Question No.1 What are the underlying principles of balance of payments? Explain various components of balance of payments with examples.

Solution: UNDERLYING PRINCIPLES OF BALANCE OF PAYMENTS

The balance of payments is part of a larger system of social accounts recording the economic activity of an economy and its various sections. The social accounts relate to economic transactions not only within the domestic economy but also between the domestic economy and the rest of the world.

Balance of payments is concerned with economic transactions, Five basic types of economic transactions may be distinguished. They are:

a) Purchases and sales of goods and services against financial items i.e. the interchange of goods and services against claims and monetary gold;

b) Barter, i.e. the interchange of goods and services against other goods and services;

c) The interchange of financial items against other financial items e.g. sale of securities for money, or the repayment of commercial debts in money;

d) The provisions or acquisition of goods and services without requital, e.g. grants in 1aid;

e) The provision or acquisition of financial items without requital, e.g. in payment of taxes or as a gift

The social accounts have common rules of credit and debit for recording economic transactions. Credit entries are made for the provision of goods and services or of financial items, whether they are sold, bartered, or acquired without requital. Debit entries are made for acquisition of goods and services or of financial items, whether these items are purchased, obtained by barter, or acquired without requital. For the first three types of transactions, the rules immediately result in equal credit and debit entries. For the remaining types, a credit entry for goods and services or financial items is matched by a debit entry for an unrequited transfer, and vice versa.

Now, Residents term is certainly not identical with the term “citizen” though there is normally a substantial overlap. As regards individuals, ‘residents’ means those individuals whose general center of interest can be said to rest in the given economy. They consume goods and services, participate in the productive process or otherwise carry out economic activity within the territory of the country on other than a temporary basis. Members of diplomatic and consular staffs and official mission, members of armed forces stationed abroad, and citizens undergoing medical treatment or studying abroad are considered residents of their own rather than of the country where they are staying. The extent to which other citizens living abroad are treated as residents (travellers) or foreigners (emigrants) depends upon a number of factors such as permanence of their living and the extent to which they shift their general “center of interest”. As regards non-individuals a set of conventions have been evolved. For example, governments and non profit bodies servicing resident individuals are residents of the respective countries. For, enterprises, rules are somewhat complex particularly those concerning unit of corporate branches of foreign multinationals, According to IMF rules, these are considered to be residents of countries where they operate, though they are not a separate legal entity from the parent located abroad, International organizations like the UN, the World Bank, the IMF are not considered to be residents of any national economy even though their offices may be located within the territories of any number of countries.

COMPONENTS OF BALANCE OF PAYMENTS

The balance of payments is a collection of accounts conventionally grouped into three main categories with subdivisions in each. Three main categories are:

1. The Current Account: Under this are included imports and exports of goods and services and unilateral transfers, which reflect government and private gifts and grant

a. Merchandise: Merchandise exports valued on F.O.B.. (Free on board) basis, on private and government account are the credit entries data for these items. They are calculated from the various documents exporters fill and submit to designated authorities.

Imports valued at C.I.F. (Cost, Insurance and Freight) are the debit entries. The difference between the totals of credits and debits appears in the ‘Net’ column. This is the balance on Merchandise Trade Account, a deficit, if negative and a surplus if positive.

b. Non-Monetary Gold Movements: Gold is both a commodity and a financial asset. It is treated as a financial assets when it is held by the monetary authority. “Monetisation” of gold refers to the transaction when the monetary authority acquires gold, from residents and non residents to add to reserves. This get recorded as a debit entry in reserve account and the offsetting credit entry is made in the non monetary gold account. Conversely, when the monetary authority acquires gold demonetisation, reserve account shows a credit and the non monetary gold movement account shows a debit. Gold imported (or exported) by other agencies form a part of the merchandise trade account.

c. Invisibles: Credits under 'invisibles' consist of services rendered by residents to non residents, income earned by residents on their ownership of foreign financial assets (interest, dividends etc.), income earned from the use, by non residents, of non-financial assets such as patents and copy rights owned by residents and the offsetting entries to the cash and in kind gifts received by residents from non-resident. Debits consist of same items with the roles of residents and non-residents reversed. A few examples may be cited as follows.

The net balance between the credit and debit entries under the heads merchandise, non-monetary gold movements taken together is the Current Account Balance. The net

balance is taken as deficit, if negative (debits exceed credits), a surplus, if positive (credits exceed debits).

2. The Capital Account : Under this are grouped transactions leading to changes in foreign financial assets and liabilities of the country. It records the changes in the levels of international financial assets and liabilities. The various classifications within the capital account are private, banking and official. Distinction is also made between short term and long term capital flaws, loans with original maturity of more than one year are classified as long term flows. Long term foreign investment measures all capital investments made between countries, including both direct foreign investment and purchases of securities

with maturities exceeding one year. Short term foreign investment measures flows of funds invested in securities with maturities of less than one year. Because of the short maturity, investors of such securities will often maintain their funds in a given country for only a short time, causing short term investment flows to be quite volatile over time.

a. Private-capital Flows: These flows consist of several type of transactions. Among them are: long term loans received by individuals and companies (other than banking institutions), investment by foreigners in the joint stock companies in India, repayment of long term loans by non resident, obtained from residents, repatriation of Indian investments abroad, deposits in non-resident (external) rupee accounts and in foreign currency non-resident accounts. Capital outflows (debit entries) comprise investments by residents in shares and other financial assets abroad, repayment of foreign loans by

residents, repatriation of foreign investments in India, long term loans made to non-residents and so forth. Short tern capital flows on private account consists of short term

borrowings and investments.

b. Banking: Capital movements in banking sector covers changes in foreign assets and liabilities of commercial banks, whether privately owned or government owned and cooperative banks. Assets consist of balances held by banks with their foreign branches or correspondent banks abroad, and rupee assets representing loans granted by Indian banks to branches of foreign banks in India and correspondent banks. Liabilities consist of Indian banks' debit balances in their foreign accounts and credit balances held by non resident banks and few other institutions with banks in India. Any increase in assets (or decrease in liabilities) will be a debit entry while a decrease in assets (or increase in liability) a

c. Official Capital flows: this category covers transactions affecting foreign financial assets and liabilities of the government of India and the Reserve Bank of India, excluding transactions relating to official reserve assets. Government of India's purchase and repurchase from the IMF are shown in a separate account. Loans received by the Government of India from foreign governments and international institutions are treated as credit entries and amortization or repayment of such loans as debit.

3. The Reserve Account : In principle, this is not different from the capital account in as much as it relates to financial assets and liabilities. However, in this category, only reserve
assets are included. These are the assets which the central bank of the country uses to settle the deficits and surpluses that arises in the other two categories. The IMF account contains, as mentioned above, purchases (credits) and repurchases from the IMF. SDRs (Special Drawing Rights) are a reserve asset created by the JMF and allocated to member countries from time to time. Subject to IMF regulations, SDRs can be used to settle international payments between monetary authorities of member countries. .An allocation is a credit and the utilization is a debit. The reserves and Monetary Gold account increases (debits) and decreases (credits) in reserve assets. Reserve assets consist of RBI holdings of gold and foreign exchange (in the form of balances with foreign central banks and investments in foreign governments securities) and Government's holdings of SDRs