CHAPTER 10

BALANCE OF PAYMENTS: MEANING AND COMPONENTS

The Balance of Payment (BOP) Accounts are an important aspect of the study of macro economy. In our four sector circular flow diagram given in Chapter 2, it has been shown that the external sector influences the working of an open economy. Macroeconomic phenomena cannot be confined with a particular economy. On the other hand, open economies react sharply to events that are occurring in the rest of world sector. In order to record the overseas transactions of a country, the BOP accounts are maintained and they constitute an important part of the national income accounts.

The BOP accounts are a summary of international transaction of a country for a given period, that is a financial year. 'The balance of payments 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'[1].

Here, are two questions that need to be answered. They are: who is a resident? What is a economic transaction?

Resident of a country ordinarily includes individuals, business units, government and their agencies. An economic transaction is an exchange of value: a process in which "there is transfer of title to an economic good, the rendering of an economic service from residents of one country to residents of other countries.[2]

Relation between National Income and Balance of Payments

Economic activity usually generates two types of transactions that give rise to international payments and receipts. Firstly, activities arising from production and sale of current output and secondly, those arising from the purchase and sale of existing assets, both real and financial.

Let us consider the first, which is production and sale of current output. In an open economy, the expenditure of consumers, investors and government in addition to the expenditure of foreigners on the country's exports

[1] International Economics, Charles P. Kindleberger Homeward, Illinois, Irwin, p. 457.
[2] ibid

generates the nation's production of goods and services. The income generated by this can be shown in the following expression:

$$Y = C + I + G + X$$

This income is disposed off in the purchase of consumer goods and services (C), savings (S) and taxes (T). Add the goods and services purchased from abroad by the domestic sectors, that is imports (M). Following expression gives the way income is disposed off:

$$Y = C + S + T + M$$

According to national income accounting, income generated must be equal to income disposed off. Therefore,

$$C + I + G + X = C + S + T + M$$

Simplifying this we obtain

$$I + X + G = S + T + M$$

Here I, G and X are *injections* into the income stream and S, T and M are *leakages* there from. So, in equilibrium planned injections must be equal to total planned leakages.

Balance of Trade and Balance of Payments

Balance of Trade takes into account only those transactions arising out of the exports and imports of goods (the visible items). It does not consider the exchange of services rendered such as shipping, insurance and banking, payment of interest and dividend or expenditure by tourists which are also known as invisible items.

Balance of Payments takes into account the exchange of both visible and invisible items. Hence, the balance of payments represents a better picture of a country's economic transactions with the rest of the world than the Balance of Trade.

Structure of Balance of Payment Accounting

The transactions are recorded in the balance of payments accounts in double-entry book keeping.[3] Each international transaction undertaken by the country will result in a credit entry and debit entry of equal size. As international transactions are recorded in double-entry accounting, the BOP accounting must always balance: that is, total amount of debits must equal total amount of credits. Of course, the balancing item Errors and Omissions must be included to 'balance' the BOP accounts. By convention, debit items and credit items are entered with a minus sign and plus sign respectively.

Transactions in BOP are classified into five major categories as given below:

1. Goods and services account
2. Unilateral transfer account
3. Long-term capital account
4. Short-term private capital account
5. Short-term official capital Account

For each of these given categories, specific types of transactions are shown as debits or credits. This is shown in Table 10.1.[4]

[3] Double-entry book keeping is an accounting principle requiring funds that come in to be entered in an account that shows where they came from and also in an account that shows where they are put. Funds that go out are entered in an account that shows what they are spent on and also in an account that shows where they came from.

[4] Dennis R. Appleyard and J. Field Homeward, International Economics, Illinois, Irwin 1992, p. 471.

Table 10.1: Classification on System of Debits and Credits in the Balance of Payments Accounts

Debits (-)	*Credits* (+)
CATEGORY - I	
A. Imports of Goods	A. Exports of Goods
B. Imports of Services	B. Exports of Services
CATEGORY - II	
Unilateral Transfers (Gifts) made	Unilateral transfers (Gifts) received
CATEGORY - III	
A. Increase in long-term foreign assets owned by home country private citizens and government.	A. Decrease in long-term foreign assets owned by home country citizens and government.
B. Decrease in long-term home country assets owned by foreign private citizens and governments.	B. Increase in long-term home country assets owned by foreign private citizens and governments.
CATEGORY - IV	
A. Increase in short-term foreign assets owned by home country private citizens.	A. Decrease in short-term foreign assets owned by home country private citizens.
B. Decrease in short-term home country assets owned by foreign private citizens.	B. Increase in short-term home country assets owned by foreign private citizens.
CATEGORY - V	
A. Increase in short-term foreign assets owned by home country government (official monetary authorities).	A. Decrease in short-term foreign assets owned by home country government (official monetary authorities).
B. Decrease in short-terms home country asset owned by foreign governments (official monetary authorities).	B. Increase in short-term home country asset owned by foreign governments, (official monetary authorities).

Since there are two major categories of accounts in the BOP accounts statement, that is, current and capital accounts, an explanation of current and capital account is in order at this stage to understand their components.

Current Account

The Current Account records imports and exports of goods and services and unilateral transfers. Exports, whether of goods (steel, machinery, rice, etc.) or services (banking services, insurance services, tourism services to foreign tourists in India, etc.) are entered as positive items in the account. This is because exports cause an inflow of foreign exchange into the country. Imports are recorded as negative items in the account because imports cause an outflow of foreign exchange from the country.

1. BOP accounts differentiate between trade in goods and trade in services. The balance of exports and imports of goods is called the *balance of visible trade*, and the balance of exports and imports of services is called the *balance of invisible trade*. The terms are used because goods are visible to the eye but services are invisible to the eye.
2. Unilateral transfers or unrequited transfers are receipts which residents of a country receive, or payments that the residents of a country make without getting anything in return, i.e. receipts or payments for which there is *no quid pro quo*. Receipts from abroad are entered as positive items and payments abroad are entered as negative items.

Private unrequited transfers are gifts that domestic residents receive from or make to foreign residents. An example of this would be Indians in Gulf countries sending back money to their relatives in India. Official unrequited transfers is the receipt of or giving of foreign aid, from developed countries or to developing countries.

The net value of balances of visible trade and of invisible trade and of unilateral transfers is the *balance on current account*.

Capital Account

The Capital Account records all international transactions that involve a resident of the domestic country changing his assets with a foreign resident or his liabilities to a foreign resident. The various forms of capital account transactions are given below.

1. *Private transactions*: These are transactions that are affecting assets or liabilities by individuals, businesses, etc. and other non-government entities. The bulk of foreign investment is private.
2. *Official transactions*: Transactions affecting assets and liabilities by the government and its agencies.
3. *Direct investment*: It is the act of purchasing an asset and at the same time acquiring control of it (other than the ability to re-sell it). An example of such an investment is the acquisition of a firm in one country by a firm in another country. The transfer of funds from the parent company abroad to the subsidiary company in the domestic country so that the subsidiary can acquire assets in the domestic country is another type of direct investment. Such business transactions form the major part of private direct investment overseas. Similar transactions by individuals could be the purchase of a house abroad, etc.
4. *Portfolio investment*: It is the acquisition of an asset that does not

give the purchaser control over the asset. An example of such investment is the purchase of shares in a foreign company or of bonds issued by a foreign government, or loans made to foreign firms or governments.

By convention, the purchase of an asset from another country appears as a negative item on the capital account for the purchasing country (there is outflow of foreign exchange). Thus, capital outflows are awarded a negative sign and capital inflows are awarded a positive sign.

The net value of the balances of direct and portfolio investment is called the *balance on capital account.*

Other items in the Balance of Payments

The remaining items that cannot be categorised into the two preceding categories constitute the other items in the balance of payments. They are included since the full balance of payments account must balance. These items are as follows:

1. *Errors and omissions*: These are to take into account the difficulty of accurately recording all the wide variety of transactions that take place in the accounting period. They may arise due to the presence of sampling of transactions rather than recording each individual transaction (for example instead of recording each of a thousand exports of lemons, they may multiply an average lemon export figure by thousand), due to dishonesty, i.e. businessmen under-reporting sales abroad to avoid taxes, or when smuggling occurs, etc.
2. *Official reserve transactions*: All transactions except those in this category may be termed as *autonomous transactions.* They are so called because they are entered into with some independent motive, i.e. not with a view to bring their consequences on the balance of payments or on the exchange rate. In contrast to this, official reserve transactions are carried out by the government and the central banks in pursuit of some international economic policy objective; while keeping an eye on such transaction's effect on the BOP and the exchange rate. As a result such transactions are not autonomous.

The first of these items is the change in the domestic country's official reserve assets. These reserves of a country are held in the form of foreign currency or foreign currency securities, gold and Special Drawing Rights (SDR) with the IMF. SDR allows a country to avail of foreign exchange in proportion to the quantum of the country's deposit of its currency with the IMF under the SDR scheme. The changes in the country's reserves must reflect the net value of all other items in the BOP. Reduction in these assets will be used to finance expenditures abroad. Reductions appear as a credit item in the BOP (because their sale causes foreign exchange inflow into the country). An increase in these reserves will appear as a debit because purchasing assets

Table 10.1: India's Balance of Payments

Sl. No	*Item*	*1990-91*	*2001-02*
1	Exports	18477	44915
2	Imports	27915	57618
3	Trade Balance	-9438	-12703
4	Invisibles (net)	-242	14054
(i)	Non-factor services	980	4199
(ii)	Investment income	-3752	-2654
(iii)	Private Transfers	2069	12125
(iv)	Official transfers	461	384
5	Current Account	-9680	1351
	Balance		
6	External assistance (net)	2210	1204
7	Commercial borrowing (net)	2248	-1147
8	IMF (net)	1214	0
9	NR deposits (net)	1536	2754
10	Rupee debt service	-1193	-519
11	Foreign investment (net) of which	103	5286
(i)	FDI (net)	97	3266
(ii)	FIIs	0	1505
(iii)	Euro equities & others	6	515
12	Other flows (net)	2284	2828
13	Capital account total (net)	8402	10406
14	Reserve use (-increase)	1278	-11757

Source: Economic Survey, 2002-03, Government of India.

will cause an outflow of foreign exchange.

The second of these transactions is the change in foreign official assets in India. Foreign central banks will hold part of their reserve assets in the form of rupees. If foreign central banks increase the amount of official reserve assets held in India it will appear as a positive item because their purchase of our rupee securities or rupees will cause inflow of foreign exchange into India. The table 10.1 gives the components of India's Balance of Payments and changes over the last decade.

Autonomous and Accommodating Items

In the discussion of these various balances in BOP account, economists use the terms such as *autonomous items*, *accommodating items*, *above the line items* and *below the line items* in the balance of payments. Let us explain their meaning.

Autonomous items in the BOP refer to international economic transactions that take place due to some economic motive such as profit maximization. These transactions are independent of the state of the country's balance of payments. These items are often called *above the line items* in the BOP.

The balance of payments is in deficit if the autonomous receipts are less than autonomous payments. This means that the foreign country has some net claims against the domestic country. The BOP is in surplus if the autonomous receipts are greater than autonomous payments. This means that the domestic country has some net claims against the foreign country.

The monetary authorities may finance a deficit by depleting their reserves of foreign currencies, or by borrowing from the IMF, or by borrowing from foreign monetary authorities. This will be shown as decrease in reserves. The monetary authority may deploy a surplus by purchasing foreign securities, foreign currency or gold. This appears as an increase in reserves.

Accommodating items in the BOP refer to transactions that occur because of other activity in the BOP, such as government financing. Accommodating items are also referred to as *below the line items.* The official settlements are seen as an accommodating item in order to keep the BOP identity. The official settlements approach to the balance of payments looks at the net monetary transfer that has been made by the monetary authorities in settlement. The assumption made in this approach is that the monetary authority is the ultimate financier of any deficit in the balance of payments or the ultimate recipient of any surplus.

Note that the official settlements approach assumes importance in a fixed exchange rate set-up. In a flexible rate set-up, much of the deficit and surplus will be automatically wiped out by an adjustment in the exchange rates, leaving less settlement work for the monetary authorities.

Disequilibrium in Balance of Payments

There are a number of factors that cause disequilibrium in the balance of payments showing either a surplus or deficit. These causes are broadly categorized into (a) Economic factors (b) Political factors and (c) Social factors.

Economic Factors

- Large-scale development expenditure that may cause large imports.
- Cyclical fluctuations in general business activity such as recession or depression.
- High domestic prices may result in imports.
- New sources of supply, new and better substitutes to existing products and changes in costs will bring about a change in trade flows and hence BOP over a period of time.

Political Factors

Political instability may cause large capital outflows and dampen the inflows of foreign capital.

Social Factors

Changes in tastes, preference and fashions may affect imports and exports.

Balance of payments disequilibrium is a serious issue for policy makers. A chronic BOP deficit leads to downgrading the economy in the world community. Domestic sectors also receive the impact of BOP deficit. Hence, the monetary authority of the country concerned and the IMF undertake certain corrective measures to deal with the disequilibrium in the BOP. So, every country in its economic agenda strives hard to perform well in its international trade in order that it will not enter into problems of BOP disequilibrium.

SUMMARY

- Balance of Payment accounts is an integral part of the national income accounts.
- BOP accounts are maintained in a double-entry accounting structure.
- Overall balance of payments is important for economic policy.
- Disequilibrium in the BOP undermines the economic fundamentals of a nation.

EXERCISES

1. Define Balance of Trade and Balance of Payments
2. Explain the five categories of classifying transactions.
3. Give the structure of Balance of Payment Accounts in India.
4. Explain the relationship between Balance of Payments and National income Accounts.
5. Define accommodating and autonomous items.
6. Explain the components of: (a) Current Account, and (b) Capital Account.
7. Describe the causes for disequilibrium in the BOP.