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Balance Of Payments its term and conditions

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Abstract: This article indicates an overview of the Balance of payments. For this article we study a number of books, magazine and research papers. This article related to balance of payment in Indian context. Secondary data is taken from various books, magazine, research papers and official site of RBI . Many terms related to monetary policy and fiscal policy is used in this article. The main objective of this research article focuses on economic transaction and foreign exchange.

Key words: Balance of payment, economic transaction, foreign exchange, unilateral transfer, statistical discrepancy.

Introduction: A country's balance of payments keeps track of both its payments to and its receipts from other countries. The B.O.P. account is the measurement of all international economic transactions between the residents of a country and foreign residents. 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. All the transactions involving payments from foreigners to Indian 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 purchase of Indian product such as computer and wheat (exports), foreign travel India (tourists services), income earned from Indian investment abroad (investment income), and foreign payments for Indian assets (capital inflow).

All payments to foreigners are entered in the "payments" column with a minus sign (-) to reflect that they are debit because they result in flow of funds to others countries. Payment include Indian purchases of foreign product such as French wine and Japanese car (imports), Indian travel abroad (services) income earned by foreigners from invest in India (investment income) and Indian payments for foreign assets (capital outflow).

Type's of B.O.P. accounts: The B.O.P. is composed of two primary sub-accounts, the current account and the financial or capital account. In addition, the official reserve account tracks government currency transaction and the net errors and omission account, is produced to create and keep the balance in the B.O.P.

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

(I)Goods Trade: This is the record of export and import of goods.

(II)Service Trade: service trade is the record of export and import of services.

(III)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 invest income. Wages and Salaries paid to non-residents workers are also included in this category.

(IV)Unilateral Transfer: Unilateral transfer include pension, remittance, gifts for which no specific services are rendered. They are called unilateral transfer because they represent the flow of funds in only one direction.

Therefore,

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

Calculation of the balance of current account: Balance of Trade + Net earnings on invisible (i.e. invisible refer to trade in services, investment income and unilateral transfers).
Balance of Trade = Exports of goods – Imports of goods.

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

(I) Capital account: Capital account is a part of B.O.P statement showing flow of foreign loan /investment and banking funds. The three major sub-categories of India's capital account balance are direct investment, portfolio investment and other long term and short term capital.

(I.I) Direct Investment: Direct investment is the net balance of capital flow 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 other country or purchases a company in other country, this would fall under direct investment in India's B.O.P accounts.

(I.II) 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.

(I.III) Other Investment asset/liabilities: It includes short term and long term trade credits, cross-border loan from all types of financial institution, currency deposits and bank deposits and other accounts receivable and payable related in cross-border trade.

Calculation of Balance of Capital account = Foreign exchange inflow – foreign exchange outflow (on account of foreign investment, foreign loan, banking transactions and other capital flows.

Error and omission: which is also termed as "**statistical discrepancy"** is an important item on the B.O.P statement, is taken into account for arriving at the overall balance. It may be noted that the statistical discrepancy arises on different accounts.

1. It arises because there are different sources of data which sometimes differ in their approach.
2. The movement of funds may lead or lag the transactions that funds are supposed to finance.
3. Certain figures are derived on the basis of estimates.
4. Error and omission are explained by unrecorded illegal transaction that may be either on the debt side or on the credit side or on both sides. Only the net amount is written on the B.O.P.

Overall B.O.P (Balance of Payment): Balance of current account + Balance of capital account + Statistical discrepancy

If the overall balance of payment is in surplus, the surplus amount is used for repaying the borrowing from IMF and then rest is transferred to the official reserve account. On the other hand, when the overall balance is found in deficit, the monetary authorities arrange for capital flow to cover up the deficit. Such inflow may take the form of drawing down of foreign exchange reserve or official borrowing from the IMF.

Causes and kinds of B.O.P Disequilibrium:

1. **Change in Price level and fundamental disequilibrium:** Change in the price level may be inflationary or deflationary. Inflation causes a deficits and disinflation causes a surplus balance in the B.O.P. deficits B.O.P resulted in increased indebtedness, depletion of gold reserve, loss of employment, distortions in the domestic economy. Surplus in B.O.P leads to wasteful expenditure and misallocation of resources.

2. **Business cycle and cyclical disequilibrium:** As Lawrence W. Towel points out; depression always brings about a drastic shrinkage in world trade, while prosperity stimulates it. A country enjoying a boom all by itself of decrease in foreign demand**.**
3. **Long run disequilibrium:** The B.O.P disequilibrium persists for long periods to certain secular trends in the economy. The high aggregated demand and higher domestic prices may result in the imports being much higher than the export.
4. **Short run disequilibrium:** It is also known as Temporal Disequilibrium. It includes disequilibrium or crop failures, rapid growth in population, and development progress increase domestic demand for imports.
5. **Structural disequilibrium:** Structural disequilibrium refers to some changes in the economy. It includes the development the alternate source of supply, development of better substitutes, exhaustion of productive resource or change in transport routes and cost etc.

Measures to correct Adverse B.O.P: There are basically two measures of correcting the adverse B.O.P:

(i) Income related measures

(ii) Price related measures

(i) Income related measures: Income related measures include the two policy tools to change disposable income are monetary policy and fiscal policies. Monetary policy operates on the demand for and supply of money while fiscal policy operates on the disposable income of the people.

Monetary policy: To solve the problem of B.O.P deficit, a tight or dear monetary policy is followed. Under it, central monetary authority raises the interest rate. Consequently, under the normal conditions, the demand for bank credit for investment consumer durable decreases. With a fall in investment and through its multiplier effect, the income of the people decreases. If marginal propensity to consume is greater then zero, demand for goods and services decreases. The fall in demand implies also a decrease in imports. The tight monetary policy is also combined with open market operation, i.e. sales of government bonds and securities.

Fiscal policy: Fiscal policy includes taxation and public expenditure. Taxation reduces household disposable income and result fall in both domestic and imported demand. The government can reduce income and demand by adopting a policy of surplus budgeting i.e. the government keeps its expenditure less then its revenue. When the government adopts a surplus budget policy, it increases tax rates and reduce public expenditure.

(iii) Price related measures: Exchange depreciation and devaluation.

In this measure reducing demand for imports through price measures requires changing the relative prices of imports and exports. Relative prices of imports and exports-import prices increase and export prices decrease can be change through Exchange depreciation and devaluation.

Exchange depreciation refers to a fall in the market value of home currency in term of foreign currency and devaluation refers to government's deliberate devaluation of home currency in term of gold and reserve currency.

(B)Direct measure: Exchange control: The exchange control refers to a set of restrictions imposed on the international transactions and payments, by the government or the exchange control authority. Exchange control may be partial, confined to only a few kinds of international transactions, or total, depending on the requirement of the country.

Conclusion: After the study of this article we can say that the overall balance of payment is in surplus, the surplus amount is used for repaying the borrowing from IMF and then rest is transferred to the official reserve account. On the other hand, when the overall balance is found in deficit, the monetary authorities arrange for capital flow to cover up the deficit. Such inflow may take the form of drawing down of foreign exchange reserve or official borrowing from the IMF. The main focus of this article to indicate the Balance of Payment in Indian context.

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