BALANCE OF PAYMENTS (BOP)

Balance of Payments (BOP) A country's BOP keeps track of both its payments to and its receipts from other countries . The BOP account is the measurement of all international economic transactions between the residents of a country and foreign residents. The balance of payment 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. All transactions involving payments from foreigners to Indians are entered in the " Receipts " column with a plus sign (+) to reflect that they are credits ; that is , they result in a flow of funds to Indians , receipts include foreign purchases of Indian products such as computers and wheat (exports), foreigners travel India (tourists services) , income earned from Indian investment abroad investment income , foreign gifts and pensions paid to Indians (unilateral transfers) , and foreign payments for Indian assets (capital inflows) . All payments to foreigners are entered in the "Payments" column with a minus sign (-) to reflect that they are debits because they result in flows of funds to other countries . Payments include Indian purchases of foreign products such as French wine and Japanese cars (imports), Indian travel abroad (services), income earned by foreigners from investments in the India (investment income), foreign aid and gifts and pensions paid to foreigners (unilateral transfers), and Indian payments for foreign assets (capital outflows).

Types of BOP Accounts

The BOP is composed of two primary sub - accounts, the current account and the financial or capital account. In addition, the official reserves account tracks government currency transactions and the net errors and omissions account, is produced to create and keep the balance in the BOP.

1. Current Account. It includes all international economic transactions with receipts and payments flows occurring within the current year. The current account consists of four categories :

a. Goods Trade : This is the record of export and import of goods .

b. Services Trade : This is the record of export and import of services .

c. Income : This is the current income related with investments that were made in previous periods . For example, if a Japanese foreign firm established its ' subsidiary firm in India, then the profit made by this subsidiary that will be repatriated back to Japan as dividend is the current investment income. Wages and salaries paid to non-resident workers are also included in this category.

d. Unilateral Transfers: Unilateral transfers include pension, remittances, gifts for which no specific services are rendered. They are called unilateral transfers because they represent the flow of funds in one direction. Therefore,

Export of goods effects the inflow of foreign exchange into the country , while import of goods causes outflow of foreign exchange from the country .

- Balance of Trade =Exports of goods - Import of goods
- Surplus Balance of Trade= Exports of goods > Imports of goods
- Deficit Balance of Trade=Exports of goods < Imports of goods
- Balance of current account Balance of Trade + Net earnings on Invisibles (i.e. invisibles refer to trade in services , investment income and unilateral transfers).

2. Capital and Financial Account: It measures all international economic transaction of financial assets. It is divided into two major components, the capital account and the financial account.

a. Capital account : Capital account is a part of BOP statement showing flow of foreign loans / investment and banking funds . The three major subject - categories of India's capital account balance are direct investment, portfolio investment and other long - term and short - term capital.

- Direct Investment : This is the net balance of capital flows into and out of a country for the purpose of exerting control over assets . For example, if an Indian firm either builds a new automotive part facility in another country or purchases a company in another country, this would fall under direct investment in India's BOP accounts.
- Portfolio Investment : It is the capital invested in activities that are purely motivated by returns . Investments that are purchases of debt securities, bonds, interest bearing bank accounts to earn a return.

b. Other Investment asset / liabilities : It includes short - term and long - term trade credits , cross - border loans from all types of financial institutions , currency deposits and bank deposits and other accounts receivable and payable related in cross - border trade .

3. Errors and omissions which is also termed as "statistical discrepancy" is an important Item on the BOP statement, is taken into account arriving at the overall balance. It may be noted that the statistical discrepancy arises on different accounts.

a. It arises because of difficulties involved in collecting BOP data. There are different sources of data which sometimes differ in their approach. In India, trade figures compiled by the RBI and DGCIS differ.

b. The movement of funds may lead or lag the transactions that funds are supposed to finance. For example, goods are shipped in March but the payments are received in April. In this case, the figures compiled on 31 March, the financial year end, will record the shipment that has been sent , but its payment would be recorded in the following year .. Such differences lead to the emergence of statistical discrepancy.

c. Certain figures are derived on the basis of estimates. For example, figures for earning on travel and tourism account are estimated on the basis of sample cases. If the sample is defective, there is every possibility of error and omission.

d. Errors and omissions are explained by unrecorded illegal transactions that may be either on the debit side or on the credit side or on both sides. Only the net amount is written on the BOP.

After the statistical discrepancy is located, the overall balance is arrived at. The overall balance represents the balancing between the credit items and the debit items appearing on the current account, capital account and the statistical discrepancy. If the overall balance of payment is in surplus, the surplus amount is used for repaying the borrowings from the IMF and then rest is transferred to the official reserves account. On the contrary, when the overall balance is found in deficit, the monetary authorities arrange for capital flows to cover up the deficit. Such inflows may take the form of drawing down of foreign exchange reserves or official borrowings from the IMF.

From this point of view, capital inflows are bifurcated into autonomous and accommodating.

- Accommodating Capital Flow: If the inflow of funds on the capital account is for meeting the overall balance of payments deficit, it is termed as accommodating or compensatory capital flow. It aims at putting the BOP in equilibrium. It is called "below - the - line" capital flow.
- Autonomous Capital Flow : It refers to flow of loans / investment in normal course of a business. For example, a foreigner paying back the loan or the inflow of foreign direct investment is an opposite example of it. This is why it goes "above - the - line" capital flow.

Balance of capital account= foreign exchange inflow- foreign exchange outflow, on account of foreign investment, foreign loans, banking transactions and other capital flows.

Official Reserves Account : Official reserves are held by the monetary authorities of a country. They comprise of monetary gold, SDR allocations by the IMF and foreign currency assets. Foreign currency assets are normally held in form of balances with foreign central banks and investment in foreign government securities. If the overall balance of payments is in surplus, the surplus amount, as it is mentioned above, adds to the official reserves account. But if the overall balance of payments is in deficit, and if accommodating capital is not available, the official reserves account is debited by the amount of deficit.

Overall BOP (Balance of payment) = Balancing Current A / C + Balance of Capital A / C + Statistical Discrepancy