Balance of Payments

The balance of payments outlines an economy's international economic dealings. Exports and imports of products, services, and financial assets are among these transactions, along with transfer payments (like foreign aid).

BoP follows the Double Entry System to record transactions with the rest of the world and has two sides – Credit side and Debit side
There are two main accounts in the BoP.

- Current account
- Capital account

The current account serves as a record of transactions including goods, transfers, and services. Commodities that are traded include both imports and exports. Factor income and non-factor income transactions or undertakings are included in trade-in services.

Transfer payments are the receipts that the citizens of a nation get for free', without having to provide any commodities or services in return. They consist of remittances, grants, and gifts. They could be provided by the government or by private residents living abroad.

The current account can be divided into four components: trade, net income, direct transfers of capital, and asset income.

1. Trade: Trade in goods and services is the largest component of the current account. A trade deficit alone can be enough to create a current account deficit. A deficit in goods and services is often large enough to offset any surplus in net income, direct transfers, and asset income.

2. Net Income: This is income received by the country's residents minus income paid to foreigners. The country's residents receive income from two sources. The first is earned on foreign assets owned by a nation's residents and businesses. That includes interest and dividends earned on investments held overseas. The second source is income earned by a country's residents who work overseas.
Income paid to foreigners is similar. The first category is interest and dividend payments to foreigners who own assets in the country. The second is wages paid to foreigners who work in the country.
If the income received by a country's individuals, businesses, and government from foreigners are more than the income paid out, then net income is positive. If it is less, then it contributes to a deficit.

3. Direct Transfers: This includes remittances from workers to their home country. Direct transfers also include a government's direct foreign aid. A third direct transfer is foreign direct investments. That's when a country's residents or businesses invest in ventures overseas. To count as FDI, it has to be more than 10% of the foreign company's capital.
The fourth direct transfer is bank loans to foreigners.

4. Asset Income: This is composed of increases or decreases in assets like bank deposits, the central bank, and government reserves, securities, and real estate. For example, if a country's assets perform well, asset income will be high. These include:

- A country's liabilities to foreigners such as deposits of foreign residents at the country's banks.
- Loans made by foreign banks abroad to domestic banks.
- Foreign private purchases of a country's government bonds, such as U.S. Treasury securities.
- Sales of the securities, such as stocks and bonds, made by a nation's businesses to foreigners.
- Foreign direct investment, such as reinvested earnings, equities, and debt.
- Other debts owed to foreigners.
- Assets, like those described, held by foreign governments.
- Net shipments of the country's currency to foreign governments.

Again, the opposite will add to asset income and subtract from the deficit. More specifically, this includes:

- Deposits at foreign banks.
- Bank loans to foreigners.
- Sales of foreign-based securities.
- A direct investment made in foreign countries.
- Debts owed to a country's residents and businesses by foreigners.
- Foreign assets owned by a country's government.
- A country's official reserve assets of foreign currency.

The capital account records all the international undertakings of assets. An asset is any one of the types in which wealth can be held. For instance, stocks, bonds, government debt, money, etc. The purchase of assets is a debit on the capital account. If an Indian purchases a USA car company, it enters the capital account undertakings as a debit (as foreign exchange is going out of India).

What is the difference between a current account and a capital account?

The current account offers a more holistic picture of a nation's trade balance, while the capital account is more tightly focused on financial investments. Foreign direct investments get recorded in a capital account, including equity investments in foreign stock.

When is a balance of payments in surplus?

A balance of payments becomes a surplus once total exports outnumber total imports. While the U.S. has an overall deficit in its international transactions, it does have a surplus in the services sector.

Present status of Balance of Payment of India

On the issue of Balance of Payments (BoP), the Economic Survey says that it encountered pressures during the year under review. While the impact of a sharp rise in oil prices was discernible in the widening of the Current Account Deficit (CAD), notwithstanding the cushion provided by the surplus on Invisibles (services, transfer, and income), policy tightening by the US Federal Reserve and the strengthening of the US dollar led to Foreign Portfolio Investment (FPI) outflows. As a result, the surplus of the capital account was lower than the CAD leading to a depletion of forex reserves on a BoP basis. The Economic Survey expresses optimism that going forward, with the expected easing of crude oil prices, the resilience of net services exports and buoyant inward remittances would result in lower CAD during the remainder of FY23 and is expected to be within sustainable limits. Moreover, a comparison with the position of the current account balance (CAB) for selected countries shows that India's current account deficit (CAD) is modest and within manageable limits.

MCQ for Practice

Q1. Which of the following are the reasons for increase in the widening of the Current Account Deficit (CAD)?

1. sharp rise in oil prices
2. policy tightening by the US Federal Reserve
3. strengthening of the US dollar led to Foreign Portfolio Investment (FPI) outflows

(a) 1,2
(b) 2,3
(c) 1,3
(d) 1
(e) 1,2,3
Ans(e)

Q2. What is the difference between a current account and a capital account?

(a) Capital account focuses on both trade balance and financial investment of the country where as current account focusses on trade balance.
(b) Capital account focuses on trade balance of the country where as current account focusses on financial investment of the country.
(c) Capital account focuses on financial investment of the country where as current account focusses on trade balance.
(d) Capital account focuses on trade balance whereas current account focusses on both trade balance and financial investment of the country
(e) None
Ans(c)