

## The Balance of payments

A country's balance of payments is simply an annual record of its financial dealings with the rest of the world. It is also a record of country's supply and demand of foreign exchange.

It is divided into various accounts - prominently

Two.

- I. Current Account
- a. Visible Trade refers to purchase of goods - (X)  $\rightarrow$  (+) entry M (-) entry - also referred as Balance of Trade
  - b. Invisible Trade - sale or purchase of services

c. Current A/c - shows sum of visible & invisible balance -

- b. Invisible transactions are further classified into three (3)

1. Non factor services - e.g. Travel, transportation insurance air services business services (consultancy) Banking Services Educational Services & Government Not Included Elsewhere  
Govt transaction - govt establishes its embassies. American Embassy exp<sup>re</sup> in India is India's exports (+) and Indian Govt exp<sup>re</sup> in Embassy in America is India's Import of services (-)

2. Investment Income - Interest, rent dividend & profits.  
Indian Invest in foreign equities, dividend that he receives is (+) entry. If American invests in India, interest that he earns (current-flow income) is (-) entry in India's B.O.P.

3. Transfers (Not income): grants, relief remittances which do not have any quid pro quo.  
- it can be private or govt.



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Balance of Payments - India 2010-11 bill \$.

I Current Account

1 Exports (goods)	256
2 Imports "	383
3 Trade Balance	-127
4 Invisibles Net	80
a) Non-factor services	44
b) Transfers	53
c) Income	-17
5 Current A/c Balance	-47

II Capital Account

Capital Account Balance	+59
6. External assistance (net) + 4	-
7. External Commercial Borrowing (net)	+12
8. Non-resident Deposits (net) + 3	-
9. Foreign Invest (Net)	+41
of which	
a) FDI (net)	+11
b) Portfolio (net)	+30
10 other flows	-1

III Reserve Change -12  
(addition (-) / withdrawal (+))

The Capital Account -

For each transaction recorded in the current account, there is an offsetting transaction recorded in the Capital account. If an Indian buys an American Car spends 20,000\$ - This is Import of goods in Our current A/c in B.O.P. It results in Foreign (American) Assets in India. When money (.\$ foreign exchange) flows in - it is a (+) entry. Therefore import of goods is (-) entry in current a/c. But American's Asset in India (Ind



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must pay (₹20,000) - ₹ inflow is a (+) entry  
(Although India has to pay in future).

Therefore in accounting sense balance of payment always balances because accounts are prepared on the basis of double entry system

M of car (Current A/c) - 20,000 ₹

Foreign assets in India (Capital A/c) + 20,000 ₹

Thus from this point of view, balance of payment balances.

(+) entry in Capital A/c means borrowing.

(-) entry in Capital A/c means lending (as Capital money is flowing out - although it increases our assets)

Indian assets abroad are divided into private holding + Indian Govt holding - short term + long term

Foreign assets in India are, too, divided into private holding + foreign govt holding - short term + long term

Classification of Capital A/c in B.O.P. (as in lines 6 7 8 9 10, is sometimes called the narrow classification of Capital A/c.

Net of Current + Capital A/c is = -47 + 59 = +12

i.e. B.O.P. is not balancing

Balance for official financing is +12 - plus figure implies → B.O.P. surplus; negative figure → B.O.P. deficit

Broader classification of Capital A/c also includes Reserves / official financing. The final section of the balance of payment account shows how the overall deficit is financed or the surplus disposed off. All items in this account are clearly accommodating items (in contrast to autonomous items)



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✓ since they arise as a consequence of other transaction

- Addition to reserve have a negative sign (-).
  - ✓ whilst drawing on reserve have a positive sign
- Similarly foreign currency borrowing (official financing) will have a positive value and lending will have a negative value.

Because the Balance of payment always balances, this does not imply that it never gives cause for concern. Balance in the accounts is achieved by accommodating transaction and in the case of deficit countries at least there is a limit on the ability of the authorities to sustain these. For instance, a deficit leads to an outflow of reserves which are limited in value or borrowing from abroad which are also limited by foreign perceptions of credit worthiness etc.

### Determination of Exchange-Rate

Two Types of Exchange rate -- Floating Exchange Rate  
- Fixed Exchange Rate

where the exchange rate are allowed to float freely, the value of one currency in terms of another is determined by the operation of market forces

- Demand for currency and supply of currency.

Say there are two countries India + America.

Exchange Rate is  $70 \text{ Rs} = 1 \text{ \$}$

Price of  $\text{\$}$  (in terms of Rs) =  $70 \text{ Rs}$

Price of Rs (in terms of  $\text{\$}$ ) =  $\frac{1}{70} \text{ \$}$

How the price of Rs (in terms of  $\text{\$}$ ) determined.

In brief DD for Rs — arises from (+) entry in



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Balance of Payment - + (a) X - Demand for Indian goods by Americans  
 + (b) X - " " " " Indian services by " "  
 + (c) American buying Indian stocks  
 + d " " Investing in India

SS of Rs (DD for \$) - arises due to (-)ve entry in Balance of Payments - a) M (-) Indians demanding American goods  
 (-) b) M (-) " " " " American services  
 (-) c) Indian buying American stock  
 (-) d) Indian investing in America.

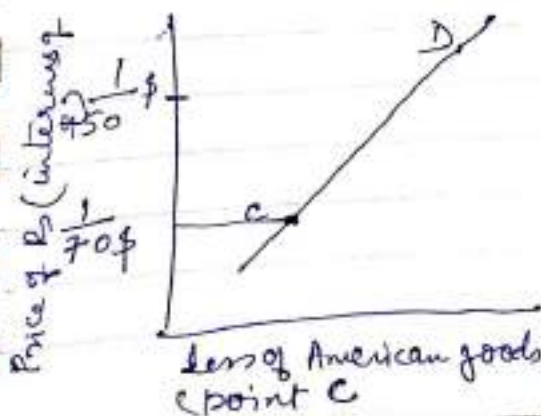
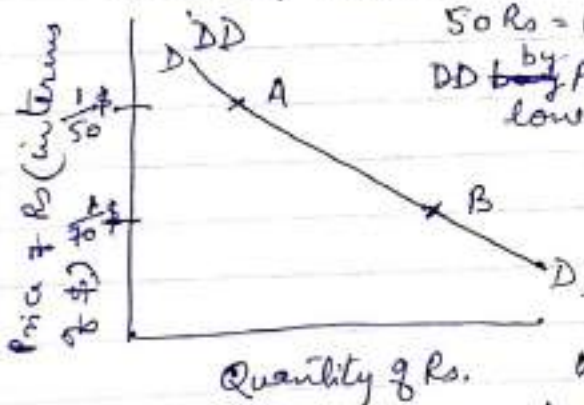
Like a demand for a normal good, Demand Curve for Rupees varies inversely with its price and SS curve of Rupees varies positively with its price.

$1 \text{ Rs} = \frac{1}{70} \$$  is a lower price of Rs compared to  $1 \text{ Rs} = \frac{1}{50} \$$   
 - right??

So when  $70 \text{ Rs} = 1 \$$  - a dollar can buy more Indian goods - so Indian exports X - DD <sup>by</sup> Americans  $\rightarrow$  for Indian goods/services/Investment will be high. (B point). When

$50 \text{ Rs} = 1 \$$  - (Price of Rs comparatively higher) - DD <sup>by</sup> Americans - for Indian goods/services/Inv will be low (Point A)

$\therefore$  AB is negatively sloped.



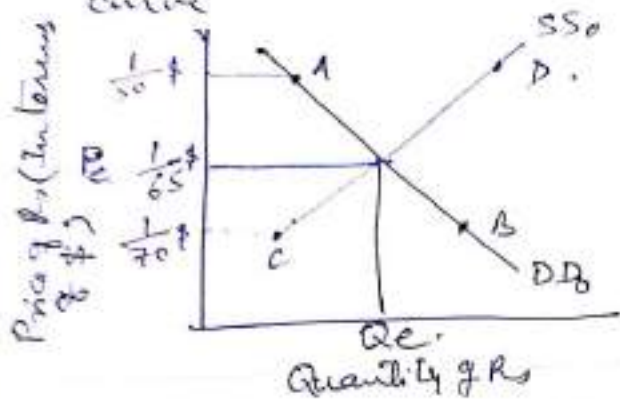
When price of Rs is  $\frac{1}{50} \$$  - Indians have to give 50 Rs to get 1 \$ - so they can afford to buy more American goods/services/foreign I. (Point D)

On the other hand, when price of Rs is  $\frac{1}{70} \$$  - Indians have to give Rs 70 to get 1 \$ - so they will demand, less of American goods/services/Investment  $\therefore$  Supply of Rs will be low (point C)



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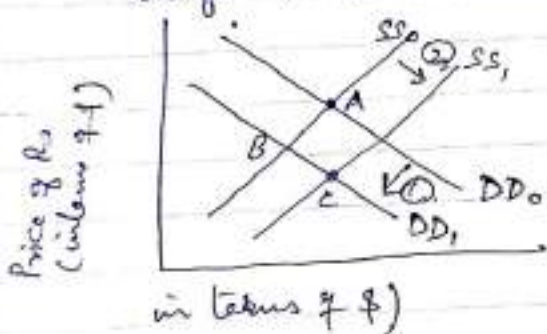
SS of Rupees curve is thus positively sloped.  
 How Exchange Rate is Determined by DD(AB) + SS(C-D) curve



$le \rightarrow DD = SS.$

Factors that affect Exchange Rate

① Inflation Rate - If Inflation rate in India is higher than America - DD for Indian goods will fall -  $DD_0 \rightarrow DD_1$  - left ward shift  $A \rightarrow B$ . Also American goods seems more attractive (relatively cheaper) so SS of Rs increase  $SS_0 \rightarrow SS_1$  (rightward shift)  $B \rightarrow C$



- As a result Rupee depreciates

② Relative Interest Rate - If interest rate in India is higher than America - Two things will happen  
 a) American will Invest more in India - So dd for Rs will increase - shift from  $DD_0$  to  $DD_2$  (rightward - A-D)  
 b) Indians will Invest less in America - SS of Rs will decrease - Shift SS from  $SS_0$  to  $SS_2$  (left ward shift) D-E  
 - So Rs appreciates from A to E

