Balance of Payment (BOP)

[UPSC Notes]

What is the Balance of Payment?

A Balance of Payment is a summary record of all economic transactions between residents of one country and the rest of the world during a fixed time period.

- It is classified as records of all receipts on account of goods exported, services returned, and capital received by residents, and payments made by them on account of goods imported, services received, and capital transferred to foreigners.
- Balance of Payment is defined as - ‘the balance of international payment’. It is an organized record or statement of all money-based transactions of one country with the rest of the world in a particular period which is normally one year.
- BPO is an indicator that shows if a country has excess or shortage in trade. Excess exports than imports indicate a trade surplus and when imports exceed export, it indicates a trade deficit.

Types of Balance of Payment

There are two types of Balance of Payment-

1) Current Account

- A Current Account refers to an account that records the export and import of goods and services.
- The current account is maintained by the Reserve Bank of India on the behalf of the government.
- All transactions related to export and import are shown as either inflow or outflow (credit/debit) at the end of the year current account might be positive or negative. The positive one is known as Current Account Surplus (CAS), and the negative one is known as Current Account Deficit (CAD).

(Note- If a country has both deficits, Current Account Deficit (CAD) as well as Fiscal Deficit (FD), then we can say that the country is suffering from Twin Deficit.)

Causes of Current Account Deficit -

- Expansion of import
- The slow growth of export
- Huge import of gold
- Huge import of crude oil
- Largely export of Agro product

Financing of Current Account Deficit-

- Control import.
- Increase export by improving competitiveness.
- Redefining fiscal policy that is rationalized the tax system and reduces public spending.
- By Monetary policy, the interest rates should be revised.
- Increase in foreign borrowing investment, especially FDI (Foreign Direct Investment).

Consequences of Current Account Deficit -

In the short term, it is helpful to deter foreign investors willing to pump capital that leads to economic growth. In the long run, it saps economic vitality as foreign investor question whether economic growth will provide enough return to their capital because-

- Demand weakens the country's assets, including country government bonds.
- The national currency loses value relative to other currencies as foreigners withdraw funds.

Filling Current Account Deficit With Foreign Exchange Reserves-

In case of a Current Account Deficit, Central Bank can attempt to affect the exchange rate directly or indirectly.

- Directly- by selling or buying foreign exchange reserves
- Indirectly- by monetary policy that increases or decreases the interest rate.

When the sum of the country's current account and the capital account is equal to zero, then the country is said to be in an equilibrium situation of the Balance of Payment.

2) Capital Account

A capital account is a summary of capital expenditure and capital income of a country with the rest of the world.

Maintained by the Reserve Bank of India on behalf of the government.

Generally, there is no deficit or surplus in Capital Account like in the Current Account.

Key Points of Balance of Payment

Here are some key points regarding the Balance of Payment:

- A Powerful BOP: If Exports exceed Imports, then the BOP is going to get powerful. In July 2020, the exports were at a 91% level of July 2019 figures. At the same time, the Imports are yet at 70- 71% of July 2019.
- Trade Surplus- June 2020: After a long period of 18 years, India has finally shifted the surplus as imports fell by 47.59% in June 2020, as matched with June 2019.
- Uplifting Domestic Manufacturing: Steps are being taken by the government to support and encourage industry and domestic manufacturing. It has raised restrictions on imports of goods and services because of the ‘Atmanirbhar’ enterprise. It also examined all Free Trade Agreements (FTA) and discovered them mostly asymmetrically.

- Mode of Manufacture: The firms investing in the country were ordered to stop having an "Assembly Workshop" by the government. The workshop was typically characterized as Indian manufacturing.

Reasons for Calculating BOP

Following are some reasons for the calculation of BOP:

- It discloses the economic and financial status of a country.
- It also acts as an indicator that helps to analyze whether a country is facing a trade surplus or trade deficit.
- It helps the government to make decisions on trade and fiscal policies.
- The Balance of Payment also helps to determine the financial relationship between one country with other countries by providing important details.

Components of Balance Of Payment

Components of BOP are as follows:

- Monetary transactions between one country and every other country in the world are gathered together under the capital account, current account, and errors and omissions for the preparation of BOP accounts. Any changes in foreign exchange reserves are also shown here.
- Capital account: It displays the country's capital income and expenditure. Foreign Direct Investment, External Commercial Borrowing, Foreign Portfolio Investment, etc. also has a role in the capital account.
- Current Account: It displays the import and export of visible and invisible items. Visible items include goods, and they are also called merchandise items. Invisible items include transfers, services, income, etc. and they are referred to as non-merchandise items.
- Errors and Omissions: Every so often, the Balance of Payment is not steady or imbalanced. This imbalanced situation is displayed in the BOP as errors and omissions. It mirrors the country's lack of ability to consider all global monetary dealings or international money transactions precisely or without any sort of errors.
- Changes in Foreign Exchange Reserves: Changes in the assets of a foreign currency include variations in the reserves controlled by the Special Drawing Rights(SDR) and also the Reserve Bank of India (RBI).
- Altogether the Balance the Payment account can be a surplus or a deficit. Excess of exports over imports indicate a trade surplus and when imports exceed export, it indicates a trade deficit. If a deficit situation occurs, then that situation can be resolved by taking money from the Foreign Exchange Account.
- A BOP crisis occurs when we observe a scenario in which the reserves in the Foreign Exchange Account fail to meet its expectations.

Calculation of Balance of Payment

The overall Balance of Payment is indicated by the total sum of the current account and capital account, which may be in surplus or in deficit.
The Balance of Payment is equal to the sum of the net credit in the current account, capital account, and financial account.

BOP = Net credit in (Current Account + Capital Account + Financial Account).

BOP Surplus

- The surplus of the Balance of Payment is the situation where the country's export of goods is more as compared with the import of the goods by the country.

BOP Crisis

- A Balance of Payment crisis is a situation where the imports of the country's goods are more as compared to the export of the country's goods.
- India faced a Balance of Payment (BOP) crisis in the 1990s when its foreign exchange reserve fell to an all-time low of only 5.8 billion dollars which was enough to import for a fortnight only.
- Such a crisis leads to take help from the International Monetary Fund (IMF), which has proposed some conditions to reform the economy of the country.
- The new economic policy in 1991 was introduced in the backdrop of the Balance of Payment (BOP) crisis which has provisions like- economic openness, ending Licence Raj, and decreasing the frontier of the state where the private sector has the ability, willingness, and expertise.

Balance Of Payment: Important Points to Note

Balance of Payment statistics was enumerated by the Reserve Bank of India.

- It releases Balance of Payment (BOP) statistics in two separate sheets of accounts, that is, the current account and capital account.
- A capital account contains all transactions which either increase or decrease government liabilities or assets.
- Investment in the country in the form of foreign direct investment (FDI), such as investment by South Korean companies such as Samsung, foreign portfolio investment (FPI), and deposits of Non-Resident Indians, falls under the capital account of the Balance of Payment.
- Transactions of goods, services like banking services, tourism, and invisible goods (buying of goods by tourists or utilizing services) come under the current account of the Balance of Payment.

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