Question No.1 What is balance of payments? Explain its major components. Why is it useful to compute a country's balance of payments?

Solution: The concept of balance of payments (BOP) has emanated from commercial and financial transactions between nations.

The balance of payments comprises three types of financial flows. First, the value of visible exports can be balanced against the value of visible imports to determine trade balance. Trade in merchandise represents these visible items like grain, oil, jewellery, garments and machines

Second, the value of invisible export can be balanced against the value of invisible imports to determine invisible balance. Invisible trade is represented by services like shipping, insurance, tourism and consultancy. When merchandise exported from India is carried in foreign ships or insured by foreign underwriters, the charges paid for these services constitute invisible imports or say import of services. On the other hand, charges received by Indian ships or underwriters for carrying foreign merchandise, or for insuring it, get counted as invisible exports or say export of services. Likewise, foreign tourists visiting India generate invisible exports for her, while Indian tourists going abroad create invisible imports for their country. When foreign consultants are hired by Indian firms, Governments or other agencies, consultancy fees amount to invisible imports. As against this, when fees for such services are received here by Indians from abroad, these fall in the category of invisible exports. Total visible and invisible exports balanced against visible and invisible imports is called current account balance. If these combined exports exceed these combined imports, there is favourable current account balance. In case, such imports exceed such exports, we have unfavourable current account balance. It is rare that both these variables are just equal or perfectly balanced.

Thirdly, the balance of payment consists of balance of investment and other capital flows, called capital account balance. If such inflows into a country exceed the outflows there from, the amount of "net inflow" would either push up the (otherwise) favourable 'current account balance' into a more favourable balance of payments, or the (otherwise) unfavourable current account balance would be transformed into a less unfavourable balance of payments. Conversely, when there is net outflow on capital account, an unfavourable current account balance would turn into a .more unfavourable balance of payments. In case there had been a favourable current account balance it may either become less favourable BOP, or an unfavourable BOP, depending on whether the net outflow is smaller or bigger than the erstwhile current account balance.

Sometimes, a distinction is made between market balance of payments and accounting balance of payments. The latter may be defined as a periodic statement summarising all the external (commercial and financial) transactions in which a country is involved during a year or any other period of time. The net result may be favourable (surplus/plus) or unfavourable(deficit/minus),to be appropriated or financed in some way so that the two sides of the account are always equal, even if a suspense account has to be raised to cover up some discrepancy (say, funds in transit) or accounting error. This is in line with the conventional code of double entry book-keeping. The market balance of payments signify the current or ongoing relationship between what comes in(inflows) and what goes out (outflows) as a result of both capital and current (visible and invisible) account transactions. In effect, BOP signify supply and demand of foreign currency (say, US dollar, British pound sterling or Japanese yen). The supply is generated, in the normal course, through (visible and invisible) exports and capital inflows, while demand emanates from (visible and invisible) imports and capital outflows. Normal supply may be diminished when foreign exchange accounts get blocked in emergent situations such as wars or hostile policies of certain countries. By the same token such supply may get augmented when blocked or frozen accounts are permitted to melt (like the release of India's sterling balances accumulated during the Second World War with the Bank of England). Normal demand, too, may get augmented when special or extraordinary payments have to be made to a foreign country or in a foreign currency (say, reparation payments imposed on Germany after the First World War, or subscriptions to United Nations an4 its Agencies since 1945). Likewise, the demand may diminish when certain (re)payments are rescheduled or waived (fully or in part) to give relief to a country stricken by droughts, floods, earthquakes, epidemics or other mishaps. Whether guided by humanitarian or political consideration, other (donor) countries may even make (discretionary/ex gratia) transfer payments which may strengthen the current account position of the (donee) country.

In effect, the demand and supply relationship may reflect itself in an upward or downward movement of the exchange rate and for in the level of external reserves. For example, the cost of one US dollar went up from about 35 to roughly 40 Indian rupees between August 1997 and February 1998. There was some loss of foreign exchange reserves when the Reserve Bank of India intervened to resist fall in the external value of the rupees. As such, official reserves account stands separately from current account and capital account. Official reserve account measures charges in the holdings of foreign currency, SDRs and gold by central bank of the country. In all these three accounts currency inflows may be viewed as credits, while outflows as deemed to be debits. During ariy period of time aggregate credits should be equal to aggregate debits. That is why deficits/surpluses in current and capital accounts lead to depletion/augmentation of official reserves. In the ultimate analysis, balance of payments summarises all the economic transactions between residents of the home country (say, India) and residents of all other countries and signifL demand and supply of foreign currency/currencies.

The BOP can be expressed as follows :
BOP = CRA (current account balance) + CPA (capital account balance) + ORA (official reserve account balance)
The BOP must always balance, since it is an accounting identity in a fried exchange rate system. If the sum current account and capital account is not zero then the government must take action by adjusting the official reserve account to balance BOP. It does **so** by buying or selling foreign currency and gold depending upon the situation, up to a total that equals the difference between current account and capital account.
In a floating rate system, market forces act to adjust the exchange rate **as** necessary to force the BOP back to zero.