



## A BASIC UNDERSTANDING OF BALANCE OF PAYMENT

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### ABSTRACT

*As there are so many determinants of human health i.e. economic factors, social factors, cultural factors, physical factors, etc. Similarly there are some determinants of economy's health of a country i.e. Balance of Payment of that country is one of the determinants. It is also an indicator of growth of economy and balance of Payment shows the economic stability, soundness of monetary and fiscal policy in an economy so because of these reasons, we are studying the basic concept or framework of balance of payment because until and unless we have basic understanding of any concept we cannot understand that concept's application in real world therefore in this paper we are going to get understanding of Balance of Payment.*

**KEY WORDS:** Balance of payment, approaches to balance of payment, measures.

### INTRODUCTION AND BACKGROUND

The international transactions (export and import of goods and services) and financial flows on other accounts (FDI, portfolio investments, loans, grants, gifts, etc.) affect the international financial position of economy of a country and all transactions, which cross the border of country, are definitely related to "Balance of Payment" of country's economy. Whenever there is openness/liberalization in trade then it gives benefits to the country but as well as it imposes some costs on country because trade liberalization leads to a faster growth of imports than exports leading balance of payments deficits and there are so many other reasons of balance of payment deficits. The monetary and fiscal policy of country is determined on the basis of the country's Balance of Payment that's why these two policies and foreign exchange reserve positions of the nation are influenced by the balance of payment.

As discussed earlier, because Balance of Payment contains all economic transactions with rest of the world therefore whatever economic transaction are done by the private and public sector with rest of the world is also accounted in it to know how much money comes in our country and goes out from our country.

The double entry book keeping system is followed in Balance of Payment that is something is debit or credit if economic transactions take place whatever country is receiving in monetary terms in respect of international transactions are credit entry in balance of payment and paying/giving in monetary terms in respect of international transactions are debit entry.

### OBJECTIVE OF STUDY

- ✦ To have overview of balance of payment
- ✦ To gain understanding of basic concepts regarding the balance of payment and also to provide this understanding to readers.

## METHODOLOGY AND DATA COLLECTION

The current study attempts to explain the concept of BALANCE OF PAYMENT and examine the interplay of various factors. The nature of research is completely descriptive. It is a conceptual study. All the relevant data used in research paper has been collected from secondary sources e.g. e- journals, newspaper, books and various e- resources.

## LITERATURE REVIEW

**Athawale (2013)**, This paper tells about issues in India's Balance of Payments in recent past. This is a descriptive paper and studies the different phases of current account deficit in India's balance of payment. Time period has been considered here 1950-2012.

This paper tells about the India's balance of payment position since its inception or independence of India. It is explaining the factors that contribute to challenging balance of payment (Deficit) and also explaining the events which had lasting impact on the India's balance of payment and measures which are undertaken by Indian government to correct those events because that events were worsening Indian economy in directly manner.

**Banerji (1989)**, This article tells us about the Economic Survey makes group wise statements that the balance of payments must be a priority area for attention in short-term economic management but this has been felt that but government was not taking actions for the same in 1988-89.

**Chand (2014)**, This paper tells about the general trends in the current account balance and in its components in India. Because of liberalised economy and switching from fixed exchange rate regime to flexible exchange rate regime, the quantum of foreign exchange inflow and outflow has surely increased on account of exports and imports respectively and also tells shift from fixed to flexible exchange rate causes the price and volumes volatility in current account transactions. It is considering the period of 41 years for conducting the study i.e. 1970-71 to 2010-11 which covers the both main periods of the Indian economy i.e. Pre reform period as well as post reform period because in 1991 there were major reforms that took place and improve the Indian import and export baskets.

**Sarkar (1994)**, This paper tells us about "India's balance of payments and exchange rate behaviour since 1971". This paper did study for the period 1971-91 and analyzing that how the India's external account items i.e. India's export earning, foreign remittances import cost affect the

balance of trade and payment and exchange rate also.

**Kumhof (2007)**, This paper tells us about Balance of payments crises under inflation targeting and a small open economy model under monetary regimes that target inflation and here small open economy consist of a government, households and tradables & non tradables manufacturing firms. The analysis in this follows two different definitions of inflation targeting i.e. consumer price index (CPI) inflation targets and domestic (nontradables) inflation targets.

It explains why such monetary regimes are vulnerable to speculative currency attacks that take place over a short period of time rather than instantaneously as under exchange rate targeting.

**Muller-Plantenberg (2010)**, This paper tells us about how the balance of payments imbalances affect foreign exchange market over time. On the basis of dynamical system approach, the paper shows how international payments depend on the joint dynamic behavior of different balance of payments components.

## CONCEPTUAL FRAMEWORK

The statement in which all international economic transactions between the residents of a country and residents of rest of world is recorded, called the balance of payment. The Balance of Payment is nothing but the balance sheet of the country on a particular time for a particular time period.

According to words of Reserve Bank Of India, balance of payment is a "Statistical statement that systematically summaries, for a specific time period, the economic transactions of an economy with the rest of the world".

Main features of balance of payment are as follows:

- ↻ International transactions
- ↻ Economic transactions
- ↻ Between residents of one country and residents of all other country
- ↻ Follows the double entry book keeping system

The followings are the reasons for balance of payment:

- ↻ It is indicator of foreign exchange reserve position in the country.
- ↻ Balance of Payment position signals the imposition and removal of control on payments in respect to dividend, royalty, license fee or cash disbursements to foreign firm or investors.
- ↻ Balance of Payment position helps the foreign investor whether to invest in a particular country or not by forecasting the economic environment of the country.

### Components of Balance of Payment:-

As discussed earlier, transactions under balance of payment are recorded in standard double entry book Keeping system in which every international transaction by country will either come in debit(outflow) or credit(inflow) according to its nature whether it is outflow or inflow transaction and total amount of debits must be equal to credits amount which is rarely happened so for balancing it we have to include(Add or Subtract ) an item which is called as 'errors and omissions' in Balance of Payment.

Components of Balance of Payment are as follows:

- ◆ Current account
- ◆ Capital account ( but in U.S. there is financial account in addition to it as observed )
- ◆ Official reserve account

### Current Account:-

It includes all international economic transactions with income or payment flows occurring within the year's i.e. current period that's why its name is current account.

It includes trade in goods and services and normally called it as export and import of visible items and invisible items. Merchandise (visible) exports, i.e. Sale of goods abroad, are credit entries because all such export transactions give rise to inflow into home country and merchandise imports, i.e. Purchase of goods from abroad, are debit entries because these give rise to outflow from home country. These exports and imports of only goods make the Balance Of Trade. *When imports of goods greater than export of goods equal to Balance Of Trade Deficit and when export of goods greater than import of goods equals to Balance Of Trade Surplus.*

Apart from above, invisible (transportation, tourism, health care, telecommunications, advertising, financial services, education, etc.) export are credit entries. i.e. Export of services or sale of services to foreigners so there is inflow of money and import of invisible are debit entries i.e. Import of services or purchase of foreign services so there is out flow of money. These two transactions visible and invisible are most important international transactions of most of the nations.

Investment income i.e. interest on loans, dividend on investment is also come under this category.

Unilateral transfers mean which flow from only one side and it is another term for gifts, government grants, disaster relief, reparations, and private remittances. When receive from abroad is credit entry and when made to abroad is debit entry.

All above transactions result in current account balance (balanced / surplus / deficit). *When imports of goods & services is greater than export of goods & services is equals to Current Account Deficit and when export of goods & services is greater than import of goods& services is equals to Current Account Surplus.*

### Capital Account:-

Capital account records the short term and long term capital transactions or buying and selling of real assets (machinery, land, building, etc) and financial assets (shares, debenture, loans, bond, foreign direct investment, and foreign institutional investment) abroad. Capital inflows are recorded as credit entries. For example, foreign ownership in home country, selling short and long term assets to foreigners, selling foreign assets acquired previously. Capital outflow is recorded as debit entries. For example, home country's people ownership in foreign country, buying short and long term foreign assets, repayments to foreigners for selling their investment made in home country. As earlier said investment and loan are recorded in capital account but incomes or payments on investments and loans are recorded in current account.

### Official Reserve Account:

Official reserves shows the holdings of foreign exchange reserve by government and official agencies which are generally accepted for settlement of international claims. These are as follows:

- Gold
- Foreign currency assets
- SDRs(Special Drawing Rights)
- Reserve position at IMF (Quota Minus IMF Borrowing)

### Errors and Omissions:-

Errors and omissions are a balancing item which is used to cancel out errors in individual items which has opposite numerical signs hence it is not necessarily show the quality of balance of payment on economy like low value of error term does not mean that balance of payment has more accurate accounting. It is occurred due to an individual transaction is not recording at correct time with regard to actual payment flow because of price and exchange rate volatility, valuation errors because price of individual assets is not correctly measured, individual items may be overestimated or underestimated due to documentation errors or because transactions or capital movements between residents and non-residents are *estimated rather than absolute*. after all above transactions in the balance of payments, if total of debit entries are equal to credit entries then it is well and good

for economic condition of country and if total of debits and credits are not equal which either credits > debit = surplus in balance of payment or debit < credit = deficit in balance of payment.

Balance Of Trade = Export of Goods - Imports of Goods  
Balance Of Current Account = Balance Of Trade + Net Earnings On Invisibles

Balance Of Capital Account = Net Inflows On FDI, FII, Foreign Loans, Banking Transactions, And Other Capital Transactions.

BALANCE OF PAYMENTS = BALANCE OF CURRENT ACCOUNT + BALANCE OF CAPITAL ACCOUNT + ERRORS AND OMISSIONS.

### Meaning of Current Account balance:-

Current account involves value of flows of goods, services, income, unilateral transfers between home and foreign country Although Current account should be balanced but this is rarely happened So current account surplus means that exports is greater than imports of all these above items and current account deficit means that imports is greater than exports of all these items. CA balance is synonymous with net foreign investment in national income accounting. The CA is related to national saving and domestic investment. National Saving(S) is bifurcated in two parts invest in home country ( $I_d$ ) or invest abroad ( $I_f$ ),

$$S = I_d + I_f$$

Therefore, net foreign investment equals to the difference between national saving and domestic investment,

$$CA = I_f = S - I_d$$

The CA balance is also related to domestic production, income and expenditure.

$$Y = C + I_d + G + X - M$$

Y = National Income / Out Put / GDP

C = Domestic Consumption

$I_d$  = Domestic Investment

G = Government Expenditure

X = Exports

M = Imports

Country's total expenditures on goods and services,

i.e.  $C + I_d + G$  is referred to as absorption (A),

$A = C + I_d + G$

$Y = A + (X - M)$

So we can say that CA balance is,

- Net foreign investment ( $I_f$ ) [CA surplus means positive net foreign investment, country is net lender]

- The difference between national saving and domestic investment ( $S - I_d$ )
- The difference between domestic product and national expenditure ( $Y - A$ )

### Approaches to Balance of Payment:-

- Elasticity approach
- Absorption approach

**Elasticity Approach:** This approach is given by the Marshall and Learner and partial equilibrium is also given by them.

Marshall-Learner (M-L) condition: Devaluation will help improve the current account balance only if,  
 $E_m + E_x > 1$

Where,  $E_m$  - Price elasticity of demand for imports and

$E_x$  - Price elasticity of demand for exports

the higher the value of elasticity, the less would be the extent of devaluation required.

### Limitation:-

- ☞ Trade in goods inelastic in a short term thus M-L condition is not met.
- ☞ J-effect (in a long run, consumer will adjust to new price and trade balance will adjust).

**Absorption Approach:** This is given by Sidney Alexander in 1959. Here absorption means that the domestic consumption of the incremental income.

National Income identity,  $Y = C + I + G + (X - M)$

$$(X - M) = Y - (C + I + G)$$

Substituting  $C + I + G$  by absorption, i.e. "A"

$$X - M = Y - A$$

- Where economy is operating at the full employment level of output ? output cannot be expanded ? balance of trade deficit can be solved through decreasing absorption without equal fall in output ? expenditure reducing policy.
- Where the economy is below the full employment level of output ? output can be increased or/and absorption can be reduced in order to bring equilibrium in the trade balance.

### Monetary Approach:-

The monetary approach to the balance of payments is an explanation of the overall balance of payments. It explains changes in balance of payments in terms of the demand for and supply of money. According to this approach, "a balance of payments deficit is always

and everywhere a monetary phenomenon.” Therefore, it can only be corrected by monetary measures.

The monetary approach can be expressed in the form of the following relationship between the demand for and supply of money:

The **demand for money ( $M_D$ )** is a stable function of income (Y), prices (P) and rate of interest (i)

$$M_D = f(Y, P, i) \dots\dots (1)$$

The **money supply ( $M_S$ )** is a multiple of monetary base (m) which consists of domestic money (credit) (D) and country’s foreign exchange reserves (R). Ignoring m for simplicity which is a constant,

$$M_S = D + R \dots\dots (2)$$

Since in equilibrium the demand for money equals the money supply,

$$M_D = M_S \dots\dots (3)$$

$$\text{Or, } M_D = D + R [M_S = D + R] \dots\dots(4)$$

A balance of payments deficit or surplus is represented by changes in the country’s foreign exchange reserves. Thus

$$\Delta R = \Delta M_D - \Delta D \dots\dots(5)$$

$$\text{Or, } \Delta R = B \dots\dots (6)$$

Where B represents balance of payments which is equal to the difference between change in the demand for money ( $\Delta M_D$ ) and change in domestic credit ( $\Delta D$ ).

A balance of payments deficit means a negative B which reduces R and the money supply. On the other hand, a surplus means a positive B which increases R and the money supply. When B = 0, it means bop equilibrium or no disequilibrium of BOP.

The automatic adjustment mechanism in the monetary approaches is explained under both the fixed and flexible exchange rate systems.

Under the fixed exchange rate system, assume that  $M_D = M_S$  so that BOP (or B) is zero. Now suppose the monetary authority increases domestic money supply, with no change in the demand for money. As a result,  $M_S > M_D$  and there is a BOP deficit.

People who have larger cash balances increase their purchases to buy more foreign goods and securities. This tends to raise their prices and increase imports of goods and foreign assets. This leads to increase in expenditure on both current and capital accounts in BOP, thereby creating a BOP deficit.

To maintain a fixed exchange rate, the monetary authority will have to sell foreign exchange reserves and buy domestic currency. Thus the outflow of foreign exchange reserves means a fall in R and in domestic money

supply. This process will continue until  $M_S = M_D$  and there will again be BOP equilibrium.

On the other hand, if  $M_S < M_D$  at the given exchange rate, there will be a BOP surplus. Consequently, people acquire the domestic currency by selling goods and securities to foreigners. They will also seek to acquire additional money balances by restricting their expenditure relatively to their income.

The monetary authority on its part, will buy excess foreign currency in exchange for domestic currency. There will be inflow of foreign exchange reserves and increase in domestic money supply. This process will continue until  $M_S = M_D$  and BOP equilibrium will again be restored. Thus a BOP deficit or surplus is a temporary phenomenon and is self-correcting (or automatic) in the long-run.

### **REASONS OF BALANCE OF PAYMENT DISEQUILIBRIUM**

Balance of Payment disequilibrium means that Balance of Payment is not in balanced position either it has surplus (inflows > outflows) or deficit (outflows > inflows), so following are the reasons for it:

#### **Economic reason:-**

There are so many economic factors which affect the inflows and outflows of the economy and directly affect the balance of payment of that country.

- **Development disequilibrium:**  
For development process there is large outflow of money in capital account because country imports the capital goods for various development plans. Development expenditure usually increases the purchasing power, demand of products within the economy and price also.
- **Cyclical disequilibrium:-**  
Due to cyclical fluctuation of the general business of that is boom and depression. In depression period, the international trade drastically shrinks whereas boom motivates it at the same time due to boom in country there is economic growth from which the imports are greater than the exports so in this sense it affects the balance of payment.
- **Structural disequilibrium:-**  
The structural changes may also affect the balance of payment position of the economy. Structural changes means that changes in the basic structure of the economy. For example, war problem in 1960s in India due to which, there was devaluation of rupee by largest percentage till now, structural changes of the

1991 in India which promoted the liberalization, globalisation, and privatisation, institutional changes ( From GATT to WTO) in 1994, changes in the pattern of the demand, etc.

- **Exchange rate disequilibrium:-**

Demand and supply of foreign currency and domestic currency is also affect the balance of payment like if the domestic currency is depreciating then our exports will increase and imports will reduce because for purchasing imported goods individual have to pay in foreign currency and when our currency is depreciating then for purchasing one unit of foreign currency we have to give up more domestic currency so they reduce the imports.

### **Political Reasons:-**

Political factors may also results in the balance of payment disequilibrium. If there is political instability in country then there is normally huge capital outflow because of future reactions of the government and political party, inadequate domestic investment and productions and recent example in India, before BJP government (Modi government) came into force, there was FII and capital inflows in the India because foreign investors' sentiments increase regarding BJP government because as seen on 15th august 2014, government launched make in India campaign.

### **Sociological Reasons:-**

Social factors also account for the balance of payment disequilibrium. For example, changes in the tastes, preferences and fashions may affect imports and exports which definitely affect the balance of payment.

## **MEASURES FOR CORRECTING BALANCE OF PAYMENT DISEQUILIBRIUM**

### **1. Automatic correction:-**

The balance of payment disequilibrium is automatically corrected in gold standard and in mercantilist theory of trade. It works when the forces of demand and supply are free to play then the equilibrium will be automatically corrected. Like if there is balance of payment deficit then demand of exchange rate exceeds supply of it which implies increase in exchange rate and fall in value of domestic currency from which exports become cheaper so exports increases and imports become costly so imports decreases. So in this way the balance of payment corrects itself.

Automatic corrections in Balance of Payment happen in fixed exchange rate system through some variables like price, interest, income, and capital flows.

### **2. Deliberate measures:-**

As all know persistent Balance of Payment deficit cannot be corrected by automatic measures all time so there is deliberate measures for correcting the Balance of Payment deficit which are widely used by the country's government so in this government deliberately takes actions to correct the deficit in Balance of Payment.

There are various deliberate measures which are grouped into these i.e. Monetary measures, Trade Measures and Miscellaneous measures.

### **Monetary Measures:-**

- **Monetary Contraction and Expansion:** if there is contraction and expansion in money supply then it will affect domestic demand of outputs which in terns influence the demand of import and export of country. if there is deficit in Balance Of Payment, government contracts the money supply in the economy which implies decline in aggregate demand means decrease in price from which exports increase because of low price and imports decrease because of high price of imports in comparison to domestic price. so in this way it will correct the Balance Of Payment deficit or disequilibrium.
- **Devaluation:** it means that reduction in the rate at which one currency is exchanged with other currency. Devaluation boosts the exports while suppress the imports, Which corrects the Balance of Payment deficit.
- **Exchange Control:** by intervening in foreign exchange market government can correct the disequilibrium in Balance of Payment.

### **Trade Measures:-**

trade measures include promoting the exports from which we gets foreign reserves for making payment for some essential imports with which we cannot do any kind of compromise and reduce the imports.

Export Promotion - reducing the export duties, providing export subsidies which should be appropriate, encouraging export promotion, increase exports by giving incentives in terms of monetary, physical, etc.

Import Control - imposing the quota and licensing, imports substitution, reducing the imports of inessentials items.

### Miscellaneous Measures:-

In Spite of all above measures there are so many other measures that can help to make the balance of payments position favorable. For examples,

- Obtaining foreign loan
- Encouraging FDI and FII's (launching of Make In India campaign by government)
- Development relating to tourism for foreign tourists

### CONCLUSION

Balance of payment is an indicator of the economy's health of a country and all the economic transactions crossing the border of the country come under the preview of the balance of payment and there is some characteristics of balance of payment transactions, like it has some economic value, international transactions, for a particular time period, between resident of one country to resident of other country. Balance of payment should be balanced but due development reasons, necessity reasons, or resources needed for its own country it either show surpluses or deficits and there are so many other reasons for its imbalances which are varied country to country, different country adopt different measure to correct these imbalances depending upon nature of country. As so many studies shown, there are inter

relationship between the balance of payment and monetary indicators for example exchange rate, inflation, price, GDP, economic growth, development process in the country, etc. All these factors or indicators affects and is affected by the balance of payment position.

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