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Balance of Payments (BoP)

It is the record of all transactions which are taken place between residents of one country and residents of other countries in the given period of time which is generally one year. These transactions are classified as credit and debit based on flow of money. For example, if money coming into the country creates credit items, which has a positive sign. However, if money is going out of the country, it creates debits items and is recorded with a negative sign.
The balance of payments consists of the current account, the capital account, the financial account and Net errors and omissions.

The current account

The current account consists of four main items.

Firstly, trade in goods. It is also called as visible trade. All those items which are touched, weighed or counted included in trade in goods. The difference between visible and invisible trade is sometimes called as balance of trade. For example, trade in cars machineries or food.

Secondly, trade in services. It includes imports and exports in services. For example, if a UK resident buys any insurance policy from a foreign insurance company, it will be recorded as an import transaction in BoP. On the other hand if any foreigner buys holidays in UK, it will be considered as exports for UK.

Third heading in the current account is **income**. For example, those who work abroad and send money home will be considered as exports and opposite to that will be import. It also records flow of money into and out of the country for interest payments, profits and dividends (IPD) on loans, investments and shares.

Fourth item which is included in the current account is **current transfers**. Current transfers are made up of central government transfers, for example, payments and receipts of taxes and subsidies from other countries and other transfers by individuals such as gifts of cash.

The capital account

The capital account records transactions which involves the transfer of ownership of fixed assets and the acquisition or disposal of non financial, non-produced assets. Included in the latter are items such as government investment grant to build a hospital overseas and debt forgiveness between a government and an overseas government. The former include overseas sales or purchase of patent trade marks, or copy rights.

The Financial Account

This is made up of four elements: direct investment, portfolio investment, and other investment and reserve assets. Direct investment relates with the change in the ownership of firms. For instance, if USA based firm build or buy any firm in UK, it will be considered exports of UK and import of USA. Portfolio investment, on the other hand, is investment in bonds or holding of shares and does not involve legal control.
'Other investment' is made up of mainly of what are called short term capital flows. These include transfer into overseas banks, and sales or purchases of short term financial instruments, such as treasury bills or commercial bills.
Reserve Assets are foreign financial assets available to, and controlled by, the monetary authorities for financing or regulating payments imbalances or for other purposes. It is an important component of balance of payments statistics and an essential element in the analysis of an economy's external position. Reserve assets consist on foreign exchange reserves,

government's holding of gold, Special Drawing Rights (SDRs) and other claims. Changes in the holding of reserves may reflect payments imbalances.

Net Errors and Omissions

Theoretically balance of payments is always balanced, but in practice, however, the accounts frequently do not balance. Data for balance of payments estimates often are derived independently from different sources; as a result, there may be a summary net credit or net debit (i.e., net errors and omissions in the accounts).

A separate entry, equal to that amount with the sign reversed, is then made to balance the accounts.

Balance of payments is always balanced?

Balance of payments accounts are constructed in such a way that this has to be true. For example if one exports of $100 and imports of $90, current account surplus will be of $10. This $10 must be invested in holding a financial claim on someone else. It represents a capital outflow from your economy which is the inevitable consequence of current account surplus of $10 and a capital account deficit of $10. The current and financial account balances are equal and opposite size. When added together, they equal zero. Conceptually the financial and current accounts are defined to be equal and opposite, in practice the national income statisticians are not able to keep accurate record of all transactions and hence there are always errors in measurements. Therefore, balancing item 'net errors and omissions is included in the balance of payments.

Does the Balance of Payments matter?

The term balance of payments deficit or balance of payments surplus must refer to the balance on some part of the payments accounts. These terms almost always apply to the current account.

In principle, the over all deficits and surpluses for any economy should balance. A surplus on the balance of payments for one country for example, is offset by a deficit elsewhere. So, if this is the case, why are economists concerned about balance of payments problems? To discuss that one should distinguish between equilibrium and disequilibrium in the BoP.

Equilibrium refers to the situation where manageable deficits are cancelled out by modest surpluses over a period of time. Under these circumstances there is no tendency for the exchange rate to change.

Disequilibrium occurs when, over a particular period of time, a country is recording persistent deficit or surplus in its BoP. As a consequence there is a change in exchange rate.

Disequilibrium in BoP can arise where:

1. The imports of goods and services exceed exports and the financial account is in deficit.
2. Exports of goods and services exceed imports but there is a persistent deficit on the financial account.
3. There is a large surplus on the current account, generating overall balance of payments surplus.

Why do economies have deficit balance of payments?

1. The economy has a high propensity to import goods. Consequently, substantial deficit are recorded annually on the trading account. This happens when there is a rise in peoples' income. In expansionary period consumer spending power increases and they prefer to

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spend more on imported items which create potentially serious problem for the overall balance of payments.

2. Another reason of disequilibrium of BoP is where a country unable to produce goods. So it will have to rely on imports.
3. Another reason for disequilibrium is unfavorable terms of trade. This situation is usually faced by developing economies because such economies mostly rely on the production of primary goods which do not have reasonable exports price.
4. There may be lack of confidence in a particular economy, resulting in few capital inflows. There may even be a situation of an exodus of capital from the economy.

Consequences of balance of payments disequilibrium

If balance of payments is deficit for a shorter period of time there is no concern for the state but if BoP is deficit over a longer period of time then government should intervene and correct the BoP situation.

Secondly, if deficit of BoP makes smaller proportion of the GDP, there is no element of concern but if deficit makes a bigger proportion of GDP then government should take appropriate steps to correct BoP.

Another important factor which must be considered is the nature of imports. If BoP is in deficit due to imports of capital goods and technologies, then it can be expected that in future BoP will be improved because such imports contribute in production, however, if consumer goods make large proportion of imports then government should make policies to correct BoP.

The first consequence is that government has to form expensive corrective policies like expenditure switching policies or expenditure dampening policies. In the former policies, whether there is retaliation from other countries because of tariff or quotas or government has to incur the cost of subsidies. In later deflationary pressure might be created which causes problems for other macroeconomic objectives.

Secondly, due to increase in the demand for imported goods, demand for domestic goods decreases, as a result there is de-industrialization which causes long term unemployment.

When BoP is in disequilibrium over a longer period of time, many risks are involved like uncertainty in economic prospects as well as devaluation in the currency. Hence, foreign investors are discouraged to make investment in that economy.

If Bop is in deficit, currency is devalued, which increase imported price, in turn cost of living rise and fuel cost push inflation.

Foreign reserves determine the credibility of the economy to make future repayments and are also used to control exchange rate. If BoP is in deficit then foreign reserves drain out which leads to fall in the credibility of the economy. Situation will be worsened if government starts borrowing to meet the deficit. it indulge the economy in foreign debts and people face consequences in terms of taxes levied by the state with the intention to make repayments.