Balance of Payments (BOP): Its Components

I. Meaning of Balance of Payments (BOP):

The balance of payments (henceforth BOP) is a consolidated account of the receipts and payments from and to other countries arising out of all economic transactions during the course of a year.

In the words of C. B. Kindleberger; "The balance of payments of a country is a systematic record of all economic transactions between the residents of the reporting and the residents of the foreign countries during a given period of time."

Here, by 'residents' we mean individuals, firms and government. By all economic transactions we mean transactions of both visible goods (merchandise) and invisible goods (services), assets, gifts, etc. In other words, BOP shows how money is spent abroad (i.e. payments) and how money is received domestically (i.e., receipts). Thus, a BOP account records all payments and receipts arising out of all economic transactions.

All payments are regarded as debits (i.e., outflow of money) and are recorded in the accounts with a negative sign and all receipts are regarded as credits (i.e., inflow of money) and are recorded in the accounts with a positive sign. The International Monetary Fund defines BOP as a "statistical statement that subsequently summarises, for a specific time period, the economic transactions of an economy with the rest of the world."

II. Components of BOP Accounts:

According to the broad nature of the transactions concerned, the BOP of a country is divided into two main parts: (i) the current account, and the (ii) capital account. The other part is official reserve account.

(i) The Current account:

The current account of BOP includes all transaction arising from trade in currently produced goods and services, from income accruing to capital by one country and invested in another and from unilateral transfers, both private and official.

The current account is usually divided in three subdivisions:
The first of these is called visible account or merchandise account or trade in goods account. This account records imports and exports of physical goods. The balance of visible exports and visible imports is called balance of visible trade or balance of merchandise trade [i.e., items 1(a), and 2(b) of Table 5.1].

Table 5.1: The Schematic BOP

A.	**Current Account**
1.	*Merchandise Trade*
	a) Visible exports
	b) Visible imports
2.	*Invisible Trade*
	a) Invisible exports
	b) Invisible imports
3.	*Other Flows*
	a) Investment income
	b) Unrequited transfers
B.	**Capital Account**
	a) Long term capital transactions
	b) Short term capital transactions
C.	**Balancing Item**
	Net Errors and Omissions
D.	**Official Reserve Account**

The second part of the account is called the invisibles account since it records all exports and imports of services. The balance of these transactions is called balance of invisible trade. As these transactions are not recorded in the customs office unlike merchandise trade we call them invisible items.

It includes freights and fares of ships and planes, insurance and banking charges, foreign tours and education abroad, expenditures on foreign embassies, transactions out of interest and dividends on foreigners' investment, and so on. Items 2(a) and 2(b) comprise services balance or balance of invisible trade.

The difference between merchandise trade and invisible trade (i.e., items 1 and 2) is known as balance of trade.

There is another flow in current account that consists of two items [3(a) and 3(b)]. Investment income consists of interest, profit and dividends on bonus and credits. Interest earned by a U.S. resident from the TELCO share is one kind of investment income that represents a debit item here. There may be similar money inflow (i.e., credit item). Unrequited transfers include grants, gifts, pension, etc.

These items are such that no reverse flow occurs. Or these are the items against which no quid pro quo is demanded. Residents of a country receive these cost-free. Thus unilateral transfers are one-way transactions. In other words, these items do not involve give and take unlike other items in the BOP account.

Thus, the first three items of the BOP account are included in the current account. The current account is said to be favourable (or unfavourable) if receipts exceed (fall short of) payments.

(ii) The Capital account:

The capital account shows transactions relating to the international movement of ownership of financial assets. It refers to cross-border movements in foreign assets like shares, property or direct acquisitions of companies' bank loans, governments securities, etc. In other words, capital account records export and import of capital from and to foreign countries.

The capital account is divided into two main subdivisions one is the short term and another is the long term movements of capital. A short term capital is one which matures in one year or less, such as bank accounts. A long term capital is one whose maturity period is longer than a year, such as long term bonds or physical capital.

Long term capital account is, again of two categories: direct investment and portfolio investment. Direct investment refers to expenditure on fixed capital formation, while portfolio investment refers to the acquisition of financial assets like bonds, shares, etc. India's investment (e.g., if an Indian acquires a new Coca-Cola plant in the USA) abroad represents outflow of money.

Similarly, if a foreigner acquires a new factory in India it will represent inflow of funds. Thus, through acquisition or sale and purchase of assets, capital movements take place. Investors then acquire controlling interest over the asset. Remember that exports and imports of equipment do not appear in the capital account.

On the other hand, portfolio investment refers to changes in the holding of shares and bonds. Such investment is portfolio capital and the ownership of paper assets like shares does not ensure legal control over the firms.

[In this connection, the concepts of capital exports and capital imports require little elaboration. Suppose, a US company purchases a firm operating in India. This sort of foreign investment is called capital import rather than capital export. India acquires foreign currency after selling the firm to a US company. As a result, India acquires purchasing power abroad. That is why this transaction is included in the credit side of India's BOP accounts. In the same way, if India invests in a foreign country, it is a payment and will be recorded on the debit side. This is called capital export. Thus, India earns foreign currency by exporting goods and services and by importing capital. Similarly, India releases foreign currency by importing visibles and invisibles and exporting capital.]

(iii) Statistical discrepancy—errors and omissions:

The sum of A and B (Table 5.1) is called the basic balance. Since BOP always balances in theory, all debits must be offset by all credits and vice versa. In practice, rarely it happens particularly because statistics are incomplete as well as imperfect. That is why errors and omissions are considered so that BOP accounts are kept in balance (Item C).

(iv) The official reserve account:

The total of A, B, C and D comprises the overall balance. The category of official reserve account covers the net amount of transactions by government. This account covers purchases and sales of reserve assets (such as gold, convertible foreign exchange and special drawing rights) by the central monetary authority.

Now we can summarise the BOP data

Current account balance + Capital account balance + Reserve balance = Balance of Payments

$(X – M) + (CI – CO) + FOREX = BOP$

X is exports,

M is imports,

CI is capital inflows,

CO is capital outflows,

FOREX is foreign exchange reserve balance.