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An MHRD Project under its National Mission on Education through ICT (NME-ICT)

Subject: Management

Production of Courseware

-Content for Post Graduate Courses

Paper: 08, International Business Operations

Module: 17, Balance of Trade and Balance of Payment

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Items	Description of Module
Subject Name	Management
Paper Name	International Business Operations
Module Title	**Balance of Trade and Balance of Payment**
Module Id	Module no-17
Pre- Requisites	Basic knowledge about Balance of Trade and Balance of Payment
Objectives	▪ To study the meaning and concept of Balance of Trade ▪ To study the role of Balance of Payment
Keywords	Balance of Trade, Balance of Payment, BoP

QUADRANT-I

Module 17: Balance of Trade and Balance of Payment
1. Learning Objective
2. Introduction
3. Meaning and concept of balance of trade
4. Meaning and concept of balance of payment
5. Principles for Valuation of transactions
6. Components of balance of payment
7. Current Account
8. Capital Account
9. Factors affecting components of BoP
10. Summary

1. Learning Objective

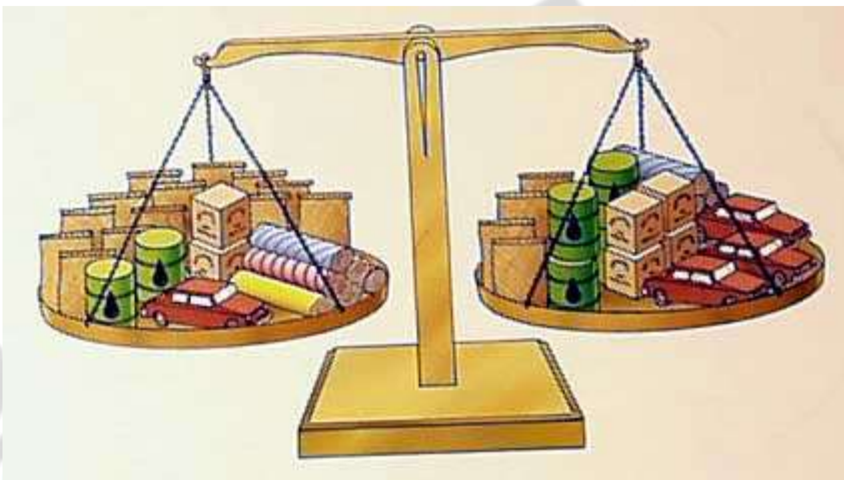
After completing this module, you will be able to:

i. Understand the meaning and concept of Balance of Trade
ii. Understand the meaning and concept of Balance of Payment
iii. Know about the current Account transactions
iv. Understand the Capital Account transactions
v. Know about the factors affecting components of balance of payment

BALANCE OF TRADE AND BALANCE OF PAYMENT

2. Introduction

Foreign trade refers to a country's trade with other countries. It consists of exports and imports. A country receives payments from other countries for its exports and makes payments to other countries for its imports. The difference between total receipts on account of exports of goods and total payments on account of imports of goods is called **Balance of Trade**. However, these receipts and payments are not necessarily in a country's own currency. Besides, receipts and payments on account of trade of goods, some other receipts and payments also take place between countries. In this chapter, you will study the meaning and importance of balance of trade and balance of payments.



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3. Meaning and Concept of Balance of Trade

The balance of trade or net exports is the difference between the monetary value of exports and imports of output in an economy over a certain period. It is the relationship between a nation's imports and exports. A positive or favourable balance of trade is known as a trade surplus if it consists of exporting more than is imported; a negative or unfavourable balance is referred to as a trade deficit or, informally, borrowed prosperity, living beyond a nation's means, or a trade gap.

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The balance of trade forms part of the current account, which includes other transactions such as income from the international investment position as well as international aid. If the current account is in surplus, the country's net international asset position increases correspondingly. Equally, a deficit decreases the net international asset position. The trade balance is identical to the difference between a country's output and its domestic demand (the difference between what goods a country produces and how many goods it buys from abroad; this does not include money re-spent on foreign stock, nor does it factor in the concept of importing goods to produce for the domestic market).

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There is marked distinction between the concepts of balance of trade and balance of payments. Balance of Trade refers to the merchandise account of exports and imports only. Balance of payment is a broader term and it includes balance of trade. It is more comprehensive than the balance of trade. It includes all international economic transactions and items such as merchandise trade, services, banking, insurance, capital flows, buying and selling of gold etc.

In short, balance of trade is a partial picture, while balance of payments is a complete picture of the country's international economic relations. Further, in the accounting sense, balance of trade may be deficit or surplus. It may, thus, be imbalanced. But balance of payments as a whole must always balance. For that reason, there is an item like "Errors and Omissions" in its structure.

4. Meaning and Concept of Balance of Payment

A country's balance of payments is commonly defined as the record of transactions between its residents and foreign residents over a specified period. Each transaction is recorded in accordance with the principles of double-entry bookkeeping, meaning that the amount involved is entered on each of the two sides of the balance-of-payments accounts. Consequently, the sums of the two sides of the complete balance-of payments accounts should always be the same, and in this sense the balance of payments always balances. However, there is no bookkeeping requirement that the sums of the two sides of a selected number of balance-of-payments accounts should be the same, and it happens that the balances shown by certain combinations of accounts are of considerable interest to analysts and government officials. It is these balances that are often referred to as "surpluses" or "deficits" in the balance of payments.

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Thus, a balance of payments (BOP) sheet is an accounting record of all monetary transactions between a country and the rest of the world. These transactions include payments for the country's exports and imports of goods, services, and financial capital, as well as financial transfers. The BOP summarizes international transactions for a specific period, usually a year, and is prepared in a single currency, typically the domestic currency for the country concerned. Sources of funds for a nation, such as exports or the receipts of loans and investments, are recorded as positive or surplus items. Uses of funds, such as for imports or to invest in foreign countries, are recorded as a negative or deficit item.

When all components of the BOP sheet are included it must balance i.e. it must sum to zero. There can be no overall surplus or deficit. For example, if a country is importing more than it exports, its trade balance will be in deficit, but the shortfall will have to be counter balanced in other ways – such as by funds earned from its foreign investments, by running down reserves or by receiving loans from other countries.

While the overall BOP sheet will always balance when all types of payments are included, imbalances are possible on individual elements of the BOP, such as the current account. This can result in surplus countries accumulating hoards of wealth, while deficit nations become increasingly indebted.

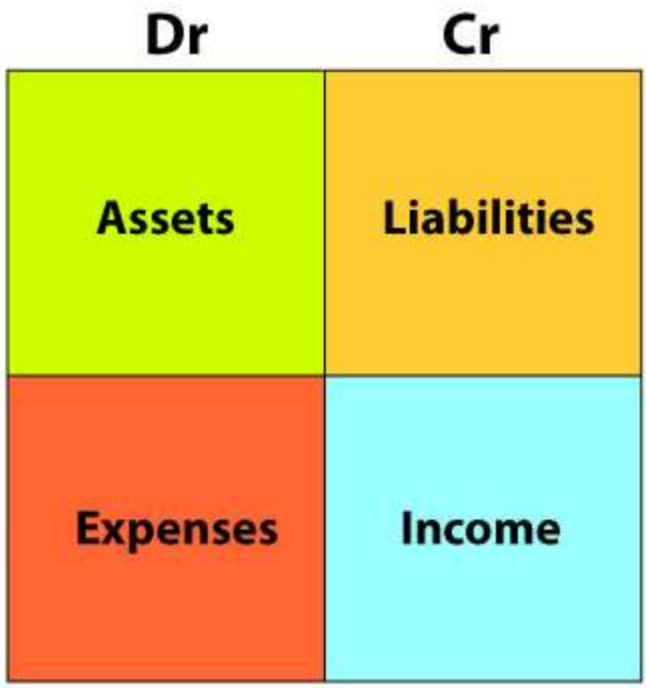
5. Principles for Valuation of transactions

Generally, a large number of transactions are recorded in the BoP account every year, therefore a uniform system should be adopted for the valuation of these transactions so that the data can be comparable across the countries and over a period of time. The IMF manual recommends the following principles to be followed for valuation of transactions entering the BoP account:

- The transactions should be valued at market prices. For this purpose, the manual describes market price as " the amount of money that a willing buyer pays to acquire something from a willing seller, when such an exchange is one between independent parties into which nothing but commercial considerations enter".
- Both imports and exports should be valued at f.o.b. basis (i.e. free on board basis). This means that the price paid for the insurance and shipment of goods should not be included as a part of the value of goods either by the importer or the exporter, but should be recorded separately as a payment for services (wherever paid to a foreign agency)
- Any transactions denominated in foreign currency should be converted into the domestic currency at the exchange rates prevailing in the market at the time the transaction took place.

6. General Principles of BOP Accounting

The double-entry bookkeeping used in accounting for the balance of payments is similar to that used by business firms in accounting for their transactions. In ordinary business accounting the amount of each transaction is recorded both as a debit and a credit, and the sum of all debit entries must, therefore, equal the sum of all credit entries. Furthermore, in business accounting it is recognized that the total value of the assets employed by the firm must be equal to the total value of the claims against those assets, that is, that all the assets belong to someone. As is well known, the claims against the assets are called the liabilities of the firm. (Assets of the firm not subject to the claims of creditors are, of course, the property of stockholders, so that, broadly speaking, the firm has two classes of liabilities: those due to creditors and those due to stockholders.)



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By accounting convention, a debit entry is used to show an increase in assets or a decrease in liabilities, while a credit entry is used to show an increase in liabilities or a decrease in assets. Since a debit entry is always accompanied by a credit entry, it follows that the value of total assets on the books of a going concern is always equal to the value of total liabilities (including the claims of stockholders). These elementary principles can be applied to the recording of transactions in the balance of payments. For example, when a foreigner gives up an asset to a resident of this country in return for a promise of future payment, a debit entry is made to show the increase in the stock of assets held by Indian residents, and a credit entry is made to show the increase in Indian liabilities to foreigners (that is, in foreign claims on Indian residents). Or when a Indian resident transfers a good to a foreigner, with payment to be made in the future, a debit entry is made to record the increase in one category of Indian assets (Indian financial claims on foreigners), and a credit entry is made to record the decrease in another category (goods).

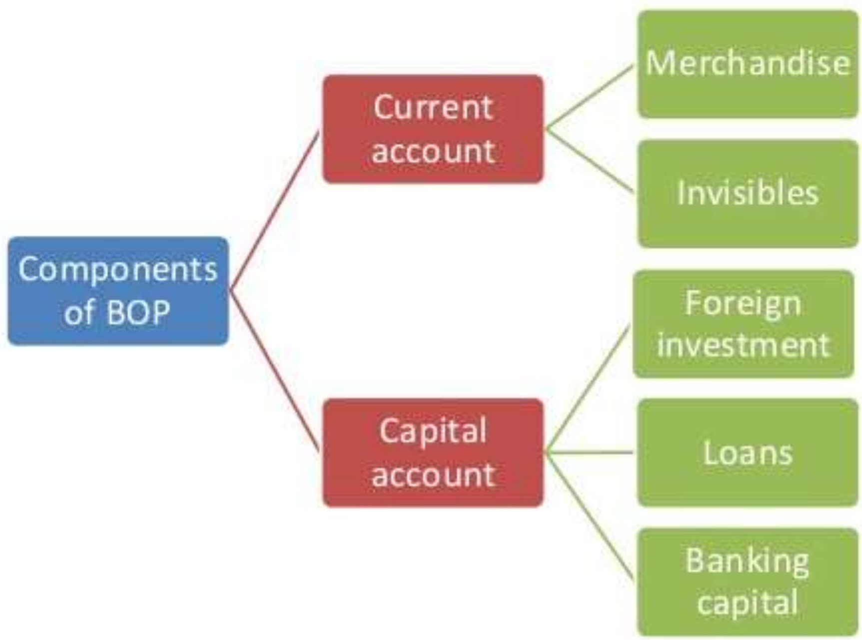
The logic underlying every transaction being entered twice is that whenever there is a transaction, whether purchase or sale, there would be a corresponding payment-either immediate or deferred, giving rise to two entries. Actually, there is a clear rule for determining the side of a BoP account on which a particular transaction should be entered. The rule is that any transaction which creates demand for the domestic currency in the forex market enters the BoP account on the credit side, and any transaction increasing its supply enters the debit side. For example, a country exports goods to another country, the demand for the domestic currency goes up as the foreign importer would need to buy the domestic currency to pay for the imports. This would appear as a credit item in the BoP account as it is a source of foreign currency. On the other hand, imports increase the supply of the domestic currency, as foreign currency would need to be bought in exchange for the domestic currency in order to pay for the imports. As the foreign currency will be use by this, so it would be appeared as a debit item. So, the transactions which increases the external purchasing power of a country is recorded as a credit entry. It represents a source of foreign exchange. Examples of such transactions are

1. Exports of goods or merchandise exports
2. Export of services like banking, insurance, travel etc, or invisibles;
3. Raising of funds from abroad, i.e. a capital inflow into the country.
4. Decrease in foreign exchange reserves and gold reserves of the monetary authority.

A transaction which reduces the external purchasing power of the country is recorded as a debit entry. It represents the use of foreign exchange reserves. Examples of such transactions are:

(a) Merchandise imports and invisible imports;
(b) A capital outflow or lending abroad;
(c) Increases in foreign exchange reserves and gold reserves of the monetary authority.

7. Components of Balance of Payments



The Balance of Payment is usually divided into three major groups of accounts. It is given as follows:

	Credit	Debit	Net
A. CURRENT ACCOUNT			
1. MERCHANDISE			
a. Exports (on f.o.b. basis)			
b. Imports (on c.i.f. basis)			
2. INVISIBLES			
a. Services			
i. Travel			
ii. Transportation			
iii. Insurance			
iv. G.n.i.e			
v. Miscellaneous			
b. Transfers			
vi. Official			
vii. Private			
c. Investment Income			
Total Current Account (1+2)			
B. CAPITAL ACCOUNT			
1. FOREIGN INVESTMENT (a+b)			
a. In India			
i. Direct			
ii. Portfolio			
b. Abroad			
2. LOANS (a+b+c)			
a. External Assistance			
i. By India			
ii. To India			
b. Commercial Borrowings (MT and LT)			
i. By India			
ii. To India			
c. Short-term			
To India			
3. BANKING CAPITAL (a+b)			
a. Commercial Banks			
i. Assets			
ii. Liabilities			
iii. Non-Resident Deposits			
b. Others			
4. RUPEE DEBT SERVICE			
5. OTHER CAPITAL			
Total Capital Account (1+2+3+4+5)			
C. ERRORS AND OMMISSIONS			

D. OVERALL BALANCE (A+B+C) **E. MONETARY MOVEMENTS (i+ii)** i. I.M.F. ii. Foreign Exchange Reserves (Increase -/ Decrease +)

8. CURRENT ACCOUNT

The Current Account records the transactions in merchandise and invisibles with the rest of the world. Merchandise covers exports and imports of all movable goods, where the ownership of goods changes from residents to non-residents and vice-versa. Therefore, Current Account captures the effect of trade link between the economy and the rest of the world.

- The merchandise traded values exports on f.o.b. (free on board) basis and are shown as credit items and the imports valued on c.i.f. (cost insurance and freight) basis are the debit items. However, the IMF BoP manual provides guidelines for compilation of the BoP statistics prescribing the valuation of both exports and imports on f.o.b. basis. The term Invisible includes travel, transportation, insurance, investment income, and other miscellaneous items. The credit under the Invisible comprises the value of services rendered by residents to non-residents. The income earned by residents on ownership of financial assets (investment income), use of non-financial assets (property income) and other receipts in cash or kind without a quid pro quo (transfer payments) are all recorded as credits. Similar remittances made by residents to non-residents are recorded as debits.

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- G.n.i.e. implies government not included elsewhere. A credit entry of the G.n.i.e. includes items like: Funds received from a foreign government for the maintenance of their embassy, consulates etc. in

India. Under the heading 'Miscellaneous', payment to foreign technical consultant for professional services rendered by him will appear as a debit item.

- A transfer also includes Official and Private. A debit entry under the heading Official Transfers constitute items like revenue contributions by the Government of India to International Institutions or any transfer (even in the form of gifts) of commodities by the government to non-residents. Private transfers include items like cash remittance by non-residents Indians for their family maintenance in India.

9. CAPITAL ACCOUNT

In the case of the Capital Account an increase (decrease) in the country's foreign financial assets are debit (credits) whereas any increase (decrease) in the country's foreign financial liabilities are credits (debits). All transactions of financial nature are entered in the Capital Account of the BoP statement. The transactions under this heading are classified into five heads: (1) Foreign Investment, (2) Loans, (3) Banking Capital, (4) Rupee Debt Services, and (5) Other Capital.

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- Any investment made by foreign residents (individual, companies, financial institutions or even a foreign government) in the acquisition of physical assets in India is a Foreign Direct Investment (FDI). It is depicted by an inflow of foreign capital and is a credit item in the BoP Statement. When a foreign country portfolio investor directly purchases financial assets in the Indian securities market it is termed as Foreign Portfolio Investment.
- Loans includes concessional loans received by the government or public sector bodies, long term and medium borrowings from the commercial capital market in the form of loans, bond issues, etc. and short term credits. Disbursements received by Indian resident's entities are credit terms while repayment and loans made by Indians are debits items.
- Banking Capital covers the changes in the foreign assets and liabilities of commercial banks whether privately owned or government owned and co-operative banks which are authorized to deal in foreign exchange. An increase in assets (or decrease in liabilities) is a debit item while a decrease in assets (increase in liabilities) is a credit item.
- The item 'Rupee Debt Service' is defined as the cost of meeting interest payments and regular contractual repayments of principal of a loan along with any administration charges in rupees by India.

Though recording of transactions in BoP statement is made according to the principle of double entry system, certain discrepancies in estimation and timing may result in a situation where debits are not exactly equal to the credits. The term 'Errors and Omissions' indicates the value of such discrepancies. A negative value indicates that receipts are overstated or payments are understated, or both, and vice versa.

10. Factors affecting the Components of BoP Account:

Exports of Goods and Services

Exports of goods and services are affected by the following factors:

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- **The Prevailing Exchange Rate of the Domestic Currency:** A lower value of the domestic currency results in the domestic price getting translated into a lower international price. This increases the demand for domestic goods and services and hence their export. This is likely to result in a higher demand for the domestic currency. A higher exchange rate would have an exactly opposite effect.
- **Inflation Rate:** The inflation rate in an economy vis-a-vis other economies affects the international competitiveness of the domestic goods and hence their demand. Higher the inflation, lower the competitiveness and lower the demand for domestic goods. Yet, a lower demand for domestic goods and services need not necessarily mean a lower demand for the domestic currency. If the demand for domestic goods is relatively inelastic, then the fall in demand may not offset the rise in price completely, resulting in an increase in the value of exports. This would end up increasing the demand for the local currency.
- **World Prices of a Commodity:** If the price of a commodity increases in the world market, the value of exports for that particular product shows a corresponding increase. This would result in an increase in the demand for the domestic currency. A fall in the demand for domestic currency would be experienced in case of a reduction in the international price of a commodity.
- **Incomes of Foreigners:** There is a positive correlation between the incomes of the residents of an economy to which the domestic goods are exported, and exports. Hence, other things remaining the

same, an increase in the standard of living or an increase in the incomes of the residents of such an economy will result in an increase in the exports of the domestic economy. Once again, this would increase the demand for the local currency.

- **Trade Barriers:** Higher the trade barriers erected by other economies against the exports from a country, lower will be the demand for its exports and hence, for its currency.

Imports of goods and Services

Import of goods and services are affected by the following factors:

- **Value of the Domestic Currency:** An appreciation of the domestic currency results in making imported goods and services cheaper in terms of the domestic currency, hence increasing their demand. The increased demand for imports results in an increased supply of the domestic currency. A depreciation of the domestic currency has an opposite effect.
- **Level of Domestic Income:** An increase in the level of domestic income increases the demand for all goods and services, including imports. This again results in an increased supply of the domestic currency.
- **International Prices:** The international demand and supply positions determine the international price of a commodity. A higher international price would get translated into a higher domestic price. If the demand for imported goods is inelastic, this would result in a higher domestic currency value of imports, increasing the supply of the domestic currency. In case of the demand being elastic, the effect on the supply of the domestic currency would depend on the effect on the domestic currency value of imports.
- **Inflation Rate:** A domestic inflation rate that is higher than the inflation rate of other economies would result in imported goods and services becoming relatively cheaper than domestically produced goods and services. This would increase the demand for the former, and hence, the supply of the domestic currency.
- **Trade Barriers:** Trade barriers have the same effect on imports as on exports-higher the barriers, lower the imports, and hence, lower the supply of the domestic currency.

9. Summary: In this module we have learnt that Balance of Payment sheet is an accounting record of all monetary transactions between a country and the rest of the world. These transactions include payments for the country's exports and imports of goods, services, and financial capital, as well as financial transfers. The BOP summarizes international transactions for a specific period, usually a year, and is prepared in a single currency, typically the domestic currency for the country concerned. Sources of funds for a nation, such as exports or the receipts of loans and investments, are recorded as positive or surplus items. Uses of funds, such as for imports or to invest in foreign countries, are recorded as a negative or deficit item. As such BOP followed double entry system. The credit balance shows the receipts of foreign exchange from abroad whereas the debit balance shows payments. It records all the commercial, financial and economic flows between the residents of a country and the residents of all other countries. BOP is divided into three major parts, Current Account, Capital Account and Official Reserve Account