

**TOPIC: COMPONENTS OF BALANCE OF PAYMENT**

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## **BALANCE OF PAYMENT**

### **Introduction of Balance of Payment**

The balance of payment is a record of all transactions between entities in one country and the rest of the world over a defined period, such as a quarter or a year. In other words, the balance of payment is a set of accounts that records all the commercial transactions made by a country with other countries over a specific period. It includes all monetary transactions for goods, services, and income during the year.

### **Meaning of Balance of Payments**

Balance of payments is an accounting statement that provide a systematic record to all the economic transaction, between resident of a country and the rest of the world , in a given period of time.

### **Structure of Balance of Payments**

- 1. Credit side:** All inflow or sources of foreign exchange are recorded
- 2. Debit side:** All outflow or uses of foreign exchange are recorded on the debit side.

#### **1. Balance Bop**

Bop is balance when receipt of foreign exchange is equal to payments of foreign exchange.

#### **2. Surplus BOP**

BOP is surplus when receipt of foreign exchange is more than payments of foreign exchange.

#### **3. Deficit BOP**

BOP is deficit when the receipt of foreign exchange is less than payments of foreign exchange.

### **Balance of Payment, Its Structure and Components**

**1. The balance of payments** of a country is a systematic record of all economic transactions between its residents and residents of the foreign countries during a given period of time.

#### **2. Structure of balance payment Accounting**

(a) Transactions are recorded in the balance of payments accounts in double-entry book keeping.

(b) Each international transaction undertaken by country will results in a credit entry and debit entry of equal size.

(c) As international transactions are recorded in double entry accounting, the BOP accounting must always balance i.e., total amount of debits must be equal to total amount of credits.

(d) The balancing item Errors and omissions must be added to “balance” the BOP accounts.

(e) By convention, debit items and credit items are entered with a minus sign and plus sign respectively.

(f) Transactions in BOP are classified into the following **five major** categories:

- |                                         |                                         |
|-----------------------------------------|-----------------------------------------|
| (i) Goods and services account          | (ii) Unilateral transfer account        |
| (iii) Long-term capital account         | (iv) Short-term private capital account |
| (v) Short-term official capital account |                                         |

### **3. Current Account**

#### **(a) Meaning**

Current account records imports and exports of goods and services and unilateral transfers.

The main components of Current Account are:

#### **(i) Export and Import of Goods (Merchandise Transactions or Visible Trade)**

A major part of transactions in foreign trade is in the form of export and import of goods (visible items). Payment for import of goods is written on the negative side (debit items) and receipt from exports is shown on the positive side (credit items). Balance of these visible exports and imports is known as balance of trade (or trade balance).

#### **(ii) Export and Import of Services (Invisible Trade)**

It includes a large variety of non-factor services (known as invisible items) sold and purchased by the residents of a country, to and from the rest of the world. Payments are either received or made to the other countries for use of these services.

Services are generally of three kinds: (a) Shipping, (b) Banking, and (c) Insurance. Payments for these services are recorded on the negative side and receipts on the positive side.

#### **(iii) Unilateral or Unrequested Transfers to and from abroad (One sided Transactions)**

Unilateral transfers include gifts, donations, personal remittances and other ‘one way’ transactions. These refer to those receipts and payments, which take place without any service in return. Receipt of unilateral transfers from rest of the world is shown on the credit side and

unilateral transfers to rest of the world on the debit side.

#### **(iv) Income receipts and payments to and from abroad**

It includes investment income in the form of interest, rent and profits.

### **4. Capital Account**

#### **(a) Meaning**

Capital account is that account which records all such transactions between residents of a country and rest of the world which cause a change in the asset or liability status of the residents of a country or its government.

The main components of capital account are:

**(i) Loans:** Borrowing and lending of funds are divided into two transactions:

#### **(a) Private Transactions**

1. These are transactions that are affecting assets or liabilities by individuals, businesses, etc. and other non-government entities. The bulk of foreign investment is private.

2. All transactions of lending to abroad by private sector and similarly repayment of loans to abroad by private sector is recorded as negative or debit item.

#### **(b) Official Transactions**

1. Transactions affecting assets and liabilities by the government and its agencies.

2. All transactions of lending to abroad by government sector and similarly repayment of loans to abroad by government sector is recorded as negative or debit item.

#### **(c) Private and official transactions borrowing are of two components**

(i) Commercial borrowings, referring to borrowing by a country (including government and private sector) from international money market. This involves market rate of interest without considerations of any concession,

(ii) Borrowings as External Assistance, referring to borrowing by a country with considerations of assistance. It involves lower rate of interest compared to that prevailing in open market.

#### **(ii) Foreign Investment (Investments to and from abroad)**

Investments by rest of the world in shares of Indian companies, real estate in India, etc. Such investments from abroad are recorded on the positive (credit) side as they bring in foreign exchange.

Investments by Indian residents in shares of foreign companies, real estate abroad, etc. Such investments to abroad are recorded on the negative (debit) side as they lead to outflow of foreign exchange.

Investments to and from abroad' includes two types of investments:

### **1. Foreign Direct Investment (FDI)**

It refers to purchase of an asset in rest of the world, such that it gives direct control to the purchaser over the asset.

(i) acquisition of a firm in the domestic country by a foreign country's firm

(ii) transfer of funds from the parent company abroad to the subsidiary company in the domestic country.

### **2. Portfolio Investment**

Portfolio Investment refers to the purchase of financial asset by the foreigners that does not give the purchaser control over the asset. A foreign Institutional Investment (FII) is also a part of portfolio investment.

For instance, purchase of shares of a foreign company, purchase of foreign government's bonds, etc. are treated as portfolio investments.

### **(iii) Change in Foreign Exchange Reserves**

1. The foreign exchange reserves are the financial assets of the government held in central bank. A change in reserves serves as the financing item in India's BOP.

2. So, any withdrawal from the reserves is recorded on the positive (credit) side and any addition to these reserves is recorded on the negative (debit) side.

3. It must be noted that 'change in reserves' is recorded in the BOP account and not 'reserves'.

## 5. Official Settlement Account

An official settlement account (OSA) is a special type of account used in international balance of payments (BOP) accounting to keep track of central banks' reserve asset transactions with one other.

The official settlement account keeps track of transactions involving gold, foreign exchange reserves, bank deposits and special drawing rights (SDRs).

Essentially, this type of account keeps track of transactions related to international reserves and central bank assets that are transferred among nations to settle either a balance of payment deficit or surplus.

- An official settlement account is used to track and account for international balance of payments between central banks.
- It is used to settle transfers of assets and global monetary reserves that circulate among nations' central banks.
- Countries look to these accounts to monitor capital outflows and inflows to and from other countries.

### Understanding Official Settlement Accounts

- OSAs are used in international balance of payments accounting, and represent the current account and the capital account of central banks.
- The current account keeps a record of a country's imports and exports of goods, services, income and transfers, and whether the country is a net creditor or net debtor.
- The capital account records the change in foreign and domestic investments, government borrowing and private sector borrowing.
- When there is either a balance of payments deficit or surplus, inflows of reserve assets or outflows of reserve assets bring the ledger back into balance.
- This is recorded in the official settlement account.