Mohamed Khaider University, Biskra

Faculty of Economics, Commerce and Management Sciences

Commerce Department

Module: English
Branch: International Trade
Level: Third year Bachelor

Lecture 01: The Balance of Payments

Learning Objectives

After teaching this Lecture the Students should be able to:

- ***Understand*** *how economies are linked together at the macroeconomic level.*

- ***Present*** *the international accounting concepts*

- Distinguish the difference between the Balance of Payments and the Balance of Trade.

1- Balance of Payments: Definitions and Features

- The balance of payments (BOP) account is a statistical record of the flow of payments between residents of one country and the rest of the world in a given time period.

- It is a statement of account recording all international receipts and payment of a country with the rest of the world. It measures all international economic transactions between residents & foreign residents.

- The balance of payments (BOP) is a summary of economic activities between the residents of a country and the rest of the world during a given period, usually one year. The main purpose of keeping these records is to inform government authorities of the overall international economic position of the country in order to assist them in arriving at decisions on monetary and fiscal policy, on the one hand, and trade and payments policy on the other. Balance of payments statistics are therefore helpful to government authorities charged with maintaining macroeconomic stability.

Features of BOP

• It is a systematic record of all economic transactions between one country and the rest of the world.
• It includes all transactions, visible as well as invisible.
• It relates to a period of time. Generally, it is an annual statement.
• It adopts a double-entry book-keeping system. It has two sides: credit side and debit side. Receipts are recorded on the credit side and payments on the debit side.

2- Balance of Trade (BOT)

Balance of Trade (BOT) is the difference between the value of exports and imports of goods i.e. visible items only. Thus,
Balance of Trade = Export of visible items – Import of visible items

3-Difference between BOP & BOT

Balance of Payments (BOP) is the summary of all the 'economic' transactions the country has had with the rest of the world (ROW) in a financial year.
Balance of Trade (BOT) is just the summary of the total exports and the total imports of the country in a financial year.

Balanced BOP is when forex payment and receipts are equal. Surplus BOP is when the forex receipts are more than the payments. Deficit BOP is when the forex payments are more than the receipts. Surplus BOT is when the exports are more than imports – it is a 'favourable BOT'. Deficit BOT is when the imports are more than the exports – it is 'unfavourable BOT'.

BOP summarizes all the inter-country transactions (ALL international transactions) and is a wider term which includes BOT. So, BOT forms a part of BOP. Whereas BOT is a narrower term, and includes only the summary of export and import of Visible Items.

	BOP	BOT
1	It is a broad term.	It is a narrow term.
2	It includes all transactions related to visible, invisible and capital transfers.	It includes only visible items.
3	It is always balances itself.	It can be favourable or unfavourable.
4	BOP = Current Account + Capital Account + or - Balancing item (Errors and omissions)	BOT = Net Earning on Export - Net payment for imports.
5	Following are main factors which affect BOP a) Conditions of foreign lenders. b)Economic policy of Govt. c) all the factors of BOT	Following are main factors which affect BOT a) cost of production b) availability of raw materials c) Exchange rate d) Prices of goods manufactured at home

BOP is a wider term and includes:

. *Visible Items*: Those items which are visible/ touchable/ tangible/physical – i.e., they can be seen and measured and touched! BOP includes the export and import of such physical goods.

. *Invisible Items*: Are those which cannot be seen (and hence invisible) or touched but can be felt mainly services. The import and export of services is included like banking/consultancy services of IT/ Legal/ Architecture/ Management/ CA etc./ insurance and logistics services.

. *Unilateral Transfers*: As the name suggests are transactions which are one way

. *Capital Transfers*: Are transfer of title or ownership of capital assets across borders. It includes purchase/ sale of capital assets like land, building, plant and machinery etc. but across borders.

4- The General Rule in BOP Accounting
a. If a transaction earns foreign currency for the nation, it is a credit and is recorded as a plus item.
b. If a transaction involves spending of foreign currency it is a debit and is recorded as a negative item.

5- The various Components of a BOP Statement
. Current Account
. Capital Account

. Reserve Account
. Errors & Omissions

CURRENT ACCOUNT BALANCE

• BOP on current account is a statement of actual receipts and payments in short period.
• It includes the value of export and imports of both visible and invisible goods. There can be either surplus or deficit in current account.
• The current account includes:- export & import of services, interests, profits, dividends and unilateral receipts/payments from/to abroad.
• BOP on current account refers to the inclusion of three balances of namely – Merchandise balance, Services balance and Unilateral Transfer balance

TYPES OF BALANCES

• Trade Balance Merchandise: exports - imports of goods
• Services: exports - imports of services Income Balance Net investment income: net income receipts from assets Net international compensation to employees: net compensation of Employees Net Unilateral Transfers Gifts from foreign countries minus gifts to foreign
countries

Capital Account Balance

• The capital account records all international transactions that involve a resident of the country concerned changing either his assets with or his liabilities to a resident of another country. Transactions in the capital account reflect a change in a stock – either assets or liabilities.
• It is difference between the receipts and payments on account of capital account. It refers to all financial transactions.
• The capital account involves inflows and outflows relating to investments, short term borrowings/lending, and medium term to long term borrowing/lending.

Note:

• There can be surplus or deficit in capital account.
• It includes: - private foreign loan flow, movement in banking capital, official capital transactions, reserves, gold movement etc.
• These are classifies into two categories- * Direct foreign investments

* Portfolio investments & Other capital

The Reserve Account

• Three accounts: IMF, SDR, & Reserve and Monetary Gold are collectively called as The Reserve Account.
• The IMF account contains purchases (credits) and repurchase (debits) from International Monetary Fund.
• Special Drawing Rights (SDRs) are a reserve asset created by IMF and allocated from time to time to member countries. It can be used to settle international payments between monetary authorities of two different countries.

Errors & Omissions

• The entries under this head relate mainly to leads and lags in reporting of transactions
• It is of a balancing entry and is needed to offset the overstated or understated components.

6- Disequilibrium in the Balance of Payments

• A disequilibrium in the balance of payment means its condition of Surplus Or deficit.
• A Surplus in the BOP occurs when Total Receipts exceeds Total
Payments. Thus, BOP= CREDIT>DEBIT.
• A Deficit in the BOP occurs when Total Payments exceeds Total Receipts. Thus, BOP= CREDIT<DEBIT.

7-Causes of Disequilibrium in the BOP

• Cyclical fluctuations

• Short fall in the exports
• Economic Development
• Rapid increase in population
• Structural Changes
• Natural Calamites
• International Capital Movements

8- Measures to Correct Disequilibrium in the BOP
8-1. Monetary Measures :
a) Monetary Policy The monetary policy is concerned with money supply and credit in the economy. The Central Bank may expand or contract the money supply in the economy through appropriate measures which will affect the prices.
b) Fiscal Policy Fiscal policy is government's policy on income and expenditure. Government incurs development and non - development expenditure,. It gets income through taxation and non - tax sources. Depending upon the situation governments expenditure may be increased or decreased.

c) Exchange Rate Depreciation By reducing the value of the domestic currency, government can correct the disequilibrium in the BOP in the economy. Exchange rate depreciation reduces the value of home currency in relation to foreign currency. As a result, import becomes costlier and export become cheaper. It also leads to inflationary trends in the country
d) Devaluation devaluation is lowering the exchange value of the official currency. When a country devalues its currency, exports becomes cheaper and imports become expensive which causes a reduction in the BOP deficit.

8-2. Non- Monetary measures :
a) Export Promotion To control export promotions the country may adopt measures to stimulate exports like: export duties may be reduced to boost exports; cash assistance, subsidies can be given to exporters to increase exports; goods meant for exports can be exempted from all types of taxes.
b) Import Substitutes Steps may be taken to encourage the production of import substitutes. This will save foreign exchange in the short run by replacing the use of imports by these import substitutes.

c) Import Control Import may be kept in check through the adoption of a wide variety of measures like quotas and tariffs. Under the quota system, the government fixes the maximum quantity of goods and services that can be imported during a particular time period.

. Quotas – Under the quota system, the government may fix and permit the maximum quantity or value of a commodity to be imported during a given period. By restricting imports through the quota system, the deficit is reduced and the balance of payments position is improved.

. Tariffs – Tariffs are duties (taxes) imposed on imports. When tariffs are imposed, the prices of imports would increase to the extent of tariff. The increased prices will reduced the demand for imported goods and at the same time induce domestic producers to produce more of import substitutes

Key Terms to learn:

- Gross national expenditure (GNE) is the total spending made by all members of the economy.

- Gross domestic product (GDP) is the total value of all *final* goods and services produced in an economy.

- Gross national income (GNI) is total income earned by residents of a country Wages, capital income, land payments

- The trade balance: is the *trade balance in merchandise and services.* This is exports of goods and services minus imports of goods and services.

- Fiscal Policy: describes the use of taxation and expenditure by the government to influence the level of business activity

- Monetary Policy: Monetary policy describes the use of variations in the quantity of money which may raise or lower interest rates, and hence either directly or indirectly lower or raise aggregate demand.

- Transaction: A transaction is an economic flow between residents and non-residents. Transactions involve changes in ownership of goods and financial assets/liabilities, the provision of services, labour and capital and transfers in cash and kind.

- Foreign Assets: Foreign assets refer to a country's claim on foreigners.

- Foreign Liabilities: Foreign liabilities refer to a country's indebtedness to foreigners.