Unit-4

Balance Of Payments-

The BOP of a country is an annual record of its monetary transaction with ~~its~~ other countries of the world. It is an important index which reflect the true economic position of a country. There are various types of monetary transactions these are classified into 3 sub heads:

1) The exports & import of a country give rise to monetary transaction with other countries. The exports give rise to receipts ~~fo~~ from foreign countries while import give rise to payments made to foreign countries for important good

2) The international lending & borrowing also give rise to monetary transaction among the countries of the world.

3) The service of foreign debts & their final repayments also give rise to monetary transactions among the countries of the world.

Thus the BOPs is an annual record of the international receipt &

payments of a country. It indicates the real ~~money~~ monetary position of a country.

40% unit I

Balance of Trade & Balance of Payment
(BOT) (BOP)

The Balance of Trade (BOT) of a country shows the trade transaction with other countries during a year. It indicates the relationship betw the value of exports & the value of imports of the country in question. The BOT takes into account only the visible exports & imports which are ~~act~~ actualy recorded into the ports. If the money value of export is greater then the money value of import, BOT is said to be favourable. On the other hand if the money value of export is less then the money value of imports than BOT is said to be ~~unfavo~~ unfavourable for the country.

On the other hand, balance of payment shows not only the visible exports & imports in the international receipts & payments but also the invisible items of the country which are not recorded ~~on~~ on the ports. The invisible items are the services rendered by shipping, insurance & banking companies, debt & repayment & payments of interest & expenditure by ~~tour~~ tourist etc. Thus the ~~BOP~~ concept of BOP is much wider & more comprehensive concept than balance of trade.

The main points of difference betw BOT & BOP are as follows-

1) In the BOT account only the exports & imports of visible goods are included; whereas BOP account includes both visible & invisible transactions. It also includes unilateral transfers & capital transaction.

2) BOT account is a part of the current account of BOP; whereas BOP account considers ~~BOT~~ both current account & capital account.

3) There may be surplus or deficit in the balance of trade account; where as BOP account always balance in accounting sense.

4) BOT ~~acco~~ account influences the N.I of a country. A surplus in the BOT account raises the N.I & deficit in the BOT reduces the N.I. On the other hand favourable BOP situation implies a surplus in the current account (i.e deficit in the

capital account.) It shows reduction in the indebtedness of the country & unfavourable BoP; on the other hand indicates growing indebtedness of the country.

5) BOT doesnot indicate the international monetary position of a country; whereas BOP indicates the real international monetary position of a country.

Components of BOP

The BOP of a country is of 2 types-
1) current account.
2) capital account.

Current account – The current account of a country consist of all transaction related to trade in goods & services & unilateral transfer. It contains receipts & payments on account of exports & imports of visible & invisible items. Exports & imports of material goods are visible items; export & imports of service are invisible items. Transactions in the current account are called real transactions' ~~bet~~ becoz they are concerned with actual transfers of goods & services which affect income, output & expenditure of 2 countries. These are also called income generating transfer. The

The current account of BOP include the following items –

a) Merchandise items:- The item merchandise item refers to the value of visible exports & imports. Exports & imports of good form the visible account & ~~had~~ have a dominant position in the current account part of the BOP. Export constitute the credit side & import the ~~debt~~ debit side.

b) Travel:- Travel is an invisible item of BOP. Travel ~~it~~ may be done ~~on~~ for reason such as business, education, health, pleasure etc. Expenditure by foreign ~~tour~~ tourist in our country ~~from the~~ form the credit items & expenditure by our tourist abroad constitute the debit item in our BOP.

c) Transportation:- International transportation of goods is another invisible transactions. Use of domestic transport service by foreigners is a credit item & the use of foreign transport services by domestic traders is a debit item.

d) Investment Income- Another invisible item in the current account of the BOP is the investment income which includes interest, rents, dividends & profits. Income from ~~for~~ capital invested abroad is ~~a~~ the credit item & the dividend item paid on capital borrowed from abroad is ~~a~~ debit item.

e) Govt transactions - It refers to the expenditure incurred by govt for the upgradatation of its organisation abroad. Ex - payment of salaries to ambassadors, high commissioners etc. Such amount received from abroad constitute the credit item & made to other countries from the debit item.

f) Donation & Gifts - Donation & gift received by a country from abroad are the credit items & sent to foreign countries are the debit items ~~from~~ in the BOP accounts.

2) Capital Account:-

The capital account of balance of payment of a country deals with the financial ~~floor~~ flow. It ~~inclu~~ includes all type of short term & long term international movement of capital. The items of capital account are :-

a) Private Loan:- Foreign loan received by the private sector is a credit item & sent to foreign countries ~~& repaid by the~~ is a debit item.

Scanned with CamScanner

b) Movement of Banking Capital - Inflow of banking capital including the central bank is a credit item & outflow of banking capital including the central bank is debit item.

c) Official Capital Transaction -

i) Loans - Foreign loans & credit received by public sector including drawing right from the IMF is credit item. Loans extended to other countries are debit items.

ii) Amortisation - Repayment of official loan by other countries is credit & repayment of official loan by ~~a~~ home country is debit item

iii) Miscellaneous - All other ~~of~~ official capital receipt including those of central bank are of credit items, all other official capital payment including those of central bank are of debit items.

~~iv) Reserves & Monetary Golds - Changes in the official foreign~~

iv) Monetary Reserves & Gold - Changes in the official foreign exchange holding, gold reserve of central Bank & SDR holding of the govt purchase from IMF & similar other capital transactions, all such receipts are ~~&~~ credits ~~are~~ & payments are debit items.

Hypothetical Example

A balance hypothetical BOP statement (in crores)

Item	Credit	Debit	Net
A. current A/C			
i) Merchandise trade invisible	400	600	-200
ii) Service	200	400	-200
iii) Investment earnings	300	200	+100
iv) Unilateral receipts	400	300	100
I Subtotal (A)	1300	1500	-200
B. Capital A/C			
v) Long term loans	400	350	50
vi) Short term Loan	200	150	50
vii) Gold movement	200	100	100
II Subtotal (B)	800	600	200
Gross Total (Subtotal A) + (Subtotal B)	2100	2100	NIL

* Q) What do you mean by disequilibrium in balance of payment? Explain the causes of disequilibrium in BOP. Also suggest some remedial measures to correct the diseqb^m in the BOP.

A country's BOP$_s$ is in equilibrium when there is perfect equality between the demand for & supply of foreign exchange. A position of disequilibrium in the BOP of a country exist if when the demand for foreign exchange exceeds its supply & vice versa. When the demand for foreign exchange ~~ex~~ exceeds its supply, there is said to be deficit in the BOP$_s$. On the contrary when the supply of foreign exchange exceeds its demands, there is said to be surplus in BOP$_s$. Wether the BOPs is in surplus or deficit there exist a disequilibrium which is not desirable in the longer economic interest of the country. However the surplus disequilibrium may not be so bad for the country as the deficit disequilibrium is. The reason is that the burden of bringing about adjustment in the BOPs fall more heavily on the deficit item then on the surplus.

Scanned with CamScanner

Causes of Disequilibrium in the BoPs

The various causes of disequilibrium in the BOPs may be broadly classified in 3 heads-
1) Natural Factor.
2) Economic factor:
3) Political factor.

1) Natural calamities such as flood, drought etc adversely effect the production in the country. As a result the export will fall & imports would increases & this will lead to deficit in country's BOPs.

2) Economic factor The various economic factor can be sub divided under the sub heads-

a) Cyclical fluction - The trade cycle causes cyclical disequilibrium in the BOPs. During depression the income of the people of the foreign country falls. As a result the export to those countries tend to decline which intern produces diseqlm in the home country's BOPs.

b) Price-Cost Structure - Rise in the price-cost structure of export industries ~~ad~~ adversely effect the volume of export & creat diseqlm in the BOPs. Increase in price due to higher wages, higher cost of raw material

etc reduce export & makes the BOP unfavoura-
-ble. ~~Intern~~

c) International Capital Movement - The internati-
-onal capital flight is another reason for the diseqlm in the ~~b~~ BOP. The countries receiving capital inflows tend to have favourable BOPs.

d) Changes in Foreign Exchange Rate - Changes in the rate of exchange is another cause of diseqlm in the BOPs. An Appreciation in external value of money makes import cheaper & export dearer. Thus import increases & export falls & the BOPs become ~~unfavo~~ unfavourable. Similarly, depreciation in the external value of money leads to reduction in import & increase in export & the balance of payments become favourable.

e) Stages of Economic Development - If a country in its initial development process it will have deficit BOP, becoz it imports raw materials, machinery etc & exports primary product. The country has to pay more for costly imports & gets less for its cheap export. This leads to diseqlm in BOP.

3) Political Factor - Political ~~also pro~~ factor also produce diseqlm in BOP. Domestic prodn is adversly effected by political instability wars etc as a result export falls & import increases, causing diseqlm in the BOPs.

* Measures To Correct Disequilibrium in BOP

The various measure to eliminate the diseqlm in BOPs are discussed below -

1) Money contraction - The govt of a country may resort to currency contraction to remove the diseqlm in the BOPs. ~~On the RBI~~ central Bank by leasing bank rate, by ~~Salin~~ selling security in the open market & by other method can reduce the volume of credit in the economy. This reduces the prices & money income. Fall in price & tend to ~~sti~~ stimulate export, while reduction in income check imports.

2) Exchange Depreciation - Depreciation means a fall in the rate of exchange ~~of~~ one currency in terms of another. ~~It~~ A currency would depreciate when its supply in the foreign exchange market is larger than the demand. The effect of depreciation of a currency is to make imports dearer & to make

export cheaper. Thus depreciation helps a country to reduce the deficit in the BOP$_s$ by checking imports & stimulating exports.

3) Devaluations - The govt of a country may resort to devaluation of a currency to correct the deficit in the BOP$_s$. It refers to the official reduction of external value of a currency. By decreasing the value of a currency in terms of foreign currency, devaluation discourage imports & encourage exports & thus correct the diseqlm in BOP$_s$

4) Exchange Control - It refers to the control over the use of foreign exchange by the central bank. Under this method all the exporters are directed by the central bank to surrender their foreign exchange earnings. The available foreign exchange is rationed among the licensed importers only & only the licensed imports are permitted.

5) Encouraging Export & Discouraging import - In order to correct the adverse BOP$_s$ all effort should be made to encourage export. The govt

should promote various export promotion programme such as reduction of export duties, provision of export subsidies, quality control etc.

Attempt should also be made to reduce import by adopting following measures to discourage imports-

a) Import duties - It is a tax on import. The govt imposes taxes on some or all imports. This raises the price of import, discourages imports & does correct the diseqlm in BOPs.

b) Import quotas - Fixing import quota is another method of correcting adverse BOP. Under this system, the govt ~~fixes~~ fixes a max quantity of a commo to be imported. Thus by restricting import by this ~~methoug~~ method the deficit in BOP can be reduced.

c) Import substitution - An effective method of correcting diseqlm in the BOPs through reducing import is to encourage industries producing import substitutes. Import substitution helps the national economy to become self sufficient & reduces its dependence on imports.

Foreign Trade Multiplier (F.T.M)

Foreign Trade multiplier also known as the export multiplier, operates like the investment multiplier of keynes. It may be defined as the amount by which the N.I of a country will be raised by a unit increase in domestic investment on export. Thus Foreign trade multiplier is given by $F_m = \frac{\Delta Y}{\Delta X}$ ~~where~~

where ΔX = Increase in exports which initiate the multiplier process

ΔY = Additional income generated by the process of successive rounds of expenditure.

Numerically:-

$$F_m = \frac{1}{1 - mpc + mpm}$$

where

mpc = marginal propensity to consume.
mpm = marginal propensity to import.

Derivation of F.T.M

In an open economy in time period t_0

$$Y_0 = C + I + (X - M) \text{ ——— } (1)$$

where t_0 = is the initial time period
Y_0 = National income
C = Consumption exp
I = Investment exp
(X-M) = Net exports

Again $C = a + bY_0$ ——— (ii)

$M = l + mY_0$ ——— (iii)

Substituting (ii) & (iii) in (1)

$$Y_0 = a + bY_0 + I + X - l - mY_0$$

$$\Rightarrow Y_0 - bY_0 + mY_0 = a + I + X - l$$

$$\Rightarrow Y_0(1 - b + m) = a + I + X - l$$

$$\Rightarrow Y_0 = \frac{a + I + X - l}{1 - b + m} \text{ ——— (IV)}$$

We have calculated In time interval t_1 let export increased by ΔX. Then the new eqll^m^ position

$$= Y_1 = C + I + X + \Delta X - M$$

$$\Rightarrow Y_1 = a + bY_1 + I + X + \Delta X - l - mY_1$$

$$\Rightarrow Y_1 - bY_1 + mY_1 = a + I + X + \Delta X - l$$

$$\Rightarrow Y_1(1 - b + m) = a + I + X + \Delta X - l$$

$$\Rightarrow Y_1 = \frac{a + I + X + \Delta X - l}{1 - b + m} \text{ ——— (V)}$$

From (V) – (IV)

$$\Rightarrow Y_1 - Y_0 = \frac{a + I + X + \Delta X - l}{(1 - b + m)} - \frac{a + I + X - l}{(1 - b + m)}$$

$$\Rightarrow \Delta Y = \frac{\cancel{a} + \cancel{I} + \cancel{X} + \Delta X - \cancel{l} - \cancel{a} - \cancel{I} - \cancel{X} + \cancel{l}}{1 - b + m}$$

$$\Rightarrow \Delta Y = \frac{\Delta X}{1 - b + m} \Rightarrow \frac{\Delta Y}{\Delta X} = \frac{1}{1 - b + m} \Rightarrow F_m =$$

Q) If MPC = 0.8 & MPM = 0.3. Find ea change in N.In

$$F_m = \frac{1}{1-0.8+0.3}$$

$$\begin{array}{r} 0.8 \\ -0.3 \\ \hline 0.5 \end{array}$$

$$= \frac{1}{1-0.5}$$

$$F_m = \frac{1}{0.5}$$

$$\frac{\Delta Y}{\Delta X} = 2$$

$$\Delta Y = 2 \cdot \Delta X$$

Q) If MPS = 0.3, MPM = 0.2 & ΔX = ₹1000 crore find ΔY.

we know

$$MPC + MPS = 1$$

$$\Rightarrow MPC + 0.3 = 1$$

$$\Rightarrow MPC = 0.7$$

now

$$F_m = \frac{1}{1-0.7+0.2}$$

$$\Rightarrow \frac{\Delta Y}{\Delta X} = \frac{1}{1-0.5}$$

$$\Rightarrow \frac{\Delta Y}{\Delta X} = \frac{1}{0.5}$$

$$\Rightarrow \frac{\Delta Y}{1000} = 2 \quad \Rightarrow \Delta Y = 2000 \text{ crores}$$

Assumption of Foreign Trade multiplier:

The foreign Trade multiplier is based on following assumption—

1) There is full employment in the domestic economy.
2) It is on a fixed exchange rate system.
3) There is no accelarator.
4) There are no tariff barriers & exhange controls.
5) Domestic investment remains constant.

Limitations

1) The assumptions of existance of full employment, free trade, absence of quantitative & other restrictions etc of the theory of foreign trade multiplier makes the theory an unrealistic one.
2) The theory of foreign trade multiplier leaves out the interaction bet'n enfrace variation & rate of exchange.
3) The foreign trade multiplier is assumed to be an instantaneous process where by its supplies the final results thus, it involves no lags & therefore unrealistic.
4) The whole analysis is applicable to a 2 country model. If there are more then 2 countries, the theory is not applicable.