

### **BALANCE OF PAYMENTS**

#### **Meaning of Balance of Payments**

- The balance of payments of the country is a systematic record of all transactions between the residents of the country and the rest of the world in a given period of time (in a year).
- Balance of payments is an important index which reflects the international economic position of a country in a given period.

#### **Economic Transactions in Balance of Payments**

Economic transactions in BOP are broadly categorized as:

##### **1. Visible Items (flow of goods)**

Visible items include all types of physical goods exported and imported. These are visible as these are made of some matter or material.

##### **2. Invisible Items (flow of services)**

Invisible items include all types of services like shipping, banking, insurance, etc. These are invisible because services are not made of matter or material.

##### **3. Capital Transfers**

Capital transfers are related to capital receipts and capital payments.

#### **Structure of Balance of Payments Account**

**Or**

#### **Components of Balance of Payments Account**

- The items which are included in the balance of payments (BOP) are called components of BOP.
- The BOP account of a country is constructed on the principle of double-entry system of book-keeping.
- Each transaction in the BOP is recorded and classified according to the credit (receipts) and debit (payments side of the balance sheet).
- Payments received from the foreign countries (or rest of the world) are called credits.
- Payments made to foreign countries (or rest of the world) are called debits.
- Various transactions in the BOP are grouped into two sections:

##### **1. Current Account and**

##### **2. Capital Account**

## **1. Current Account**

### **Meaning**

- Current account refers to an account which records exports and imports of goods and services and unilateral transfers during a given period of time.
- In other words the current account of a country consists of all transaction relating to trade in good and services and unilateral transfers.

### **Components of Current Account**

The main components of current account are explained below:

#### **(i) Visible Items (Exports and Imports of Goods)**

- This category includes all merchandise exports and imports or physical goods exported and imported
- All exports of visible items (goods) are recorded as positive (+) items as these increase the flow of foreign exchange into the country.
- All imports of visible items (goods) are recorded as negative (-) items as these cause the flow of foreign exchange out of the country.
- The difference between export and import of goods is termed as balance of visible items, merchandise trade or simply balance of trade (BOT).

#### **(ii) Invisible Items**

These are the items which are not tangible and can not be seen. Invisible items are classified into three groups:

- (i) Services
- (ii) Unilateral transfers
- (iii) Income

#### **A. Exports and Imports of Services (invisible Trade)**

- It includes a large variety of non-factor services (Like shipping, banking, insurance, interest, dividend, tourism etc.) sold to and purchased by the residents of a country to rest of the world.
- Exports of services are recorded as positive (+) items. Payments received from these services are put on the credit side.
- Imports of services are recorded as negative (-) items. Payments made to foreigners for these services are put on the debit side.
- Balance occurring on account of exports and imports of services is recorded as balance of invisible trade.

#### **B. Unilateral Transfers (Unrequited Receipts and Payments)**

- Unilateral transfers refer to those receipts and payments which take place without any services in return. These are 'one-side' or 'one way' transactions.

- These include gifts, remittances, indemnities, aid etc. to and from foreigners.
- Receipts of unilateral transfers are recorded as positive items (+) and put on the credit side.
- Payments of unilateral transfers are recorded as negative items (—) and put on the debit side.

### **C. Incomes**

- Incomes are classified into investment income and compensation of employees.
- Investment income includes interest, dividends; profits etc. Compensation of employees includes wages and salaries etc.
- Incomes received by the residents of a country from foreigners are recorded on the credit side.
- Payments made by the residents of the country to rest of the world for labour services and capital services are recorded on the debit side.

### **Balance on Current Account**

- In the current account, receipts from exports of goods, services and unilateral transfers are recorded as credits (+) because they represent receipts from foreigners.
- On the other hand, payments for imports of goods services and unilateral transfers are entered as debits (—) because they represent payments to foreigners.
- The net value of these credits and debits is the balance of the current account.
- When values of credit items are more than debit items, it indicates surplus in current account.
- When values of debit items are more than credit items, it indicates deficit in current account.
- Surplus or deficit of current account is adjusted through capital account.

**Current account balance = Balance of visible trade + Balance of invisible trade + Balance of unilateral transfers.**

## **2. Capital Account**

### **Meaning**

Capital account of balance of payments records all such transactions between the residents of a country and rest of the world which causes change (Increase or decrease) in the assets or liability status of residents of a country or its government. (Borrowings, capital repayments, sale of assets, change in stock of gold and reserves of foreign currency etc).

### **Components of Capital Account**

Following are the main components of capital account:

#### **(i) Official Transaction**

- These are those transactions which affect assets and liability status of the govt. of a country or in agencies.
- Example: Indian government borrows money from IMF, World bank or from any other country These are included under 'credit' term.
- Repayments of loans by the governments to rest of the world are included under 'debit' term.

#### **(ii) Non-Official or Private Transactions**

- These are transactions which affect assets and liabilities of private sector (Individuals, business a other non-government entities).
- Example: Investment by an individual of country A in country B.
- Receipts of such transactions are included in credit term and their repayments are in debit term..

#### **(iii) Foreign Direct Investments (FDI)**

- It refers to purchase of assets in abroad along with the power to control them.
- In other words it is the act of purchasing an asset and at the same time acquiring control of it.
- Example: Purchase of a firm by Reliance Group in USA, purchase of a house abroad by a individual,

#### **(iv) Portfolio Investment**

- It refers to purchase of assets in abroad but without any control over them.
- In other words it is the acquisition of an asset that does not give the purchaser control over the assd
- Example: Purchase of shares or bonds of a company in country A by residents of country B. A purchase of shares of a company by the Reliance Group.

#### **(v) Banking Capital**

It refers to the capital transactions in the form of foreign exchange transaction and investment in foreign currency and securities by the foreign branches of Indian commercial banks.

### **Balance on Capital Account**

- In the capital account borrowings from foreigners and direct investment by foreigners represent capital inflows. They are positive items or credits because these are receipts from foreigners.

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- On the other hand lending to rest of the world and direct investment in rest of the world represents outflows. They are negative items or debits because they are payments to foreigners.
- The net value of these credits and debits is the balance of capital account.

**Difference between current account and capital account**

<b>Basis</b>	<b>Current Account</b>	<b>Capital Account</b>
<b>Meaning</b>	Current account of a country refers to an account which records exports and imports of goods and services and unilateral transfers during a given period of time.	Capital account of balance of payments records all such transactions between the residents of a country and rest of the world which causes change (increase or decrease) in the assets or liability status of the residents of a country or its government.
<b>Components</b>	Current account = visible trade + invisible trade + unilateral transfers	Capital account = official transactions + non-official transactions + foreign direct investment + portfolio investment + banking capital
<b>Lending and Borrowing</b>	Current account includes interest on past lending and borrowing.	Capital account is that part of BOP account which shows all payments made or received by the way of settling old debts or creating new debts.
<b>Concept</b>	Current account is a flow concept as it includes all items of flow nature.	Capital account is a stock concept as it includes all items showing change in stock.

**Basic balance or Overall Balance**

- The sum of current account and capital account is termed as the basic balance.
- A deficit in the current account of BOP is settled by a net surplus on capital account.
- A surplus in current account of BOP must match with a deficit in the capital account.

**Structure of BOP or Accounts of BOP**

<b>Assets</b>	<b>Liabilities</b>
<b>Current Account</b>	
Export of goods (Visible items)	Import of goods
Export of services (Invisible items)	Import of services

Unrequited receipts (Gifts, remittances, indemnities etc.)	Unrequited payments (Gifts, remittances, etc. to foreigners)
<b>Capital Account</b>	
Capital receipts (Borrowings from abroad, capital repayment by or sale of assets to foreigners)	Capital payments (Lending to capital repayments to or purchase of assets from foreigners)

### **Autonomous and Accommodating Items in BOP**

#### **(A) Autonomous Items in BOP**

- Autonomous items or transactions refer to those international economic transactions which are done for some economic motives or economic considerations such as profit maximization.
- These transactions are independent of the state of the country's BOP or not related to establish BOP identity. These transactions are not influenced by the foreign exchange position of the country.
- These items are generally called 'above the line items' in BOP.
- Deficit or surplus in BOP depends upon the balances of autonomous items.
- Examples: Exports, Imports etc.
- Autonomous receipts > Autonomous payments → Surplus in BOP
- Autonomous receipts < Autonomous payments → Deficit in BOP

#### **(B) Accommodating Items in BOP**

- Accommodating items or transactions refer to those transactions which are undertaken to cover the deficit or surplus in balance of payments. Therefore, their magnitude is determined by the autonomous transactions.
- These transactions are related to establish BOP identity.
- These items are also called 'below the line items'.
- Government financing, official settlements are used as accommodating items to keep the BOP identity.
- The official settlement approach is based on the assumption that monetary authority or the central bank of the country is the ultimate financier of any deficit in the BOP or the ultimate recipient of any surplus.

### **Balance of Trade (BOT)**

- Balance of trade is the difference between the money value of exports and imports of goods.
- It is also termed as Balance of visible items of BOP or merchandise trade.

**BOT = Export of visible items (goods) — Imports of visible items (goods) + Surplus in**

BOT if a country exports more goods than it imports, it has a favorable or surplus in the BOT.

**Deficit in BOT**

If a country imports more goods than it exports, it has an unfavorable or deficit in the BOT

**Difference between Balance of Trade (BOT) and Balance of Payments (BOP)**

<b>Basis</b>	<b>Balance of Trade (BOT)</b>	<b>Balance of Payments (BOP)</b>
<b>Meaning</b>	Balance of trade is the difference between the money value of exports and imports of goods Or Balance of visible items of BOP.	The balance of payments of the country is a systematic record of all transactions between the residents of the country and the rest of the world in a given period of time.
<b>Components</b>	It records only merchandise (i.e. goods) transaction of visible items.	It records transactions relating to both goods and services or visible and invisible items.
<b>Capital transaction</b>	It does not record transactions of capital nature.	It records transactions of capital nature
<b>Scope</b>	It is a narrower concept. It is a part of current account of BOP.	It is a wider concept. It includes balance of trade balance of services, balance of unilateral transfer and balance of capital transaction.
<b>Position</b>	It may be favorable, unfavorable or in equilibrium,	It is always in balance in the sense that receipt is always made to be equal to payment side.

**Balance of Payment Always Balances**

- The BOP always balances in the accounting sense according to the principal of accounting.
- BOP accounts are prepared on the basis of double entry system of book- keeping under which receipts (credit side) are always equal to payments (debit side). As a result accounts are always in balance.
- The balance of current account need not be equal but can show surplus or deficit. Deficit or surplus in current account is balanced by an equal amount of surplus or deficit in capital account.
- If there is a deficit in current account of a country, it is offset by a matching surplus in the capital account by borrowings from abroad or withdrawing out of its gold and foreign exchange reserves.

- On the other hand, if there is a surplus in current account, it is offset by a matching deficit in the capital account. So surplus or deficit of current account is accommodated by capital account, therefore BOP is always in equilibrium or balance.



**BALANCE OF PAYMENTS**

**Multiple Choice Questions**

**Choose the correct option:**

1. BoP is measured as:
  - (a) difference between visible items of exports and imports
  - (b) difference between invisible items of exports and imports
  - (c) difference between external and internal flow of gold
  - (d) difference between all receipts of foreign exchange and payments of foreign exchange
  
2. Balance of trade is measured as:
  - (a) difference between import and export of goods
  - (b) difference between import and export of services
  - (c) difference between import and export of capital
  - (d) difference between all exports and all imports
  
3. In which of the following categories are the transactions of balance of trade recorded?
  - (a) Visible items
  - (b) Invisible items
  - (c) Capital transfers
  - (d) All of these
  
4. Current account records transactions relating to:
  - (a) export and import of goods
  - (b) non-factor and factor income
  - (c) current transfers
  - (d) all of these
  
5. Which of the following items relate to BoP on capital account?
  - (a) Foreign investment
  - (b) Loans
  - (c) NRI remittances
  - (d) All of these
  
6. Which of the following are not included in balance of trade?
  - (a) Payment of interest and dividend
  - (b) Expenditure by the tourists
  - (c) Borrowing from rest of the world
  - (d) All of these

7. If the value of visible exports exceeds the value of visible imports, the balance relates to:  
(a) current account BoP (b) capital account BoP  
(c) balance of trade (d) none of these
8. Unilateral transfers are:  
(a) one-sided payments (b) reciprocal payments  
(c) factor incomes (d) all of these
9. Surplus in BoP occurs when:  
(a) receipts = payments (b) receipts < payments  
(c) receipts > payments (d) both (a) and (c)
10. Invisibles balance refers to:  
(a) Exports - Imports  
(b) Trade balance + Balance of non-factor services  
(c) Balance of non-factor services + Balance of income + Balance of transfers  
(d) Exports-Imports + Balance of factor services
11. When balance of payments balances:  
(a) current account + capital account = zero  
(b) official reserves account is a part of current account  
(c) official reserves account is a part of capital account  
(d) both (a) and (c)
12. Exports = Rs 1,000 lakh, imports = Rs 1,650 lakh, balance of trade shows:  
(a) surplus of Rs 650 lakh  
(b) deficit of Rs 650 lakh  
(c) balance of Rs 2,650 lakh  
(d) none of these

**Answers**

- |        |        |        |         |         |         |
|--------|--------|--------|---------|---------|---------|
| 1. (d) | 2. (a) | 3. (a) | 4. (d)  | 5. (d)  | 6. (d)  |
| 7. (c) | 8. (a) | 9. (c) | 10. (c) | 17. (d) | 18. (b) |

**Fill in the Blanks**

**Choose appropriate word and fill in the blank**

1. \_\_\_\_\_ records imports and exports of goods only. (Balance of trade/Balance of payments)
2. \_\_\_\_\_ account transactions do not give rise to 'future claims' (Current/Capital)
3. There is a flow of foreign exchange into the country when we \_\_\_\_\_ goods and services (Export/Import)
4. \_\_\_\_\_ = Compensation of employees + Investment income. (Factor Incomes/Transfer Incomes)
5. Export and import of all types of goods is recorded in the \_\_\_\_\_ account of BoP. (current/capital)

**Answers**

1. Balance of trade
2. Current
3. export
4. Factor Incomes
5. current

**Assertion and Reason**

In the following questions (1-2), a statement of Assertion (A) is followed by a statement of Reason (R). Choose the correct alternative among those given below.

**Alternatives:**

- (a) Both Assertion (A) and Reason (R) are true and Reason (R) is the correct explanation of Assertion (A)
- (b) Both Assertion (A) and Reason (R) are true and Reason (R) is not the correct explanation of Assertion (A)
- (c) Assertion (A) is true but Reason (R) is false
- (d) Assertion (A) is false but Reason (R) is true

1. **Assertion (A)** : BoP always balances when accommodating items are reflected as a part of current account.

**Reason (R)** : Accommodating items are meant to restore a balance in BoP accounts.

2. **Assertion (A)** : 'Borrowings from abroad' is recorded in the credit side of capital account of the balance of payments accounts.

**Reason (R) :** 'Borrowings from abroad leads to the receipt of foreign exchange from rest of the

**Answer**

1. (d) Assertion (A) is false but Reason (R) is true
2. (a) Both Assertion (A) and Reason (R) are true and Reason (R) is the correct explanation of Assertion (A)

**Choose the Correct Alternative**

In the following questions (1-2), two statements are given. Read the statements carefully and choose the correct alternative among those given below.

**Alternatives:**

- (a) Both the statements are true
- (b) Both the statements are false
- (c) Statement 1 is true and Statement 2 is false
- (d) Statement 2 is true and Statement 1 is false

1. **Statement 1 :** Accommodating items are free from the considerations of profit.  
**Statement 2 :** Increase in the official reserves is a sign of BoP equilibrium.
2. **Statement 1 :** Trade surplus occurs when exports are greater than imports.  
**Statement 2 :** Balance of trade is a part of capital account.

**Answers**

1. (c) Statement 1 is true and Statement 2 is false
2. (c) Statement 1 is true and Statement 2 is false

**Short Answer Questions**

1. **Indian Rupee has been depreciating in the recent times.**

**What effect will it have on the CAD?**

**Ans.** As a result of depreciation of the rupee, foreign goods become expensive while domestic goods become cheaper. This should lead to a rise in exports and fall in imports. Accordingly, CAD should improve. But, if we are importing certain essential raw materials (the imports of which cannot be cut) our import bill may swell with the increase in exchange rate. Accordingly, CAD may not improve. In fact, it may deteriorate further.

**2. What is 'current account deficit' in the balance of payments?**

**Ans.** Current account, deficit in BoP refers to the deficit occurring on account of:  
Trade balance

- + Balance on invisibles (= balance on factor income balance on non-factor income
- + balance on transfers).

**3. What is the Balance of Payments (BOP)?**

- The balance of payments (BOP) is a systematic record of all transactions between the residents of a country and the rest of the world over a specific period, usually one year. It reflects the international economic position of a country by recording all economic transactions, including trade in goods and services, capital transfers, and financial flows.

**4. What are the main categories of economic transactions in the BOP?**

- The main categories of economic transactions in the BOP are:
  1. **Visible Items:** Physical goods that are exported and imported.
  2. **Invisible Items:** Services such as shipping, banking, insurance, etc.
  3. **Capital Transfers:** Transactions related to capital receipts and payments.

**5. What are the components of the Current Account in the BOP?**

- The components of the Current Account in the BOP are:
  1. **Visible Items:** Exports and imports of physical goods.
  2. **Invisible Items:** Services (non-factor services like shipping, banking), unilateral transfers (gifts, remittances), and incomes (investment income and compensation of employees).

**6. What does the Capital Account in the BOP record?**

- The Capital Account in the BOP records transactions that cause changes in the assets or liabilities of residents of a country. It includes official transactions (like government borrowings), non-official transactions (private sector investments), foreign direct investments (FDI), portfolio investments, and banking capital.

**7. Differentiate between the Current Account and the Capital Account in the BOP.**

- **Current Account:** Records exports and imports of goods and services, and unilateral transfers. It is a flow concept, including all items of flow nature.

- **Capital Account:** Records transactions causing changes in assets or liabilities, such as borrowings and investments. It is a stock concept, showing changes in stock.

**8. What are Autonomous Items in the BOP?**

- Autonomous items or transactions are international economic transactions done for economic motives, such as profit maximization, and are independent of the country's BOP status. Examples include exports and imports. These are also known as 'above the line items.'

**9. What are Accommodating Items in the BOP?**

- Accommodating items or transactions are undertaken to cover deficits or surpluses in the BOP. They are determined by autonomous transactions and include government financing and official settlements. These are also called 'below the line items.'

**10. Explain the term 'Balance of Trade (BOT).'**

- The Balance of Trade (BOT) is the difference between the money value of a country's exports and imports of goods. It is also referred to as the balance of visible items of the BOP. A favorable BOT occurs when exports exceed imports, while an unfavorable BOT occurs when imports exceed exports.

**11. Why does the Balance of Payments always balance?**

- The BOP always balances because it is based on the double-entry bookkeeping system, where total receipts (credits) always equal total payments (debits). A surplus or deficit in the current account is offset by an equivalent deficit or surplus in the capital account, ensuring overall balance.

**12. Differences between Balance of Trade (BOT) and Balance of Payments (BOP)**

Basis	Balance of Trade (BOT)	Balance of Payments (BOP)
<b>Meaning</b>	Difference between the money value of exports and imports of goods.	Systematic record of all transactions between residents of a country and the rest of the world.
<b>Components</b>	Records only merchandise (goods) transactions (visible items).	Records transactions relating to both goods and services (visible and invisible items).
<b>Capital Transactions</b>	Does not record transactions of capital nature.	Includes transactions of capital nature (e.g., borrowings, investments).
<b>Scope</b>	Narrower concept, part of	Broader concept, includes balance of

	the current account of BOP.	trade, balance of services, balance of unilateral transfers, and balance of capital transactions.
<b>Position</b>	Can be favorable, unfavorable, or in equilibrium.	Always balances as receipts equal payments (in accounting terms).

### **CBSE Questions**

**1. Define autonomous transactions in balance of payments of an economy.**

**Or**

**Define autonomous items of balance of payment account.**

2. State on which side of capital account/current account will the following transactions be recorded and why:

- (i) Interest on loan received from Nepal.
- (ii) Import of mobile phones from China.

[ (i) Interest on loan received from Nepal will be recorded in the credit side of current account as it causes inflow of the foreign currency to the home country.

(ii) Import of mobile phones from China will be recorded in the debit side of current account as it causes outflow of the foreign currency through visible imports.]

### **Numerical Questions with Answers**

**1. Question:**

- A country has the following transactions during a year:
  - Exports of goods: Rs 500 million
  - Imports of goods: Rs 600 million
  - Exports of services: Rs 200 million
  - Imports of services: Rs 150 million
  - Unilateral transfers received: Rs 50 million
  - Unilateral transfers paid: Rs 30 million
- Calculate the balance on the current account.

**2. Question:**

- In a given year, a country's capital account has the following transactions:
  - Borrowings from abroad: Rs 400 million
  - Repayments of loans to foreigners: Rs 250 million
  - Foreign direct investment (FDI) inflows: Rs 300 million
  - Portfolio investment inflows: Rs 150 million
  - Portfolio investment outflows: Rs 100 million
- Calculate the balance on the capital account.

**3. Question:**

- A country's current account shows the following:
  - Exports of goods: Rs 700 million
  - Imports of goods: Rs 800 million
  - Exports of services: Rs 300 million
  - Imports of services: Rs 250 million
  - Unilateral transfers received: Rs 100 million
  - Unilateral transfers paid: Rs 50 million
- If the capital account shows a net inflow of Rs 200 million, what is the overall balance of payments?

**4. Question:**

- If a country's balance on the current account is a deficit of Rs 150 million and the capital account shows a net outflow of Rs 50 million, what measures might the country take to balance its BOP?