**BALANCE OF PAYMENTS**

 **B.A 2nd Sem (Honours)**

A country’s balance of payments not only records a country’s economic transactions with the rest of the world, it also inherently connects to the national economy. The balance of payments helps us understand a country’s position in trade of goods and services in the world, its income and capital flows with other countries and its exchange rate policies

**Definition:**

The balance of payments (BOP) is a ***statistical statement*** that ***systematically*** summarizes, for a ***specific time period***, the ***economic transactions*** of an economy with the rest of the world.

Pay attention to the highlighted terms in the definition. The BOP is a statistical statement, thus giving us numerical information. The statistical information is presented in a systematic manner thus we need to understand the rules of how the numbers are compiled. Economic transactions include transactions in goods, services, factor compensation, and assets. Although trade is an important part of BOP, BOP is not just about trade; its coverage is much broader. BOP

summarizes these transactions for a specific time period. So it is a flow concept, like a company’s income statement which summarizes a company’s revenue and spending for a particular time period.

**The general rule in BOP accounting is specified as follows:**

Credit (+): A flow for which the country is paid: inflow of funds. E.g.: Exports of goods, services to foreigners, income generated from investing abroad, sales of assets to foreign investors

Debit (-): A flow for which the country pays: outflow of funds. E.g.: Imports of goods, travel expenses in foreign countries, income paid to foreign investors, purchases of foreign assets

That is, if a transaction earns or generates foreign currency for the nation, it is called a credit and is recorded as a plus item. If a transaction involves spending foreign currency, it is a debit and is recorded as a negative item. All credit items in the BOP have to be accounted for by the debit items. So the sum of all the plus numbers in the BOP has to be equal to the sum of the entire debit numbers in absolute values. That is, technically, all the accounts in the ***balance*** of payments must sum to zero.

**Total credits + Total debits = 0**

This is analogous to an individual’s personal account. Suppose by the end of the year, you review your household’s income and spending for the year. An inflow of funds is a credit while spending is a debit. Your total inflow has to be accounted for by your spending or saving.

The balance of payments is divided into two major accounts:

a. current account

b. capital account

The current account includes all items of income and outlay – imports and

exports of goods and services, investment income, and transfer payments whereas capital account records all international purchases or sales of financial assets.

**Current Account**

The current account of balance of payments include both visible and invisible items. The visible items include all goods exported and imported and the invisible items are travel, insurance, transportation, interest on loans etc.

**Capital Account**

 The capital account of balance of payments includes borrowings from

 foreign countries and lending to other countries. External assistance

 and commercial borrowings are two main form.

Current account represents net income of a country over a period of time. But capital account shows the net change of assets and liabilities during a particular year. The basic differences between both accounts are as follows:

1. Current account deals with exports and imports of a country, but capital account deals with the assets, capital transfer of a country.
2. Current account is used for trade affair but capital account is used for miscellaneous affairs.
3. Current account is the sum total of the net balance of export and import and net income and direct transfer, but the capital account is sum total of non-financial assets acquired/ disposed of insurance received from foreign insurance companies for catastrophic losses and debt forgiveness.
4. Current account records all the trading related funds inflows and outflows but capital account is such bigger than the current account because it deals with capital investment and expenditure. It also includes the investments of private and public companies.

QUESTIONS

1. Define the balance of payments.

Answer: The balance of payments (BOP) can be defined as the statistical record of a country’s international transactions over a certain period of time presented in the form of double-entry bookkeeping.

2. Why would it be useful to examine a country’s balance of payments data?

Answer: It would be useful to examine a country’s BOP for at least two reasons. **First**, BOP provides detailed information about the supply and demand of the country’s currency.

**Second,** BOP data can be used to evaluate the performance of the country in international economic competition. For example, if a country is experiencing perennial BOP deficits, it may signal that the country’s industries lack competitiveness.

3. Explain how a country can run an overall balance of payments deficit or surplus.

Answer: A country can run an overall BOP deficit or surplus by engaging in the official reserve transactions. For example, an overall BOP deficit can be supported by drawing down the central bank’s reserve holdings. Likewise, an overall BOP surplus can be absorbed by adding to the central bank’s reserve holdings.

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