Balance Of Payments (BoP)

Balance Of Payments

- " The balance of payments of a country is a systematic record of all economic transactions between the residents of one country and residents of foreign countries during a given period of time ."

Components of BoP

- **CURRENT ACCOUNT-** records transactions relating to export and import of goods, services, unilateral transfers and international incomes. Thus, balance on current account is the value of exports minus the value of imports, adjusted for international incomes and net transfers.
- The export and import of goods are called visible items whereas invisible items include shipping, banking, insurance, gifts.

<u>Components of BoP</u>

- **<u>CAPITAL ACCOUNT- </u>** records all international economic transactions relating to change in assets-both financial and physical. It is a record of short term and long term capital transactions, both private and official. These are classifies into two categories-

✓ *Direct foreign investments*

✓ *Portfolio investments*

Structure Of BoP

- Balance of payments is a complete record of Total Receipts and Total Payments of a country in relation to other countries over a given time period. Total Receipts are called CREDIT and Total Payments are termed as DEBIT.
- Credit side comprises of all those values received from foreign countries. On the other hand, Debit side comprises of all the payments made to other countries.
- It is maintained in a double entry book keeping system.

Structure Of BoP

CREDITS	DEBITS
ITEMS OF	**CURRENT ACCOUNT**
▪ Export of Goods	▪ Import of Goods
▪ Exports of Services	▪ Import of Services
▪ Unilateral Transfer Receipts (gifts, indemnities from foreigners).	▪ Unilateral Transfer Payments (gifts, indemnities to foreigners).
▪ Income receipts.	▪ Income Payments
ITEMS OF	**CAPITAL ACCOUNT**
▪ Capital Receipts (borrowings from capital repayments by or sale of assets to foreigners).	▪ Capital Payments (lending to, capital repayments to or purchase of assets from foreigners).

Categories Of BoP

- **BALANCE OF TRADE-**

Balance of Trade= Export of goods- Import of goods.

- **BALANCE OF CURRENT ACCOUNT-**

Balance of Current Account= Balance of Trade+ Balance of Invisibles+ Balance of Transfers.

- **BALANCE OF CAPITAL ACCOUNT-**

Balance of Capital Account= Capital Receipts- Capital Payments

<u>DISEQUILIBRIUM IN BOP</u>

- A disequilibrium in the balance of payments may appear either as a surplus or as a deficit.

✓ **A <u>Surplus</u> in the BOP** occurs when Total Receipts exceeds Total Payments. Thus,

BOP= CREDIT>DEBIT

✓ **A <u>Deficit</u> in the BOP** occurs when Total Payments exceeds Total Receipts. Thus,

BOP= CREDIT<DEBIT

Causes of deficit in the Balance of Payments

- ✓ Fall In Export Demand
- ✓ Growth Of Population
- ✓ Change in foreign Exchange Rate
- ✓ Huge International Borrowings
- ✓ Developmental Expenditures
- ✓ Demonstration Effect

Population Growth - A Cause of Disequilibrium in BOP

Measures To Correct Disequilibrium in the BOP

Monetary measures

- **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 become cheaper. It also leads to inflationary trends in the country.

- **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.

Measures To Correct Disequilibrium in the BOP

- **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.

- **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.

Measures To Correct Disequilibrium in the BOP

Non- Monetary measures

- **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.

- **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.

Measures To Correct Disequilibrium in the BOP

- **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.

Exchange Rate

- Exchange Rate refers to the rate at which the currencies of different countries are traded. Foreign Exchange is any currency issued by a foreign government.
- It is done mainly through commercial banks which act as clearing houses by buying and selling foreign currencies.

Exchange Rate Systems

- **Fixed Exchange Rate System**

  In a fixed exchange rate system, the rate of exchange is fixed by the central bank of the country by official action, the country's central bank stands ready to buy and sell its currency at a fixed price in terms of some other currency. Under this, authority for devaluation or revaluation of currency rests with government of the country.

- **Flexible Exchange Rate System**

  In a flexible exchange rate system, exchange rate is left free to be determined in the foreign exchange market by the forces of demand and supply. In this, central bank allows the exchange rate to adjust to equate the supply and demand for foreign exchange.

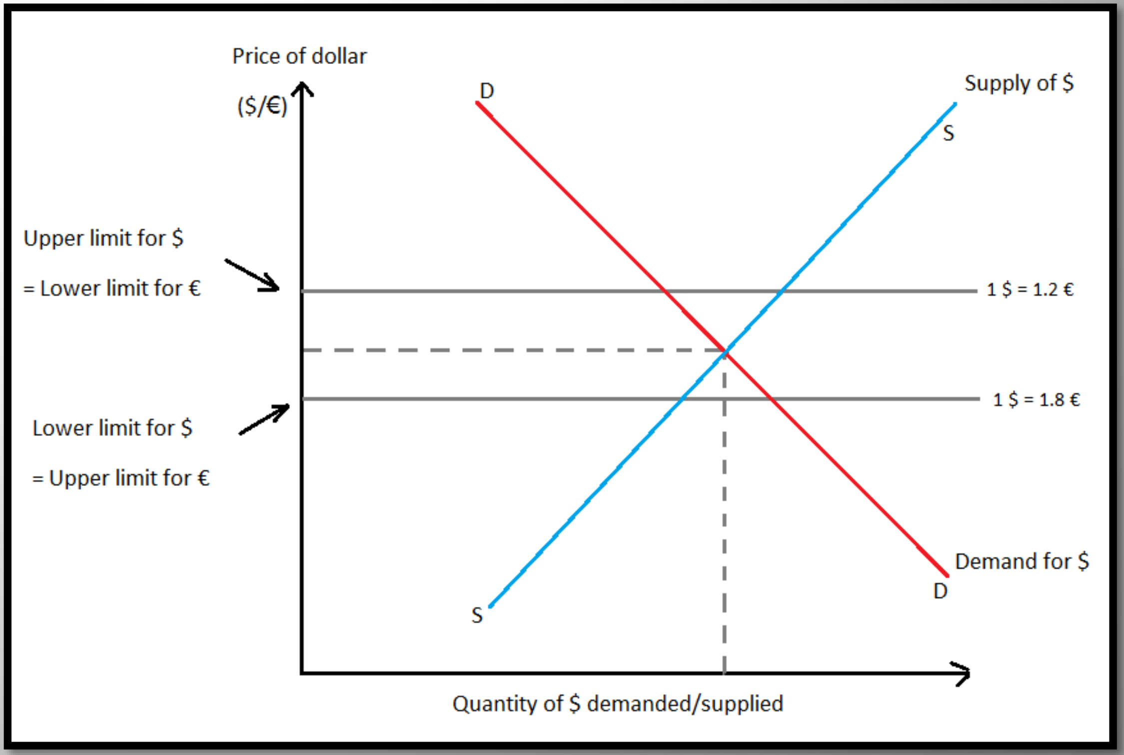
Types of Exchange Rate Systems

- Based on the level of intervention by the central bank of the country in maintaining currency value, exchange rate regimes can be classified into:

- ✓ **FIXED RATE**
- ✓ **HARD PEG**
- ✓ **ADJUSTABLE PEG**
- ✓ **SOFT PEG**
- ✓ **LOW FREQUENCY PEGGING**

Equilibrium Rate of Exchange

- Equilibrium rate of exchange is determined at that level where demand curve of foreign exchange is equal to supply curve of foreign exchange. In the figure, the determination of foreign exchange rate has been illustrated.



Determination of Exchange Rate System

- **Gold Standard System:** when the gold content of currencies is considered to determine the value the currencies of countries, it is referred as mint par exchange. The actual exchange rate is equal to the mint par of exchange and addition/subtraction of bank commission.
- **Paper Currency System:** under this system, determination of the exchange rate usually takes into account the purchasing power of a national currency. Purchasing power depends on the price level in the country and fluctuates with the change in price level.

Determinants of Exchange Rates

- Exchange Rates are determined by the demand for and the supply of currencies on the foreign exchange market.

The demand and supply of currencies is determined by:-

- ✓ relative interest rates
- ✓ demand for imports
- ✓ demand for exports
- ✓ investment opportunities
- ✓ speculative sentiments
- ✓ global trading patterns
- ✓ changes in relative inflation rates

India's Balance of Payments

- **The crisis of the early 1990s**

✓ The 1990s saw some major changes in India's BoP position. In the beginning of the 1990s, the country witnessed a major crisis in BoP.

✓ India responded to the crisis by introducing a host reforms which had a significant bearing on the BoP front. The rupee was decontrolled substantially, foreign portfolio investments were welcomed as never before and Indian companies were allowed to raise capital from the international capital markets.

✓ India's foreign trade expanded as tariff and non-tariff barriers to trade were reduced. India faced BoP crisis due to significant increase in international oil prices, a sharp downturn in international equity prices.

THANKYOU