BALANCE OF PAYMENTS (BOP)

FOR REGULATORY EXAMS

Balance of Payments

The Balance of Payments or BoP is a statement or record of international trade and financial transactions made between a country and the rest of the world within a defined period. These records include transactions made by individuals, companies, and the government.

Just as companies/firms are needed to present the Balance Sheet and Cash flow at the end of year, in the same way National Governments need to know their positions with respect to their country's receipts and payments with respect to foreign currency. And this is indicated through the statement named as **Balance of Payment**.

Balance of payment indicates the combined effect of balance of trade along with various other receipts and payments on different accounts from the rest of world countries.

Balance of trade (a part of BoP) indicates the difference between value of imports and exports (Goods & Services) of a country.

The balance of payment is the difference between exports of (goods + services + capital transfers) less the imports of (goods + services + capital transfers).

Types of Balance of Payment Accounts:

1. Balance of Payments Deficit:

It means that the country imports more goods, services, and capital than they export. It must borrow from other countries to pay for its imports.

This is also known as Unfavourable Balance of Payments.

Imports (Goods, Services & Capital Transfers) > Exports (Goods, Services & Capital Transfers)

2. Balance of Payments Surplus:

It means that the country exports more than it imports. It provides enough capital to pay for all domestic production. The country might even lend outside its borders.

This is also known as Favourable Balance of Payments.

Exports (Goods, Services & Capital Transfers) > Imports (Goods, Services & Capital Transfers)

Various Accounts of Balance of Payments:

Balance of payment has the following four forms or accounts:

1. Current account
2. Capital account
3. Unilateral transfer accounts
4. Official reserve accounts

1. Current Accounts:

The current account is a country's trade balance plus net income and direct payments. The trade balance is a country's imports and exports of goods and services. The current account also measures international transfers of capital.

A current account is in balance when the country's residents have enough to fund all purchases in the country.

Current Account = (Visible + Invisible Exports) – (Visible + Invisible Imports)

Items of Current Account

I. Exports and Imports of Visible Goods

All visible and material goods which are exported and imported constitute items of current account.

II. Invisible Items or Non-material Goods or Services

i. Transportation and Travelling Services:

Whenever foreign tourist, businessman, students, or others (for availing health, education, and pleasure benefits) use the domestic transports and travelling facilities, then from the view of BOP it can be named as exports.

In the same way, when nationals of the country use the facilities of foreign transports then it is termed as imports. The difference between the values of transport received and used forms the part of current account within the statement of Balance of payments.

ii. Services of the Experts:

Services of foreign experts are availed by domestic country, in the same way local experts' services will be availed by other countries. The values of services received from abroad are known as imports and value of services rendered by domestic nationals to foreign countries are termed as exports. The difference between the exports and imports of services forms part of balance of payment on current account.

iii. Investment Income and Expenses:

Rent, interest, profit, and dividend are also invisible items of balance of payments. Receiving income from abroad is termed as receipt in foreign currency. In the same way income earned by the foreigners from the country is known as payments in foreign currency. The difference between the foreign income receipts and foreign expense payment also forms part of balance of payment on current account.

iv. Donation and Gifts:

The Donation, gifts etc., are non-compensated transactions, in other words they are unilateral transactions. Hence the receipt of the same from abroad by the natives of nation are termed as receipts and given to other countries are termed as payments. The difference between the donation, gifts receipts from abroad and donation, gifts given to other countries also forms part of balance of payments on current account.

v. Services Rendered by Commercial Undertakings:

The allied trade and commerce firms such as shipping companies, banks, and insurance companies etc., are involved in providing and receiving services within a country and with rest of the countries of world. The difference between the exports and imports of exchange of services like shipping, banking, insurance, etc., forms part of balance of payments on current account.

vi. Government Transactions:

Generally, the Government of every country provides the services of embassies, offices of high commissioners and other missions abroad to maintain the harmonious relationship and spends funds to maintain the offices, and relationship. Such expenditure is termed as payments.

In the same way, the particular domestic country, earns the foreign currency from the government of other country for their offices in domestic country and these are known as receipts. The difference between the payments and receipts of such services forms a part of balance of payments on current account.

vii. Miscellaneous:

The miscellaneous or invisible items such as commission, advertisement, royalties, patent fees, rent, membership fees etc., are provided to abroad and received payments from abroad. On the other hand, the country takes or uses these items and makes payments to rest of world. The difference between the receipts and payments of these invisible services forms part of balance of payments on current accounts.

Items of Current Account

Payment	Receipt
Imports of Goods	Exports of Goods
Import of Services Services of Foreign Experts Services of Foreign Companies	Export of Services Services of Domestic Experts Services of Domestic Commercial Companies
Income to foreigners from investment made in home country.	Income from foreign investments.
Gifts & Donations to Foreigners	Gifts & Donations from Foreign Countries.
Government Expenditure in Foreign Countries	Income from Foreign Government's Expenditure
Payment for domestic use of foreign transportation.	Receipts from transportation services.
Mixed expenditure in foreign countries.	Mixed expenditures by foreigners in home country.
Expenditure by domestic tourists abroad.	Expenditure by foreign tourists in home country.

2. Capital Account:

All types of short-term and long-term international capital transfers, movement of gold and billion metals, receipts and payments of private and government accounts, institutional and private loans, interest, profit, grants etc., form part of capital account. As capital account is concerned with financial transfers, so they have no direct effect on income, output, and employment of the country.

Component of Capital Account:

The principal items or components of capital account are as under:

i. Gold Movement:

Central bank of every country buys and sells gold from home and to abroad. It means that exports and imports of the gold by the central bank which makes the payments and receipts of amount of gold. The amount of gold bought is reflected under "debit side" and sales of gold are reflected under "credit side".

ii. Reserve, Monetary Gold and SDR:

Governments' foreign currency assets, gold reserves of Central bank, SDR of the IMF and other similar capital transactions, etc., are included under "credit items" and the payments on these transactions are reflected under "debit items".

iii. Movement in Banking Capital:

Inflow of banking capital besides central bank is reflected under "credit items" and outflow of banking capital besides central bank is reflected under "debit items".

iv. Private Foreign Loan Flow:

Private sectors of the country received foreign loans from abroad. These receipts of foreign loans are included under "credit items". The private sectors of the country also pays the foreign loans to abroad country, this repayment of foreign loan is included under "debit items".

v. *Official Capital Transactions:*

Public sectors of the country receive foreign loans from International Monetary Fund. These receipts of loans are included under "credit items" and the public sector also pays the loans to International Monetary Fund which is included under "debit items".

vi. Miscellaneous:

Besides the above items, central bank receives other kinds of governmental capital. These types of receipts are also included under "credit side" and the central bank makes the payments for these governmental capitals which are included under "debit side".

Items of Capital Account

Payment	Receipt
Capital Payments	Capital Receipts
Outflow of Banking Capital	Inflow of Banking Capital
Reserves & Monetary Gold Payments	Reserves & Monetary Gold Inflows
Repayment of loans by Government	Loans received by the Government.
Repayment of private loans from foreigners	Foreign Private Loans
Purchase of gold in international markets.	International sale of gold.

3. Unilateral Transfer Account:

This account is somewhat like the capital account, except that it involves capital movements and gifts for which there are no return commitments or claims. Thus, a personal remittance to a resident of a foreign country involves no commitment for repayment and is classified as a unilateral transfer. These unilateral transfers may be on private account or governmental accounts in the form of grants.

4. Official Reserve Transaction Account:

This consists of changes in international reserve assets – those used for setting accounts between government central banks. On account of deficit or surplus emerging out in capital account, current account and unilateral transfers with other countries, the inter-governmental settlements needed to be done regularly.

5. Errors and omissions:

Sometimes the balance of payment does not balance. This imbalance is shown in the BOP as errors and omissions. BOP is compiled using the double entry bookkeeping system consisting assets and liabilities.

Overall balance of payments is calculated as under:

Balance of Payments = Balance of Current Account + Balance of Capital Account + Unilateral Transfer Account + Errors & Omissions

Importance of Balance of Payments (BoP)

i. First, the balance of payment provides detailed information concerning the demand and supply of a country's currency.

ii. Second, a country's balance of payments data may signal its potential as a business partner for the rest of the world. If a country is grappling with a major balance of payments difficulty, it may not be able to expand imports from the outside world.

On the other hand, a country with a significant balance of payments surplus would be more likely to expand imports, offering marketing opportunities for foreign enterprises, and less likely to impose foreign exchange restrictions.

iii. Third, balance of payments data can be used to evaluate the performance of the country in international economic competition. Suppose a country is experiencing trade deficits year after year. This trade data may then signal that the country's domestic industries lack international competitiveness.

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Sources Referred:

- http://www.yourarticlelibrary.com/
- Economic Times
- Wikipedia