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BALANCE OF PAYMENT: A TOOL OF ECONOMIC ANALYSIS

Dr. C. CHITRA & Dr. D. MURUGESAN
Associate Professors, Department of Commerce-G,
Vels Institute of Science, Technology and Advanced Studies, Pallavaram

Abstract

Measuring and assessing the external position of a country are essential steps in the economic policymaking process. Data on the transactions and financial flows between a country and the rest of the world, which are systematically summarized in the balance of payments, form the basis of any analysis of a country's external position and need for adjustment. The balance of payments (BOP) is the record of all international financial transactions made by the residents of a country. There are three main categories of the BOP: the current account, the capital account, and the financial account. The current account is used to mark the inflow and outflow of goods and services into a country. The capital account is where all international capital transfers are recorded. In the financial account, international monetary flows related to investment in business, real estate, bonds, and stocks are documented. The current account should be balanced versus the combined capital and financial accounts, leaving the BOP at zero, but this rarely occurs.

Keywords: External Position, BOP, Current account, Capital account, Financial account, Monetary Flows, Balance of Trade.

Introduction

Balance of Payment (BOP) is a statement which records all the monetary transactions made between residents of a country and the rest of the world during any given period. This statement includes all the transactions made by/to individuals, corporate and the government and helps in monitoring the flow of funds to develop the economy.

When all the elements are correctly included in the BOP, it should sum up to zero in a perfect scenario. This means the inflows and outflows of funds should balance out. However, this does not ideally happen in most cases. A BOP statement of a country indicates whether the country has a surplus or a deficit of funds i.e when a country's export is more than its import, its BOP is said to be in surplus. On the other hand, the BOP deficit indicates that a country's imports are more than its exports. Tracking the transactions under BOP is something similar to the double entry system of accounting. This means, all the transactions will have a debit entry and a corresponding credit entry.

Importance of the Balance of Payments

- The balance of payments helps any country determine if its currency's value is appreciating or depreciating.
- It provides almost accurate information on the commercial and/or financial performance of the external sector of an economy.
- Balance of payments helps to monitor the import-export transactions in a given period.
- It analyses the export growth potential of a country. It helps the government make sustainable fiscal and trade policies and strategies.
- BOP helps to analyze macroeconomic policies to preserve the external balance of

the national economy. It also contributes to correcting temporary and structural imbalances that may arise in the external accounts of a given economy.

- It allows us to analyze the relations of a country with other countries in a certain period. This way, you can see how some accounts relate to others.

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.

A Country's BOP is Vital for the Following Reasons

- The BOP of a country reveals its financial and economic status.
- A BOP statement can be used as an indicator to determine whether the country's currency value is appreciating or depreciating.
- The BOP statement helps the Government to decide on fiscal and trade policies.
- It provides important information to analyze and understand the economic dealings of a country with other countries.

By studying its BOP statement and its components closely, one would be able to identify trends that may be beneficial or harmful to the economy of the county and thus, then take appropriate measures.

Components of a Balance of Payment

There are three components of balance of payment viz current account, capital account, and financial account. The total of the current account must balance with the total of capital and financial accounts in ideal situations.

Current Account

The current account is used to monitor the inflow and outflow of goods and services between countries. This account covers all the receipts and payments made with respect to raw materials and manufactured goods. It also includes receipts from engineering, tourism, transportation, business services, stocks, and royalties from patents and copyrights. When all the goods and services are combined, together they make up to a country's Balance of Trade (BOT).

Various Categories of Trade and Transfers

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
- It could be visible or invisible trading, unilateral transfers or other payments/receipts. Trading in goods between countries are referred to as visible items and import/export of services (banking, information technology etc) are referred to as invisible items. Unilateral transfers refer to money sent as gifts or donations to residents of foreign countries. This can also be personal transfers like money sent by relatives to their family located in another country.

Capital Account

All capital transactions between the countries are monitored through the capital account. Capital transactions include the purchase and sale of assets (non-financial) like land and properties.

The capital account also includes the flow of taxes, purchase and sale of fixed assets etc by migrants moving out/into a different country. The deficit or surplus in the current account is managed through the finance from the capital account and vice versa. There are 3 major elements of a capital account:

- Loans and borrowings – It includes all types of loans from both the private and public sectors located in foreign countries.
- Investments – These are funds invested in the corporate stocks by non-residents.
- Foreign exchange reserves – Foreign exchange reserves held by the central bank of a country to monitor and control the exchange rate does impact the capital account.

Financial Account

The flow of funds from and to foreign countries through various investments in real estates, business ventures, foreign direct investments etc is monitored through the financial account. This account measures the

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changes in the foreign ownership of domestic assets and domestic ownership of foreign assets. On analyzing these changes, it can be understood if the country is selling or acquiring more assets (like gold, stocks, equity etc).

The importance of the balance of payment in India can be determined from the following points:

- It monitors the transaction of all the imports and exports of services and goods for a given period
- It helps the government analyze a particular industry export growth potential and formulate policy to sustain it
- It gives the government a comprehensive perspective on a different range of import and export tariffs. The government then increases and decreases the tax to discourage import and encourage export, individually, and be self-sufficient

The Sources of Supply of Foreign Exchange

- Purchase of goods and services by foreigners
- Foreign Direct Investment (FDI) into our country
- Inflow by the NRIs settled in foreign countries
- Speculative purchase of home currency by foreigners

Deficit In The Balance of Payments

When autonomous foreign exchange payments exceed autonomous foreign exchange receipts, the difference is the balance of payments deficit. The autonomous transactions in foreign exchanges are those transactions that are independent of the state's balance of payments and are undertaken for an individual's own sake.

Receipts (Credits)	*Payments (Debits)*
1) Exports of goods	1) Imports of goods
Trade Account Balance	
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
Current Account Balance (1 to 4)	
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)	
Capital Account Balance (5 to 8)	
9) Change in reserves (+)	9) Change in reserves
Total Receipts = Total payments	

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

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.

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 becomes 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.

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.

2. 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.

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

Official Reserve Transactions and their Importance in the Balance of Payments

Official reserve transactions mean running down the country's foreign exchange reserves in case of a deficit in the balance of payments by selling foreign currency in the foreign exchange market. In case of surplus, the country can buy foreign exchange and increase its official reserves. A country is said to be having its balance of payment in equilibrium when the sum of its current account and non-reserve capital account equals zero, which means the current account deficit is financed entirely by international borrowings without any movement in the country's official reserves.

India's Balance of Payment

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
Of which:						
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**
Of which:						
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.

- 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.
- 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. 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 of 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.

3. Problem of Trading Blogs

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

4. Negative Attitude

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

5. Poor Infrastructure

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

Conclusion

Balance of payments is an important concept in the economics of a country and various components make up the balance of payments. The balance of payments cannot be zero as a deficit in the current account will be offset by a surplus in the capital account and vice versa. However, a deficit in the balance of payments is considered harmful for the economy as it means a lot of dependency on imported products and foreign investment in the country. While some might say a deficit can boost a country in times of recessions, it generally shows a lack of self-dependency and gross domestic product.

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