtained from their periodic returns on foreign currency assets and rupee liabilities. Data on nonresident deposits with resident banks are obtained from exchange control records, the survey of unclassified receipts, and information submitted by the relevant banks to the RBI.

- **Reserve Assets**

Transactions under reserve assets are obtained from the records of the RBI. They comprise changes in its foreign currency assets and gold, net of estimated valuation changes arising from exchange rate movement and revaluations owing to changes in international prices of bonds/securities/gold. They also comprise changes in SDR balances held by the government and a reserve tranche position at the IMF, also net of revaluations owing to exchange rate movement.