IASBABA'S PRELIMS EXCLUSIVE PROGRAM (PEP) 2022

ECONOMY HANDOUTS

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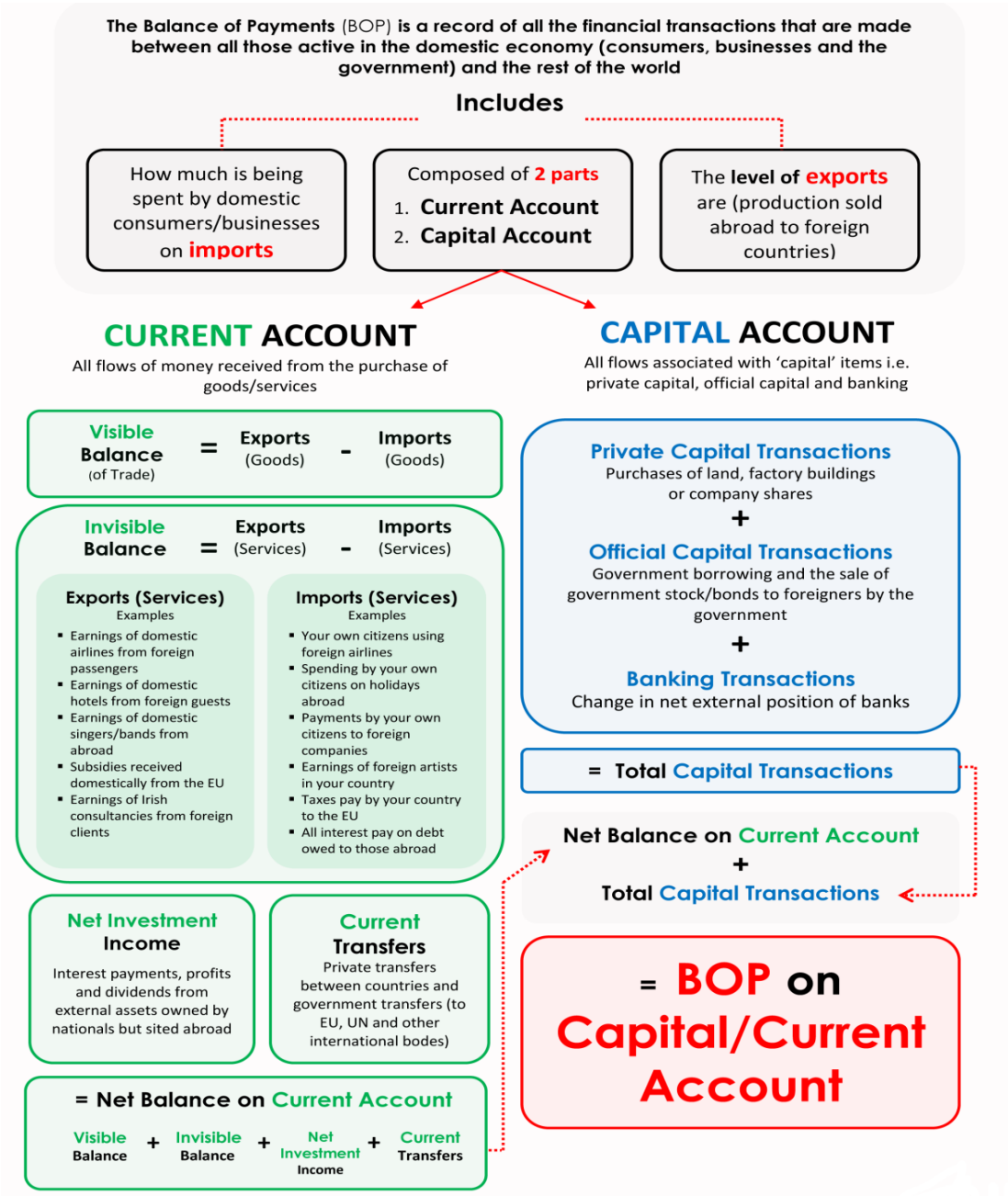
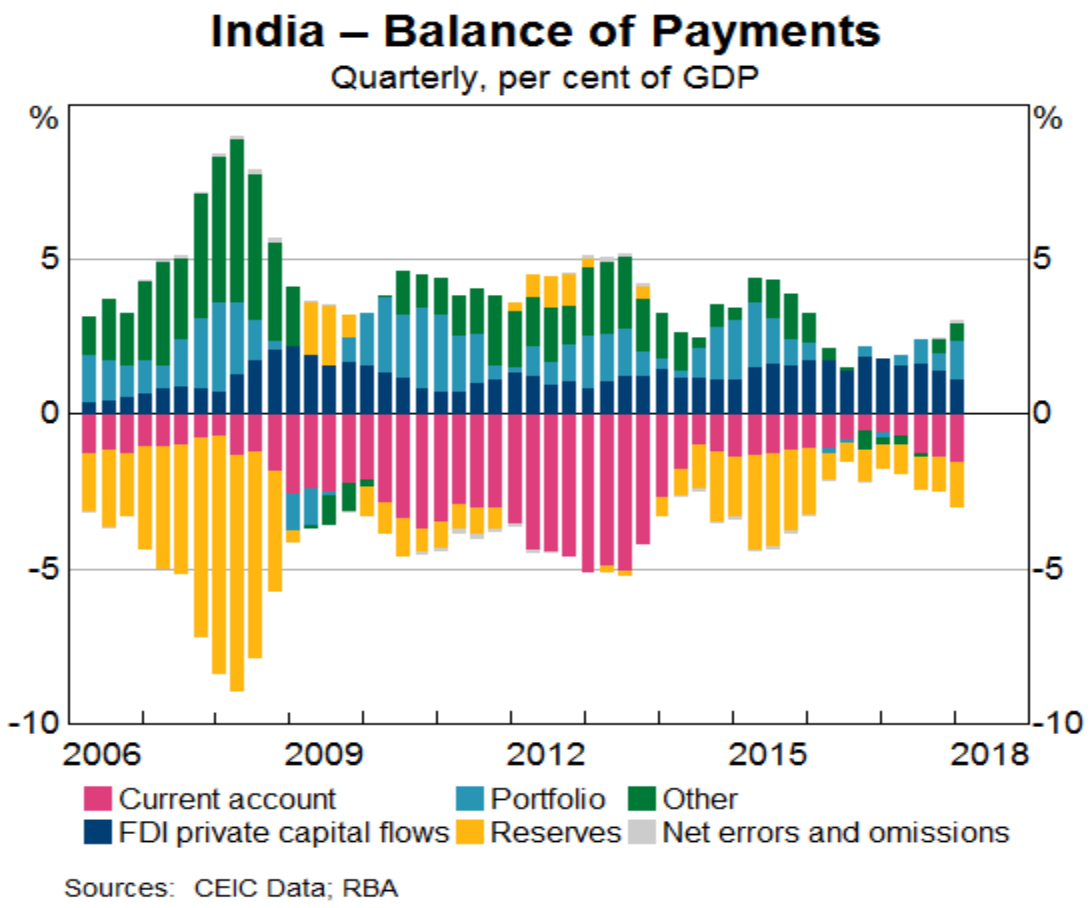
BALANCE OF PAYMENT (BOP)

BoP is a statement of all transactions made between entities in one country and the rest of the world over a defined period of time, such as a quarter or a year.



- The BOP of a country gives information about its ability to pay for its imports.
- It gives information about the position of the country with respect to issues like currency crisis, capital flows and its impact on the economy etc.
- It also gives valuable insights into its economic output which is required for its economic growth.
- The components of the balance of payment are:
  1. **Current account**: It includes the financial transactions dealing with the export and import of goods, services, unilateral transfers, investment income etc.
  2. **Capital account**: It includes the financial transactions dealing with assets such as foreign direct investment, foreign portfolio investment, foreign loans etc.
  3. **Official reserve transactions**: It conducted by the central bank in case of the BOP deficit or BOP surplus.
  4. **Errors and omissions**: It is the element of BOP (other than the current account and the capital account) which refers to the balancing items reflecting the inability to record all the international financial transactions.



CURRENT ACCOUNT TRANSACTIONS

- It includes all the transactions for exports and imports of goods, services, unilateral transfers and investment income etc.
- The receipts from the exports of goods, services, investment income, and unilateral transfers are shown as positive items or credit in the current account.
- Whereas the payments made for the import of goods, services, investment income sent abroad and unilateral payments are shown as negative items or debit in the current account.
- The balance on current account refers to the net value of these credits and debits.
- When the net value of these transactions is negative, then it leads to the current account deficit (CAD).
- While if the net value of all these transactions is positive then it is known as current account surplus. The current account shows the income generated from the foreign sources.
- The major components of the current account are as follows:

Merchandise transactions or the visible trade (export and import of goods)	• The major part of foreign trade transaction includes the export and import of a country. • Payments made for the import of goods from other countries are shown as a negative side or debit items, and the receipts from the export of goods to other countries are shown as positive items. • The balance of these exports and imports is called as the Balance of Trade or the Merchandise Trade Balance. • If the imports are more than exports, it will lead to trade deficit; while if the exports are more than imports, it will lead to a trade surplus. • India has experienced consistent trade deficits except for the two years in the 1970s.
Invisible trade (the export and import of services):	• It includes the export and import of services such as Information Technology services, banking, insurance and consultancy services offered to foreign countries, BPO, tourism, outsourcing etc. • The export of services is shown as a credit in the current account, while the import of services is shown as a debit to the current account. • Since the export and import of services are invisible, they are known as invisible trade.

Unilateral or unrequited transfers (one sided transactions)	• The unilateral or unrequited transfers are one-way transfer which include gifts and donations, personal remittances, foreign aid, charitable donations, withdrawal of NRI deposits locally etc. • The inward transfers are shown as a credit to the current account and the outward remittances are shown as a debit to the current account.
Income receipts and payments (investment income)	• It refers to the income from the investments made in the foreign countries, profits from the subsidiaries of companies located abroad, interest earned from loans and investments abroad, dividend income from the shares in the foreign companies etc. • If the income is received from foreign sources, it is shown as a credit to the current account and if the payments are made to the residents of foreign countries, then it is shown as a debit to the current account.

CAPITAL ACCOUNT TRANSACTIONS

- Capital account refers to the record of all the transactions of the capital inflows and capital outflows which affect a country's foreign assets and liabilities.
- It deals with all the international capital trade transactions between the residents of one nation with other.
- The capital account shows net the changes in the ownership of a country's assets and liabilities. For example, if an Indian citizen buys a property in a foreign country it will be shown as a debit in the capital account.
- The capital account components include foreign investment such as FDI and FPI, immovable properties, intangible assets trade credits, borrowings from other countries, banking capital, changes in the foreign exchange reserve etc.
- The NRI deposits, Special Drawing Rights, funds held in foreign countries etc are also included in the capital account.
- The capital account is concerned with the claims and liabilities of financial nature regardless of the time period.
- The capital account is used for financing deficits in the current account or absorbing any surplus of the current account.
- As the capital account deals with financial transfers, it does not have any direct impact on the output, income and the employment of the nation.
- Components of capital account

Borrowing and lending from foreign countries	• It includes the financial transactions related to borrowing money from foreign countries by the private sector companies or individuals, government etc. • The receipts from abroad which include the repayment of loans from the foreign citizens etc are shown as a credit in the capital account. • The financial transactions dealing with lending to abroad by the private sector companies, individuals and the government, and the repayment of loans taken from foreign countries is shown as a debit in the capital account.
Investments to and from the foreign countries	• The investments from the foreign countries in the Indian companies, government bonds, real estate etc in India are shown as a credit in the capital account as they lead to the inflow of foreign exchange. • The investments made by the Indian residents in the stocks and shares of companies abroad, government bonds, real estate etc are shown as a debit in the capital account as they lead to the outflow of foreign exchange.
Foreign direct investment (FDI)	• When the foreign residents buy Indian capital assets such as companies, industrial complexes, machines etc, it is shown as a credit to the capital account. • The FDI investment made by Indians in the foreign countries is shown as a debit in the capital account.
Foreign portfolio investment (FPI)	• When the foreign residents purchase stocks, government bonds, corporate securities etc, then these transactions are shown as a credit to the capital account. • When the Indian residents purchase securities and bonds in foreign countries, it is shown as a debit in the capital account.
Changes in the Foreign Exchange Reserves	• The foreign exchange reserves are the financial assets held by the central bank (RBI for India) of the country. • These reserves serve as financing item in the Balance of payments. • Any withdrawal from the foreign exchange reserves is shown as credit, while any addition in the reserves is shown as a debit in the capital account. • The changes in foreign exchange reserves is shown in the BOP account and not the actual foreign exchange reserves.