

MODULE 8

The Balance of Payments

■ A country's Balance of Payments (BOP) Account (at the end of each yearly period) is the relationship between the total receipts (inflows) that it procures, and the total payments (outflows) that it incurs, in the course of its International Trading transactions, with the rest of the world.

■ The BOP is comprised of two sides, which are:

- the **Credit side (all payments received)**,
and

- the **Debit side (all payments paid out)**.

-- The Credit side is the record of all payments received (or inflows), that the

country gets from other countries and trading partners, in the course of its transactions with the rest of the world.

-- The Debit side is the record of all payments (or outflows), that the country pays out to other countries, in the course of its transactions with the rest of the world.

■ Furthermore, each of these two sides is comprised of three sections, namely:

- (1) Current Account section,**
- (2) Capital Account section, and**
- (3) Net Reserves section.**

■ *The Current Account* contains entries of all Visible and Invisible Items of Trade.

-- Visible Items of Trade are tangible **merchandise exports and imports.**

-- Invisible Items of Trade are intangible **services** (such as banking, shipping, insurance, tourism, etc.).

■ *The Capital Account* contains all monetary flows with the rest of the world.

-- These include all monetary and financial transfers involving such things as: **profits, loans, interest payments, dividends, fees, etc.**, that are repatriated across borders.

■ *The Net Reserve* is simply the country's reserve of foreign exchange saved.

Example of BOP Account

- An example of a typical BOP Account of a country, is given below.
- We assume the country is the United States; and this is simply a prototype or hypothetical BOP Account.

The BOP Account

Credit		Debit
(i) The Current Account		
*VIT: Exports -----	8	*Visible: Imports ----- 12
*IIT: Shipping/Banking/Ins.-----	3	*Invisible (Shipping/Bking/Ins) ----- 3
(ii) The Capital Account		
*Profit repatriation to U.S.-----	4	*Profit repatriations from U.S. ----- 3
*Loans to U.S. -----	1	*Loans & Aid to other countries ---- 4
*FDI from abroad -----	2.5	*FDI to other countries ----- 2
*Interest payments from int'l debtors -----	2	*Interest paid to int'l lenders ----- 0.5
*Fees from foreign student -----	2.5	*Fees paid for foreign student ----- 0.5
(iii) Net Reserve		
*Foreign Exchange reserve -----	3	*Foreign Exch. Withdrawals ----- 1
Total -----	26	Total ----- 26

■ First, we note that this prototype BOP account is **BALANCED**, in the amount of $\text{Credit} = \text{Debit} = \26 billion .

■ Yet, although this overall account is balanced, there are imbalances among the various components, such as the BOT (\$4 billion deficit), or the Net reserve of foreign exchange (\$2 billion credit).

-- A country's state of BOP indicates its overall economic health.

-- A country with, say, a \$2 billion deficit on its current account (due to a huge deficit balance of trade) may get \$2 billion in the form of a short-term (or long-term) grant, or loan, from another country or external financial institution, to finance this deficit, and thus balance its BOP.

-- This means that the country balances its BOP by running a surplus on its Capital account in the amount of \$2 billion.

- Alternatively, most countries have official Reserves of foreign currency (and/or gold) that they can draw from, and use to cover any Current account deficits that might arise.

Uses of the BOP Account

- Apart from the GDP, the BOP is the alternative instrument for measuring a country's economic performance, and for measuring the country's overall economic health.
- The BOP is used as an external indicator of economic situation of a country.
- The BOP account is used to maintain transparency in a country's economic data.
- With increasing globalization of economic activities, the BOP is used as a source of statistical data of international transactions.
- The BOP is used as a predictor of the likely direction of the country's currency

Exchange Rate.

- The BOP is used to predict the likely direction of the country's FDI flow.
- The BOP data is used for monetary and financial monitoring of the economy.