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Subject: Management

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Paper: **12, Business Environment**

Module: **24, Balance of Payments**

ज्ञान-विज्ञान विमुक्तये

ePathshala पाठशाला

MHRD Govt. of India

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Items	Description of Module
Subject Name	Management
Paper Name	Business Environment
Module Title	Balance of Payments
Module Id	Module no.-24
Pre Requisites	Basic knowledge of what International Trade is.
Objectives	To study the basic Components of Balance of Payments
Keywords	Balance of Payments, Balance of Trade, Current Account, Capital Account.

QUADRANT-I

1. Module 24 : Balance of Payments
2. Meaning of Balance of Payments
3. Importance of Balance of Payments
4. Factors affecting Balance of Payments
5. Components of Balance of Payments
5.1 Current Account and its components
5.2 Capital Account and its components
5.3 Change in official international Reserve Account
6. India's External sector developments in 2014-15
7. Difference between Balance of Trade and Balance of Payments
8. Difference between Balance of Trade and Current Account
9. Summary

Learning Outcome:

After completing this module the students will be able to:

- Define the Concepts of Balance of Payments.
- Understand the Components of Balance of Payments.
- Understand the difference between Balance of Payments and Balance of Trade.
- Examine the India's Balance of Payments Position

1. Introduction

In the contemporary world, International trade is the backbone of every economy. No economy in the world remains cut off from the rest of world. International trade among different countries involves transactions related to the exchange of capital, goods & services across international borders and territories resulted in inflow and outflow of foreign exchange. So there is need to make a systematic record of economic transactions between different nations in order to know the net position of foreign exchange at a given point of time. Balance of payment serves the said purpose by making a record of all monetary transactions with other countries.

2. Meaning of Balance of Payments

The balance of payments is a book keeping system for recording all payments that have a direct bearing on the movement of funds between a nation (private sector and government) and foreign

countries. Balance of payments records balance of visible trade, balance of invisible trade or services and capital transfers among different countries. All transactions resulted in inflow of foreign exchange credited in the account while the transactions resulted in outflow of foreign exchange debited with negative sign in the account.
Thus the difference in the Balance of Payments account will show three positions (a) Balanced (b) Favourable (c) Unfavourable.

(a) Balanced Balance of Payments = Inflow of foreign Exchange = Outflow of foreign Exchange
(b) Favourable Balance of Payments = Inflow of foreign Exchange > Outflow of foreign Exchange
(c) Unfavourable Balance of Payments = Outflow of foreign Exchange > Inflow of foreign Exchange

2.1 Definition of Balance of Payments

2.1.1 In the words of **C. B. Kindleberger;** *"The balance of payments of a country is a systematic record of all economic transactions between the residents of the reporting and the residents of the foreign countries during a given period of time."*

2.1.2 *"Balance of payments is a statistical statement that subsequently summarises, for a specific time period, the economic transactions of an economy with the rest of the world."*

-The International Monetary Fund

2.1.3 "*Balance of payments is a record of a country's international transactions with the rest of the world".*

- Organisation for Economic Co-operation & Development

In other words, Balance of Payments shows how money is spent abroad and how money is received domestically.

2.2 Features of Balance of Payments

- **Double entry system:** Receipts and payments record is maintained on the basis of double entry system.
- **Systematic Record**: Balance of payments records systematically all economic transactions related to goods, services and capital transfers.
- **Comprehensive:** Balance of Payments consists of three main parts: Current Account, Capital Account and Official reserves settlement balance.
- **Specified period of time**: Balance of Payments records transactions that occur within given year.
- **All Transactions**: Balance of Payments records transactions of Government agencies as well as business sector with rest of the world.

3. Importance of Balance of Payments

- Balance of Payments truly gauges the international solvency position of reporting country.
- In the context of developing nations, balance of payments shows the extent of country dependence on the financial assistance provided by developed nations.
- The economic dealings fall under Balance of Payments would create demand and supply of different currencies.
- Balance of Payments helpful in determining the exchange rate of country's currency with other currencies. The surplus in Balance of Payments results into addition to foreign reserves which would create the demand for Indian currency that ultimately leads to the appreciation of INR.

  Similarly, there would be the depletion of foreign reserves on account of the deficit in Balance of Payments that would create demand for US dollar leads to depreciation of INR.
- Favorable and adverse trends in Balance of Payments position affects the formulation of monetary policy, fiscal policy, foreign trade policy etc. of the country.

4. Factors affecting Balance of Payments

The balance of payments showcases the country's economic performance and dependence on other countries which is influenced by innumerable factors. Some of the most influencing factors are discussed as follows:

- **Trade barriers:** Trade barriers significantly affect the imports and exports of a country. Higher the trade barriers imposed by the foreign country against exporting country, lower will be the demand for goods and services supplied by exporting country. The external trade policy of the foreign nation to restrict imports and subsidize export would change the prices of goods and services produced in the domestic country that make the import and export more or less attractive to the domestic economy.

- **Inflation rate:** The inflation rate in the domestic economy as against other economies affects the trade performance and international competitiveness of domestic goods and services. Higher inflation rate in the domestic country would result in the decline in exports on account of lower demand for domestic goods and services. On the other hand, it would also increase the demand for imported goods which are relatively cheaper than domestically produced.

- **Exchange rate:** The value of a domestic country currency relative to other currencies also affect the balance of payments position. The lower value of the domestic currency would facilitate the settlement of export transactions at a lower international price that ultimately increases the demand for goods and services of exporting country. On the other hand, it may also affect negatively and make the imports dearer for the domestic country.

- **Income of foreigners:** It is well-known fact that as the income increases the consumption level (expenditure on goods and services) also increases leading to greater imports. Thus, the increase in the standard of living and income level of residents of an overseas country to whom the domestic country is going to export goods and services positively affects the balance of payments position of exporting country.

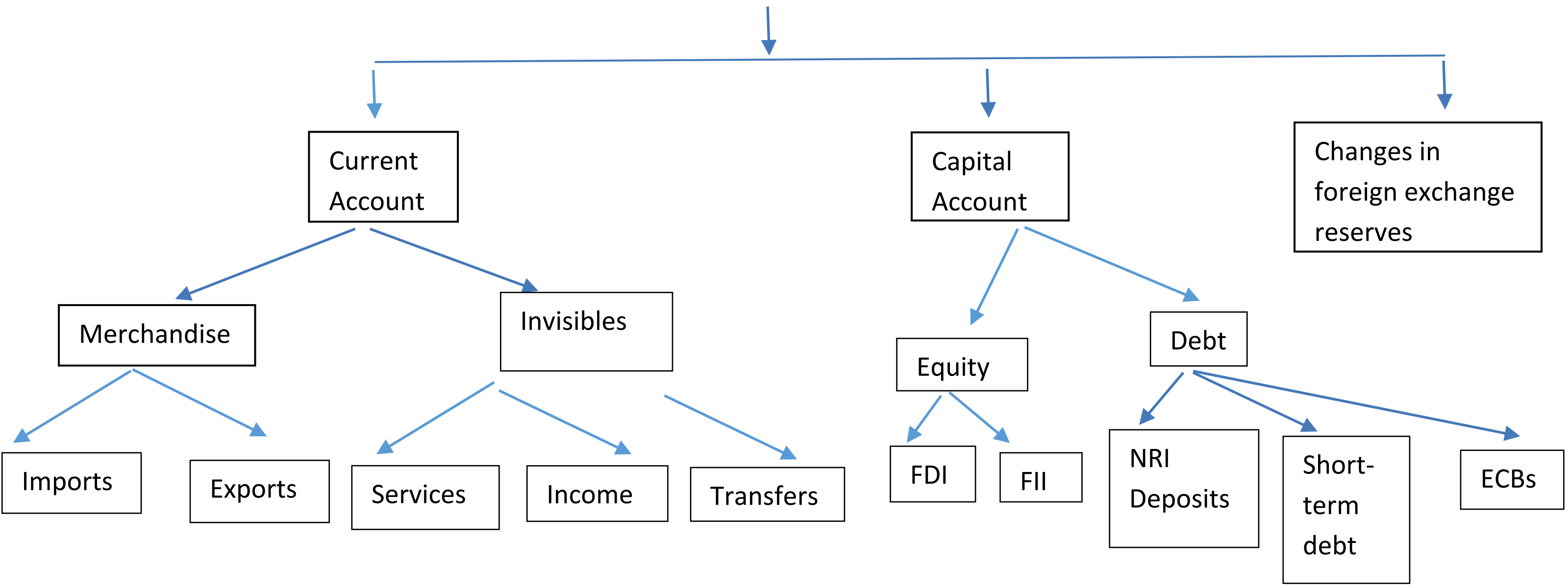
- **National Income**: Higher imports of goods and services can be experienced in a situation when the income level (National Income) of domestic country increases. The importing country will face unfavourable balance of payments position which reflects an increased demand for foreign goods and services.

- **Government policies:** The domestic country's Government policies such as the export promotion or import substitution have a significant effect on its Balance of payment position. The domestic firms can produce goods and services at a relatively lower price than the global competitors as the Government offer subsidies to them. The lower price charged from overseas economies enables the domestic country to capture a larger share of the global market. On the other hand, if the Government restrict import by imposing taxes and fixing quota of imported goods, the prices of foreign goods would increase resulting in higher demand for domestically produced goods and services. This leads to the favourable balance of payments position of the domestic country.

- **Developmental activities:** There has been a substantial increase in import expenditure on petroleum products for expanding industrial and transport sectors. To meet the requirements of capital goods such as machines, electrical equipment, metals and transport equipment etc. developing countries depend on developed nations. All these developmental activities results into the huge outflow of domestic currency and demand of foreign currency for making import payments leads to the deficit in balance of payment account of developing economies.

  Other factors affecting country's balance of payments position include the cost of production of goods and services at home and abroad, cyclical fluctuations, political disturbance etc.

Major components of Balance of Payments



5.1 Current Account

Current Account of the balance of payments contains the record of receipts and payments of transactions related to trade in goods and services, investment incomes and transfers during a given period of time. The current account is calculated by adding the balance of merchandise trade (Goods), the balance of trade in services, net investment incomes and unilateral transfers.

Current account = Trade balances + Net Services + Net Investment Income + Net Transfers

The main components of Current Account include: (i) Balance of Trade (ii) Balance of Invisibles Trade (iii) Unilateral Transfers (iv) Net Income which are explained as follows:

5.1.1 Balance of Trade

In the words of **Benham,** *"Balance of trade of a country is the relation over a period between the values of its exports and imports of physical goods".*

Balance of trade = Visible Exports – Visible Imports

Balance of Trade is also known as the ***Balance of Visible Trade*** *or* ***Balance of Merchandise Trade*** *or* ***Trade balance.*** Trade balance is the prominent constituent of current account that is calculated by deducting total imports of goods from the total exports of goods.
Balance of Trade can be favourable or unfavourable
(a) If merchandise import payments are more than exports receipts, then the country has a trade deficit.
(b) If merchandise exports receipts are more than import payments, then the country has a trade surplus.

5.1.2 Balance of Invisible Trade (services)

Services mainly include travel & tourism, transportation, royalties, construction, communication, banking, insurance, professional and other services. Balance of trade in services is measured by deducting import payments of services availed from other countries from the export receipts of services availed by rest of the world.

Net services = Export – Import of services

5.1.3 Transfers (private and official)

Transfers represent one-sided transactions without any consideration that cover both private and official transfers. Private transfers mainly include gifts, donations, grants, personal remittances by migrants, repatriation of savings etc. Official transfers represent grants, donations and other assistance received or given by the Government from bilateral and multilateral institutions. Net transfer is stated by the difference in receipts from and payments made to rest of the world on account of unilateral transfers.

5.1.4 Net Investment Income

Net investment income includes income in the form of interest, dividend and profits for servicing of the foreign capital transaction. Investment income receipts comprise interest received on loans to Non-resident, dividend & profit received on foreign investment and reinvested earnings etc. while the Investment income payments include payment of interest on debentures and Non-resident deposits, dividend & profit to Non- resident shareholders etc.

Current Account Balance can be named as current account deficit (CAD) or current account surplus.
(a) If the receipts on account of export of goods, services, transfers and investment income are more than payments made for import of goods, services, transfers and investment income then the country has **Current Account Surplus**.

(b) On the other hand **Current Account Deficit (CAD)** arises when payments made for import of goods, services, transfers and investment income are more than the export receipts of goods, services, transfers and investment income.

5.2 Capital Account

If a country faces Current account deficit (CAD) then there is need to boost foreign capital into the country. Capital account is an account which records all foreign currency that flows into the home country and domestic currency that flows into a foreign nation in the form of capital investments. Thus the capital account describes the flow of capital between the domestic country and foreign countries.

Capital Account = Net Foreign Direct Investment + Foreign Portfolio Investment + Banking Capital and Loans + ECB & Trade credits

The main components of capital account include: a) External assistance b) External Commercial Borrowings c) Short term debt d) Banking Capital e) Foreign Investment f) other capital which are explained as follows:

a) External assistance: External assistance refers to financial aid or loan given by India to foreign Governments and loans extend by foreign Governments to India under various agreements and repayment of such loans.

b) External commercial borrowings (ECBs): External commercial borrowings (ECB) is another important constituent of capital account which is relatively less fickle than foreign investment. ECB refers to money borrowed from abroad by Indian corporate in the form of medium/long term loans, commercial paper, bonds, credit, notes etc.

c) Short term debt: *"Short term credit is defined as the drawls in respect of loans utilized and repayments with a maturity of less than one year."* **- RBI**

d) Banking capital: It comprises foreign assets and liabilities of commercial banks in the form of foreign currency holdings, Non-resident deposits, other than non-resident deposits, movement in balances of foreign central banks and international institutions like IBRD, IDA, ADB, IFC, IFAD, etc., maintained with RBI.

e) Foreign investment: Foreign direct investment (FDI) and portfolio investment are important building block under the capital account of the balance of payments.

"FDI refers to an investment made to acquire lasting or long term interest in enterprises operating outside of the economy of the investor."

"Portfolio investment is defined as cross-border transactions and positions involving equity or debt securities, other than those included in direct investment or reserve assets."

- International Monetary Fund (IMF)

(e) **Other items in capital account**: "Other capital comprises mainly the leads and lags in export receipts, funds held abroad, India's subscription to international institutions, quota payments to IMF, remittances towards recouping the losses of branches/subsidiaries and residual item of other capital transaction not included elsewhere." **- RBI**

5.3 Changes in Official International Reserve Account

According to RBI, "Movement in reserves records the changes in the foreign currency assets held by the RBI and SDR balances held by the Government of India." Official reserve change is calculated by adding current account balance and capital account balance i.e.

Official Reserve change = Current account balance + Capital account balance

Foreign exchange reserves are not part of the balance of payment, only the 'change in reserves' is reported in Balance of Payments.

Current account balance + Capital account balance + Reserve balance = Balance of Payments

6. India's External sector developments in 2014-15

The salient features of India's external sector developments in 2014-15 are summarized below:

i. Merchandise exports and Merchandise imports declined by 0.6 % and 1% respectively in 2014-15 as compared to 2013-14 due to declining Petroleum Oil Lubricants exports and imports.

ii. The trade deficit was 7.1% of GDP in 2014-15, the lowest since 2006-07.

iii. Net services exports (US$76.6 billion) raised by 4.7% which acts as a cushion to shrink the size of trade deficit.

iv. Net private transfers mostly in the form of remittances increased marginally by US$ 0.4 billion in 2014-15 on account of restrained global growth and falling crude oil prices.

v. Interfusion of lower trade deficit with moderate growth of 2.5% in the invisibles surplus resulted in lower Current Account Deficit of only 1.3 % of GDP in 2014-15 as compared to 1.7% of GDP in 2013-14.

vi. There was 64% surge in net foreign investment during 2014-15.

- Net FDI (FDI into India - outward FDI) reached an all-time high of US$31.3 billion in 2014-15.
- Net portfolio investment also reached their highest level so far of US$42.2 billion in 2014-15 (US$32.4 billion in 2009- 10).

vii. Net capital flows in 2014-15 were at their second highest level at US$88.2 billion which were 4.3% of GDP as compared to 2.6 % of GDP in 2013-14.

ix. There was high accumulation of US$61.4 billion in foreign exchange reserves in 2014-15 which was about 4 times of foreign exchange reserves in 2013-14 (US$ 15.5 billion).

7. Balance of Trade vs. Balance of Payments

(i) Balance of Trade is a narrow concept and part of Balance of Payments whereas Balance of Payments is a broader term.

(ii) Balance of Payments includes current account, capital account and change in official foreign exchange reserve whereas Balance of Trade is a component of the current account.

(iii) Balance of Trade deals with import and export of goods only. Balance of Payments takes into consideration all items mainly goods, services and capital account transactions.

Balance of Trade = Exports of Goods – Imports of Goods

Balance of Payments = (Exports of Goods+ Export of Services + Capital Receipts) – (Imports of Goods + Import of Services + Capital Payments)

(iv) The deficit of Balance of Trade can be met by Balance of Payments but deficit of Balance of Payments cannot be met by Balance of Trade.

(v) Balance of Payments is a true indicator of the economic performance of an economy and more significant than the balance of trade. Balance of Payments has a greater impact on country national income, employment etc.

(vi) Balance of Trade does not record transactions of capital nature whereas Balance of Payments includes balance of trade, balance of services, balance of Unilateral Transfers and balance of capital transactions.

(vii) Even if Balance of Trade is unfavourable, Balance of Payments can be favourable on account of more receipts on invisibles and capital accounts.
Similarly, even if Balance of Trade is favourable, Balance of Payments can be unfavourable on account of fewer receipts on capital account and invisibles.

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8. Balance of Trade vs. Current Account

(i) The trade balance is the amount a country receives for the export of goods and services minus the amount it pays for its import of goods and services. The current account is the trade balance plus the net amount received for domestically-owned factors of production used abroad.

Balance of trade = Visible Exports – Visible Imports

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

(ii) Trade balance is a narrow concept. Current account is a broader term and includes balance of trade.

(iii) Balance of trade does not take into account services which are invisible in nature whereas Current account manages transactions related to trade in goods and services.

India's Current Account performance as per Economic Survey 2015-16

Table 1 summarizes the India's Current account and its component (US$ billion)

		2011-12	2012-13	2013-14	2014-15 (PR)	2014-15 H1 (Apr-Sept 2014) (PR)	2015-16 H1 (Apr-Sept 2015) (P)
I	**Current Account**						
i	Exports	309.8	306.6	318.6	316.5	164.6	135.6
ii	Imports	499.5	502.2	466.2	461.5	239.4	207.2
iii	Trade Balance	-189.8	-195.7	-147.6	-144.9	-74.7	-71.6
iv	Invisibles (net)	111.6	107.5	115.2	118.1	56.3	57.2
	A. Services	64.1	64.9	73.0	76.6	36.5	35.3
	B. Transfers	63.5	64.0	65.3	65.7	32.8	32.4
	C. Income	-16.0	-21.5	-23.0	-24.1	-13.0	-10.5
	Current Account Balance	-78.2	-88.2	-32.4	-26.8	-18.4	-14.4

Source: RBI
Notes: PR: Partially Revised ; P : Provisional

I. Current Account Developments in HI of 2015-16 (Apr- Sept 2015)

During the H1 of 2015-16 a remarkable improvement was seen in the contraction of Current Account Deficit (CAD). The CAD was reported at US$ 14.4 billion in H1 of 2015-16 as against US$ 18.4billion in H1 of 2014-15.

i) Merchandise exports (on BoP basis) stood at US$ 135.6 billion which was declined by 17.6 per cent in H1 of 2015- 16. The major reason for the overall decline in exports was decline in POL (Petroleum Oil Lubricants) exports. POL exports declined by 50 % in H1 of 2015- 16 on account of a fall in the international prices of petroleum crude products.

ii) Merchandise imports stood at US$ 207.2 billion which was declined by 13.4 per cent in H1 of 2015-16 on account of lower levels of POL imports resulted into decline in total imports.

iii) As a result of decline in both exports and imports, during the first half of 2014-15 **trade deficit** fell from US$74.7 billion (7.5 % of GDP) to US$71.6 billion (7.2 % of GDP) in the first half of 2015-16.

iv) **Net invisible account** that covers services, transfers, and income has increased marginally by around US$1.0 billion to US$57.2 billion in the first half of 2015-16 as compared to the first half of 2014-15.

A. **Net services** declined to US$35.3 billion in H1 of 2015-16 as against US$36.5 billion in H1 of 2014-15, mainly due to lower growth of services exports than that of services imports.

B. During the first half of 2015-16, **net private transfers** declined marginally to US$32.7 billion as compared to US$33.1 billion in the corresponding period of the previous year.

C. **Net income**, which is the net outgo on account of the interest/dividend of the stock of capital flows that have come to India. During the first half of 2015-16, it moderated to US$10.5 billion as against US$13.0 billion in the first half of 2014-15.

Moderate growth in the invisibles surplus, coupled with lower trade deficit, resulted in lower **Current Account deficit (CAD)** of US$14.4 billion (1.4 % of GDP) in H1 of 2015-16 as compared to US$ 18.4 billion (1.9 % of GDP) in HI of 2014-15.

India's Capital Account performance as per Economic Survey 2015-16

Table 2 summarizes the India's Capital account and its component (US$ billion)

		2011-12	2012-13	2013-14	2014-15 (PR)	2014-15 H1 (Apr-Sept 2014) (PR)	2015-16 H1 (Apr-Sept 2015) (P)
II	**Capital Account**						
i	External Assistance	2.3	1.0	1.0	1.7	0.7	0.2
ii	ECBs	10.3	8.5	11.8	1.6	0.8	-0.9
iii	Short-term Debt	6.7	21.7	-5.0	-0.1	-1.4	-1.2
iv	Banking Capital of which:	16.2	16.6	25.4	11.6	-0.5	18.3
	Non-Resident Deposits	11.9	14.8	38.9	14.1	6.5	10.1
v.	Foreign Investment	39.2	46.7	26.4	73.5	37.3	7.9
	A. FDI	22.1	19.8	21.6	31.3	15.1	16.7
	B. Portfolio Investment	17.2	26.9	4.8	42.2	22.2	-8.7
vi.	Other Flows	-7.0	-5.1	-10.8	1.0	-0.4	1.0
	Capital Account Balance	67.8	89.3	48.8	89.3	36.4	25.4
III	**Errors and Omissions**	-2.4	2.7	-0.9	-1.1	0.1	-0.4
	Capital Account Balance (including errors & omissions)	65.3	92.0	47.9	88.2	36.5	24.9

Source: RBI

Notes: PR: Partially Revised ; P : Provisional

II. Capital account developments in H1 of 2015-16 (Apr- Sept 2015)

Net capital inflow was placed at US$ 25.4 billion in H1 of 2015-16 as against US$ 36.5 billion in the corresponding period of previous year. The main components of capital account are discussed as follows-

i) External assistance (US$ 0.2 billion) - During the first half of 2015-16 there was sharp reduction in external assistance by 71.4% stood at US$ 0.2 billion as compared to corresponding period of the last year.

ii. External Commercial borrowings (ECBs) (US$-0.9 billion) - Net ECBs were US$ 0.8 billion in first half of 2014-15; during H1 of 2015-16, net ECBs logged an outflow of US$ 0.9 billion.

iii. Short term credit (- US$ 1.2 billion) –During the H1 of 2015-16 there was outflow in short-term credit of US$ 1.2 billion which was decline as compared to H1 of 2014-15 stood at - US$ 1.4 billion.

iv. Banking capital including NRI Deposits (US$ 10.1 billion) - During H1 of 2015-16, NRI deposits reached US$10.1 billion as against 6.5 billion in H1 of 2014-15.

v. Foreign Investment (US$ 7.9 billion) – During the first half of 2015-16, net foreign investment fell to US$7.9 billion as against US$37.3 billion in the first half of 2014-15, mainly due to outflows of portfolio investment.
Net portfolio investment logged an outflow of US$8.7 billion in H1 of 2015- 16 as against net inflow of US$22.2 billion in H1 of 2014-15.

During H1 of 2015-16, net capital/finance flows declined by 32 % placed at US$24.9 billion on account of outflow in net portfolio investment as against US$36.5 billion in H1 of 2014-15.

India's change in Foreign Reserve position as per Economic Survey 2015-16

Table 3 summarizes the India's change in Foreign Reserve position (US$ billion)

		2011-12	2012-13	2013-14	2014-15 (PR)	2014-15 H1 (Apr-Sept 2014) (PR)	2015-16 H1 (Apr-Sept 2015) (P)
	Current Account Balance	-78.2	-88.2	-32.4	-26.8	-18.4	-14.4
	Capital Account Balance (including errors & omissions)	65.3	92.0	47.9	88.2	36.5	24.9
IV	**Overall Balance**	-12.8	3.8	15.5	61.4	18.1	10.6
V	**Reserves Change** (-) indicates increase, (+) indicates decrease	12.8	-3.8	-15.5	-61.4	-18.1	-10.6

So
urce: RBI
Notes: PR: Partially Revised ; P : Provisional

III. Change in Foreign Reserve position in H1 of 2015-16 (Apr- Sept 2015)

Low levels of Current Account deficit (CAD) coupled with moderate rise in capital inflows resulted in accretion in foreign exchange reserves of US$10.6 billion in H1 of 2015-16 as against US$ 18.1billion in H1 of 2014-15.

9. Summary

Balance of Payments is a statistical statement of monetary transactions of the nation for a specific period that shows country imports and exports of visible & invisibles, various capital transactions with rest of the world and the effect of that on its foreign exchange reserves. Balance of Payments comprises current account, capital account and change in foreign exchange reserves. Current account of the balance of payments includes transactions of exports and imports of goods, services and transfers. Capital account involves inflows and outflows relating to investment & borrowings to and from abroad. India's Balance of Payments position had improved substantially resulted in higher accretion in foreign exchange reserves due to a sharp contraction in current account deficit and a sharp rise in financial flows in the form of FDI and portfolio.