Balance of Payments (BOP)

Balance of Payments (BOP)?

- The *Balance of Payments* or *BOP* is a statement or record of all monetary and economic transactions made between a country and the rest of the world within a defined period (*every quarter or year)*.

- These records include *transactions made by individuals, companies and the government* and helps in monitoring the flow of funds to develop the economy

- *BOP* statement of a country indicates whether the country has a s*urplus 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 and if BOP a country's imports are more than its exports, its called BOP deficit

- It is a double entry statement of accounting

Why Important?

The BOP statement is very important for a country, Because

- BOP of a country reveals its *financial and economic status*
- It can be used as *an indicator* to determine whether the *country's currency* value is appreciating or depreciating
- It 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.

Components of BOP

A. *Current Account*

B. *Capital Account*

C. *Financial Account*

A. Current Account

- *Most important* component of BOP, it monitors the flow of funds from goods and services trade *(import and export)* between countries

- Two Parts

1. ***Visible Trade***- *Trade in Goods*, money earned through exports are credited into this account, while payments made for imports are debited. The difference between the totals is known as ***Balance Of Trade***

2. ***Invisible Trade***- *Trade in Services*, The income earned from the sale of Indian services abroad is known as an invisible export, When Indian residents spend money on foreign services, they are creating invisible imports, because payment is going out of India

The main invisibles are- Government Expenditure, Interest, profits and dividends, transportation, tourism, private payments etc

Current Account= Visible trade + Invisible trade

B. Capital Account

- Capital account of BOP records all those *transactions*, between the residents of a country and the rest of the world, which cause a *change in the assets or liabilities* of the residents of the country or its government

- It is related to *claims and liabilities* of financial nature

- The transactions, which lead to *inflow of foreign exchange* (like receipt of loan from abroad, sale of assets or shares in foreign countries, etc.), are recorded on the *credit or positive side* of capital account

- Similarly, transactions, which lead to *outflow of foreign exchange* (like repayment of loans, purchase of assets or shares in foreign countries, etc.), are recorded on the *debit or negative side*

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- The *net value of credit and debit* balances is the balance on capital account.
- Three important elements of Capital Account are,

1. ***Loans & borrowings*** – It includes all types of loans from both the private and public sectors located in foreign countries
2. ***Investments*** – These are funds invested in the corporate stocks by non-residents
3. ***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

- Capital Account is concerned with *financial transfers*. So, it does not have *direct effect on income, output and employment* of the country

C. Financial Account (Official Financing)

- 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 *changes in the foreign ownership* of domestic assets and domestic ownership of foreign assets
- It shows the *balance of monetary movements* into and out of the country
- A *positive figure* reveals a net inflow of funds into a country. Alternatively, a net outflow is represented by a *negative figure*

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- When there is a *negative figure*, the amount has to be paid for either by:

A. *borrowing from other central banks and international organisations, or*

B. *using up reserves which have been saved over the years, or*

C. *borrowing and withdrawing reserves*

- When there is positive figure, then loans can be *repaid and reserves replenished*

The Balancing Act

- The Current Account should be *balanced* against the combined-capital and financial accounts
- However it is difficult to happen
- 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
- A country has a BOP problem when a section of its accounts are in *regular deficit or surplus*. Deficit problems are *more serious* than surplus ones, as surpluses usually result from successful international trading, whilst deficits indicate failure.
- *Persistent imbalances* indicate that the BOP is in *fundamental disequilibrium*. This usually requires the government to undertake ***remedial measures***.