

Dr.SNS RAJALAKSHMI COLLEGE OF ARTS AND SCIENCE

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Coimbatore- 49



**DEPARTMENT OF COMMERCE WITH
INFORMATION TECHNOLOGY**

MANAGERIAL ECONOMICS
Balance of Payment

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BALANCE OF PAYMENTS

DEFINITION AND MEANING

The Balance of Payments, also referred to as the Balance of International Payments, is an **accounting statement that summarizes all economic transactions between the residents of a country and the rest of the world during a given period. It captures imports and exports of goods and services, capital flows, foreign investments, loans, and transfers.** Transactions are recorded from the perspective of the home country, including those undertaken by government bodies, private firms, and individuals. In essence, BoP acts as a mirror reflecting how much a nation owes to or is owed by the rest of the world, and whether it is a net lender or borrower globally.

BALANCE OF PAYMENTS IMPORTANCE

The Balance of Payments is significant for several reasons:

Economic Health Indicator: It provides an overview of a country's financial and economic status, indicating whether the economy is growing sustainably.

Currency Valuation: BoP data helps determine the direction of a country's currency whether it is appreciating or depreciating relative to other currencies.

Policy Formulation: Governments and central banks use BoP statistics to shape fiscal, trade, and monetary policies, ensuring macroeconomic stability.

Investment Decisions: International investors and agencies rely on BoP data to assess the economic environment and investment potential of a country.

Understanding Trade Performance: BoP allows policymakers to analyze trade imbalances, capital flows, and international investment patterns

COMPONENTS OF BALANCE OF PAYMENTS

The Balance of Payments is broadly divided into three main components:

1. The Current Account
2. The Capital Account
3. Errors and Omissions.

These components collectively provide a holistic picture of a nation's foreign transactions.

CURRENT ACCOUNT

The Current Account captures the flow of goods, services, income, and transfers between a country and the rest of the world. It reflects how a nation is performing in its international trade and is composed of the following sub-components:

Balance of Trade (BoT): This is the **net difference between exports and imports of goods.** A positive balance (more exports than imports) indicates a trade surplus, while a negative balance indicates a trade deficit.

Net Services: It includes services like tourism, banking, transportation, IT services, and royalties earned or paid internationally.

Net Primary Income (Factor Income): This represents earnings from foreign investments minus payments made to foreign investors.

Net Current Transfers: These are unilateral transfers such as foreign aid, remittances, and gifts received or sent abroad.

The Current Account balance is calculated as:

Current Account = Trade Balance + Net Services + Net Income + Net Transfers

A surplus in the current account indicates that a country is a net lender to the rest of the world, while a deficit indicates that it is a net borrower. Generally, the trade balance is the most influential component of the current account, significantly impacting whether the account records a surplus or deficit.

CAPITAL ACCOUNT

The Capital Account records transactions related to the buying and selling of assets such as stocks, bonds, real estate, and loans between residents and non-residents. It includes:

Foreign Direct Investment (FDI): Investments made by foreign entities to acquire ownership or control in domestic firms.

Portfolio Investments: Transactions in stocks, bonds, and other financial instruments.

Loans and Borrowings: International lending and borrowing activity, including assistance from foreign governments and institutions.

A capital account surplus indicates more money is flowing into the economy than leaving it, while a deficit shows the opposite. These movements often mirror investor confidence and the country's attractiveness for foreign capital.

ERRORS AND OMISSION

Despite meticulous accounting, discrepancies can arise in recording all international transactions. These are captured under errors and omissions in the BoP, **reflecting unrecorded or misreported transactions.**

Changes in Foreign Exchange Reserves

Foreign exchange reserves, maintained by the central bank, include foreign currency holdings and Special Drawing Rights (SDRs). Changes in these reserves play a critical role in stabilizing the BoP. For instance, a deficit in the BoP can be corrected through foreign reserve adjustments, while a surplus can lead to accumulation of reserves....