Balance of Payment

Meaning

The balance of payments of a country is a systematic record of all its economic transactions with the outside world in a given year. It is a statistical record of the character and dimensions of the country's economic relationships with the rest of the world. In short, Balance of payment (BoP) is an accounting statement which records economic transactions between Normal Resident of a specific country with the rest of the world.

According to Bo Sodersten, "The balance of payments is merely a way of listing receipts and payments in international transactions for a country".

Accounting Principle of Balance of Payment

The compilation or accounting principle of Balance of Payment is based on two principles as:

1. Residence principle: In compiling the BoP account, it is necessary to distinguish residents of an economy from non-residents. The concept of residence in the system of the balance of payments is not based on the criteria of national identity or the legal criteria for the determination of residents of a particular state. The economic entity (individuals or organizations) is said to be the resident of that country if its center of economic interest falls in the economic territory of that country and has already engaged in economic activities and transactions on a significant scale in that country for one year or more or if that economic unit intends to do so.

2. Double-entry bookkeeping Principle: The balance of payments account of a country is constructed on the principle of double-entry bookkeeping. Each transaction is entered on the credit and debit side of the balance sheet. Thus, the total debit and the total credit of the balance of payments are always equal. Hence it is for this reason that balances of payments for a country must always balance in accounting sense.

3. Principle of the uniform system for valuation of transactions: The third principle of the balance of payments is the principle of the uniform system for valuation of transactions, recorded in the balance of payments. The essence is that market prices that are aligned with economic transactions are used for the evaluation of transactions in real recourses and financial assets and liabilities. The market price refers only to the price for one specific transaction. Compliance with the given principle ensures comparability of the balance of payments in different countries, as well as comparability of accounts of the balance of payments of the particular country.

4. **Principle of timing:** The fourth principle of the balance of payments is the principle of timing. Each transaction should be reflected in the balance of payments on the credit side and on its corresponding debit side at the same time, and both parties of the transaction should record the operation under the same number, which corresponds to the date of its execution.

5. **Principle of unit of account:** During the compilation of the balance of payments, the unit of account should be clearly defined. Accordingly, it should be used the same unit of account used during internal payments and accounting by the country will also be used in the preparation of the balance of payments. However, it is necessary to note that the balance of payments in most countries is kept in U.S. dollars.

Importance of Balance of Payment

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

1. It reveals the economic and financial details of a country.

2. The BOP statement can be an indicator to determine whether the currency of a country is appreciating or depreciating.

3. BOP helps the government on trade and fiscal policies.

4. It provides important information to understand and analyze the economic dealings of one country with the other.

5. The government can formulate appropriate policies to divert the funds and technology imported to the critical sectors of the economy that can drive future growth.

Types of Balance of Payment

Balance of Payment is classified into as:

1. Favourable Balance of Payments: Excess of goods and services exported plus capital transferred to abroad over the goods and services imported and capital transfers from abroad is known as favourable balance of payments

2. Unfavorable balance of payments: An imbalance in a nation's balance of payments in which payments made by the country exceed payments received by the country. This is also termed a balance of payments deficit.

Structure of Balance of Payments

The following are the main components that form the basis of the structure of balance of payments.

1. Current Account: The current account is useful for monitoring inflow and outflow of goods and services. Thus, this account covers all the payments and receipts that are made with respect to manufactured goods and raw materials. Furthermore, it also includes receipts from tourism, engineering, business services, transportation, etc.

There are many categories of trades that occur between the countries. These trades could be visible or invisible. When trades happen in goods between the countries than it is called as visible items. While the trade happening in import or exports of services, is referred to as invisible items.

2. Trade Balances: Trade Balances are the difference between Exports and Imports of visible goods. These items can be touched, seen and measured. It shows whether a nation enjoys surplus or deficit.

3. Capital Account: The capital transactions that occur between the countries are monitored under the capital account. Thus, capital transactions include the sale and purchase of assets like properties. Furthermore, the capital account also includes the flow of taxes, sales and purchases of fixed assets for a migrant moving in or out of the country. The three major elements of the capital account are investments, foreign exchange reserves, and loans and borrowings.

4. Account of Financing: The surplus or deficit on account of current account, capital account and errors or omissions is financed or bridged up through external assistance (loans), gross drawing from the IMF, allocation of SDRs and increase (-) or decline (+) in reserves.

The different components of balance of payments account that form the basis of the structure of balance of payments of India can be shown through the following Table:

TABLE 20.2. Balance of Payments Account of India.

I. Current Account
  1. Exports
  2. Imports
  3. Trade Balance
  4. Invisibles (net)
     A. Services
     B. Income
     C. Transfers
  5. Goods and Services Balance
  6. Current Account Balance

II. Capital Account
  (*i*) External Assistance (net)
  (*ii*) External commercial Borrowings (net)
  (*iii*) Short Term Debt
  (*iv*) Banking Capital (net)
  (*v*) Foreign Investment (net) of which
     A. FDI (net)
     B. Portfolio (net)
  (*vi*) Other Flows (net)

III. Capital Account Balance
  Errors and Omissions

IV. Overall Balance.

V. Reserve [Increase(–) / Decrease (+)]

Disequilibrium of Balance of Payment

When a country's current account is at a deficit or surplus, its balance of payments (BOP) is said to be in disequilibrium. 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.

Types of Disequilibrium of Balance of Payment

Broadly speaking, there are five different types of disequilibrium in the BOP:

1. Cyclical Disequilibrium.
2. Secular Disequilibrium.
3. Structural Disequilibrium.
4. Short run Disequilibrium.
5. Fundamental Disequilibrium

1. Cyclical Disequilibrium: Cyclical Disequilibrium in the BOP arises due to the influences of cyclical fluctuations. Cyclical Disequilibrium in the BOP occur as a result of business cycle/Trade cycle follow different paths and patterns in different countries

2. Secular Disequilibrium: Secular disequilibrium in the balance of payments is a long-term, phenomenon, caused by persistent, deep-rooted dynamic changes that slowly take place in the economy over a long period of time. It may be caused by changes in several dynamic forces or factors such as capital formation, population growth, technological changes etc.

3. Structural Disequilibrium: Structural disequilibrium arises from structural changes occurring in few sectors of the economy at home or abroad which may alter the demand for supply conditions for exports or imports or both. A change in foreign demand for exports can arise from a change in technology, the invention of the cheaper substitute. Structural disequilibrium is caused by changes in technology, tastes and attitude towards foreign investment. Political disturbances, strikes, lockouts, etc., which affect the supply of exports, also cause structural disequilibrium.

4. Short run Disequilibrium: Disequilibrium caused on a temporary basis for a short period, say one year is called short run disequilibrium. Such disequilibrium does not pose a serious threat as it can be overcome within a short run. Such an disequilibrium may be caused due to international borrowing and lending. When a country goes for borrowing or lending it leads to short run disequilibrium. Such disequilibrium is justified as they do not pose a serious threat

5. Fundamental or Long Run Disequilibrium: The term fundamental disequilibrium has been originally used by the I.M.F., to indicate a persistent and long-term disequilibrium in a country's balance of payments. Fundamental disequilibrium is generally caused by dynamic factors and particularly leads to chronic deficit in the balance.

Causes of Disequilibrium in Balance of Payment:

The following are the important causes producing disequilibrium in the balance of payments of a country:

1. Trade Cycles: Cyclical fluctuations, their phases and amplitudes, differences in different countries, generally produce cyclical disequilibrium

2. Huge Developmental and Investment Programmes: Huge development and investment programmes in the developing economies are the root causes of the disequilibrium in the balance of payments of these countries. Their propensity to import goes on increasing for want of capital for rapid industrialisation; while exports may not be boosted up to that extent as these is the primary producing countries.

3. Changing Export Demand: A vast increase in the domestic production of foodstuffs, raw materials, substitute goods, etc. in advanced countries has decreased their need for import from the agrarian underdeveloped countries. Thus, export demand has considerably changed, resulting in structural disequilibrium in these countries.

4. Population Growth: High population growth in poor countries also had adversely affected their balance of payments position. It is easy to see that an increase in population increases the needs of these countries for imports and decreases the capacity to export.

5. Huge External Borrowings: Another reason for a surplus or deficit in the balance of payments arises out of international borrowing and investment. A country may tend to have an adverse balance of payments when it borrows heavily from another country, while the lending country will tend to have a favourable balance and the receiving country will have a deficit balance of payments.

6. Inflation: Owing to rapid economic development, the resulting income and price effects will adversely affect the balance of payments position of a developing country. With an income, the marginal propensity to import being high in these countries, their demand for imported articles will rise.

7. Demonstration Effect: Demonstration effect is another most important factor causing deficit in the balance of payments of a country — especially of an underdeveloped country. When people of underdeveloped nations come into contact with those of advanced countries through economic, political or social relations, there will be a demonstration effect on the consumption pattern of these people and they will desire to have western style goods and pattern of consumption so that their propensity to import increases, whereas their export quantum may remain the same or may even decline with the increase i in income, thus causing an adverse balance of payments for the country.

8. Reciprocal Demands: Since intensity of reciprocal demand for products of different countries differs, terms of trade of a country may be set differently with different countries under multi-trade transactions which may lead to disequilibrium in a way

Measures to Correct Disequilibrium in Balance of Payment

Following are the main methods of Correct Disequilibrium in Balance of Payments:

1. 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.

2. 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 government expenditure may be increased or decreased.

3. 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.

4. Devaluation: devaluation is lowering the exchange value of the official currency. When a country devalues its currency, exports become cheaper and imports become expensive which causes a reduction in the BOP deficit.

5. 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.

6. 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.

7. 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.

8. 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.

9. 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.

Is Balance of Payments Always in Equilibrium?

Balance of payments always balances means that the algebraic sum of the net credit and debit balances of current account, capital account and official settlements account must equal zero.