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BALANCE OF PAYMENTS

CC-10: INDIAN ECONOMY- ISSUES AND POLICIES-2

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Balance of Payments

According to Kindle Berger, "The balance of payments of a country is a systematic record of all economic transactions between the residents of the reporting country and residents of foreign countries during a given period of time".

It is a double entry system of record of all economic transactions between the residents of the country and the rest of the world carried out in a specific period of time

when we say "a country's balance of payments" we are referring to the transactions of its citizens and government.

Balance Of Payment : Definition

The balance of payments of a country is a systematic record of all economic transactions between the residents of a country and the rest of the world. It presents a classified record of all receipts on account of goods exported, services rendered and capital received by residents and payments made by them on account of goods imported and services received from the capital transferred to non-residents or foreigners.

- Reserve Bank of India

Features

- 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.

Importance of Balance Of Payments

1. BOP records all the transactions that create demand for and supply of a currency.
2. Judge economic and financial status of a country in the short-term
3. BOP may confirm trend in economy's international trade and exchange rate of the currency. This may also indicate change or reversal in the trend.
4. This may indicate policy shift of the monetary authority (RBI) of the country.
5. BOP may confirm trend in economy's international trade and exchange rate of the currency. This may also indicate change or reversal in the trend.

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.

A country has to deal with other countries in respect of the following

1. **Visible items** which include all types of physical goods exported and imported.

2. **Invisible items** which include all those services whose export and import are not visible. e.g. transport services, medical services etc.

3. **Capital transfers** which are concerned with capital receipts and capital payment.

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Disequilibrium In The Balance Of Payments

A disequilibrium in the balance of payment means its condition of Surplus Or deficit

- ✓ **A <u>Surplus</u> in the BOP** occurs when Total Receipts exceeds Total Payments. Thus,

BOP= CREDIT>DEBIT

- ✓ **A <u>Deficit</u> in the BOP** occurs when Total Payments exceeds Total Receipts. Thus,

BOP= CREDIT<DEBIT

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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

Measures To Correct Disequilibrium in the BOP

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.

Measures To Correct Disequilibrium in the BOP

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.

Measures To Correct Disequilibrium in the BOP

e) *Deflation*

Deflation is the reduction in the quantity of money to reduce prices and incomes. In the domestic market, when the currency is deflated, there is a decrease in the income of the people. This puts curb on consumption and government can increase exports and earn more foreign exchange.

f) *Exchange Control*

All exporters are directed by the monetary authority to surrender their foreign exchange earnings, and the total available foreign exchange is rationed among the licensed importers. The license-holder can import any good but amount if fixed by monetary authority.

Measures To Correct Disequilibrium in the BOP

II. 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.

Measures To Correct Disequilibrium in the BOP

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.

1. 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.
2. 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

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Trends in BOP

RISING DEFICITS

- Deficits have been most serious in respect of current account
- Started in 1950s and rose with no interruption, and at accelerated rate, culminating into a crisis in 1990s
- Plan wise – This trend strained the economy in various degrees
- First year plan – Deficits were small, easily managed, little burden on economy
- Second year plan (with emphasis on industrialisation under Mahalanobis strategy)- deficits rose 10 times bigger

Reversing trend

- In subsequent 3 plans (3rd to 5th), deficits rose two to three times bigger than second plan

- In the 3 annual plans (1966-1969), deficit crossed the big figure of Rs One thousand crores in each year

- But sharp increase took place in 6th and 7th plan

- Same feature continued to mark the 2 annual plans after 7th plan (1990-91 and 1991-92), the eighth plan and the first 3 years of 9th plan

- Then, situation started improving, surplus of Rs. 16426 crore in 2001-02 of the 9th plan

Contribution of each component

- Deficits in BOPs have originated in all its 3 components

✓ Trade in goods or merchandise

✓ Trade in invisibles

✓ Normal capital movements (Transactions on private & government account)

- Biggest contributor was BOT (Difference between exports and imports on merchandise account)

- BOT - Remained negative almost throughout the period, risen massively in the recent years

Contd…

- Net invisibles (receipts – payments) also added to overall deficits but only for a few years
- Middle 1990s- net invisibles has been a net surplus
- 1990s, it was a helpful factor in reducing the deficits in BOP
- Due to this, balance on current account showed smaller deficits
- But for plus net invisibles, the balance on current account would have shown bigger deficits
- Movement of non-monetary gold-little/nil impact
- Capital transactions at times been helpful, sizeable in reducing deficits

Big trade deficits

- Since 1951, deficits in trade balance have increased substantially with the passage of time
- Thus the strains on overall BOP situation are the making of the deficits in the trade balance
- Same has been the case plan wise (Except 4^{th} year)
- The same trend (Proportional to BOP) in each plan continued till 9^{th} plan where trade deficit turned out to be double of the average deficit during the eighth plan period

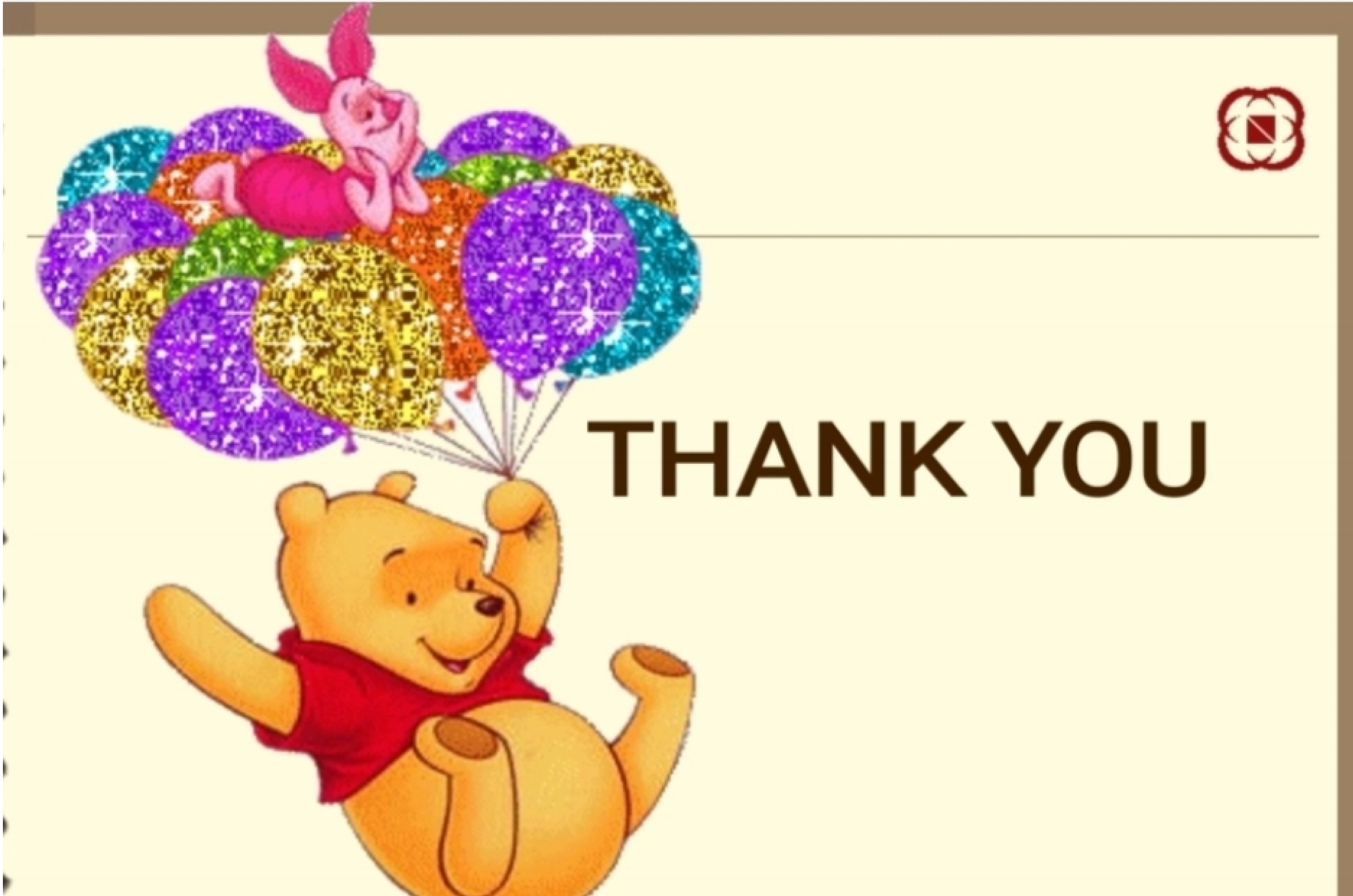
	EXPORTS(+)		IMPORTS(-)		TRADE BALANCE	
PLAN	TOTAL	AVERAGE PER ANNUM	TOTAL	AVERAGE PER ANNUM	TOTAL	AVERAGE PER ANNUM
FIRST YEAR PLAN(1951-56)	3109	622	3650	730	-541	-108
SECOND PLAN(1956-61)	3063	613	5402	1080	-2339	-467
THIRD PLAN(1961-66)	3735	747	6119	1224	-2384	-477
FOURTH PLAN(1969-74)	9049	1810	9862	1972	-813	-162
FIFTH PLAN(1974-79)	23648	4730	27697	5540	-4049	-810
(1979-80)	6418	(-)	9143	(-)	-2725	(-)
SIXTH PLAN 1980-85)	44763	8953	73005	14601	-28242	-5648
SEVENTH PLAN(1985-90)	87071	17414	125759	25152	-38688	-7738
ANNUAL PLANS(1990-92)	78076	39038	101504	50752	-23428	-11714
EIGHTH PLAN(1992-97)	438593	87719	526650	105532	-88066	-17613
NINTH PLAN(1997-02)	842002	168400	1023817	204763	-181815	-36363
TENTH PLAN(2002-05)	910183	303394	1146846	382282	236663	-78888

Table 1: Trend in External Openness			
			(Percent of GDP)
	Merchandise Exports plus Imports	Receipts plus Payments (Current Account)	Total Receipts plus Payments (Current and Capital)
1951-52	15.8	18.5	19.7
1965-66	7.7	9.9	14.1
1973-74	7.8	12.1	17.8
1990-91	14.6	19.4	31.5
1999-00	20.6	31.2	46.8
2008-09	40.6	60.6	111.6
2011-12	43.8	61.5	109.6

- Early 1950s, India was reasonably open
- 1951-52 – Merchandise trade accounted for 16% gdp
- The share of external sector in India's GDP gradually declined with the inward looking policy of import substitution
- Policy emphasis on **import saving** rather than **export promotion**
- Import-substituting strategies were expected to gradually increase export competitiveness through efficiency-gains achieved in the domestic economy. But this did not happen

Volume of Foreign Trade

Year	Exports (Including Re exports)	Imports	Trade Balance
1950-51	606	608	-2
1960-61	642	1122	-480
1970-71	1535	1634	-99
1980-81	6711	12549	-5838
1990-91	32553	43198	-10645
2000-01	203571	230873	-27302
2006-07	571779	840506	-268727
2008-09	840755	1374436	-533681
2009-10	845543	1363736	-518202
2010-11	1142649	1683467	-540818
2011-12	1024707	1651240	-626533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