Q. Explain the concept of BOP and distinguish it from BOT.

Ans. Meaning of BOP. Balance of payments (BOP) is a systematic record of all economic transactions. Visible as well as invisible, in a period, between one country and the rest of the world. It shows the relationship between one country's total payments to all other countries and its total receipts from them. Balance of payments thus is statement of payments and receipts on international transactions. Payments and receipts on international account are of three kinds : (a) the visible balance of trade; (b) the invisible items ; and (c) capital transfers.

Definition of BOP. *Kindleberger* defines balance of payments as "a systematic record of all economic transactions between the residents of the reporting country and the residents of foreign countries during a given period of time."

In the words of *Benham*, "*Balance of payments of a country is a record of the monetary transactions over a period with the rest of the world.*"

Main Features of Balance of Payments.

Balance of Payments has the following features :

(1) Systematic Record. It is a systematic record of all economic transactions between one country and the rest of the world.

(2) All Transactions (visible & invisible). It includes all transactions, visible as well as invisible.

(3) Fixed Period of Time. It relates to a given period of time. Generally, it is an annual statement.

(4) Double Entry System. It adopts a double-entry book-keeping system. It has two sides : credit side and debit side. Receipts are recorded on the credit side and payments on the debit side.

(5) Equilibrium, surplus & Deficit. When receipts are equal to payments, the balance of payments is in equilibrium ; when receipts are greater than payments, there is surplus in the balance of payments; when payments are greater than receipts, there is deficit in the balance of payments.

(6) Always Balance in Accounting Sense. In the accounting sense, total credits and debits in the balance of payments statement always balance each other.

(7) Adjustment of Differences. Whenever there is difference in actual total receipts & payments, need is felt for necessary adjustment.

(8) All Items-Govt. & Non-Govt. BOP include receipts & payments of all items Govt. & non-Govt.

Balance of Payments and Balance of Trade

Balance of payments (BOP) should be distinguished from balance of trade (BOT).

Meaning BOT. Balance of trade refers to the export and import of visible items, *i.e.* material goods. It is the difference between the value of visible exports and imports. Visible items are those items which are recorded in the customs returns; for example, material goods exported and imported. If the value of visible exports is greater than that of visible imports, the balance of trade is favourable ;

if the value of visible imports is greater than that of visible exports the balance of trade is unfavourable; if the value of visible exports is equal to that of visible imports, the balance of trade is in equilibrium. Balance of trade is also known as merchandise account of exports and imports.

Definition. In the words of *Benham*, *"B of T of a country is the relation over a period between the values of her exports and values of her imports."*

Balance of payments, on the other hand, is a more comprehensive concept because it covers (a) visible items (i.e., balance of trade or merchandise account) and (b) invisible items. Invisible items are those items which are not recorded in the customs returns; for example, services (such as transportation, banking, insurance, etc.), capital flows, purchase and sale of gold, etc. Thus, balance of payments is a broader term than balance of trade; balance of payments includes both visible as well as invisible items, whereas balance of trade includes only visible items.

Difference between Balance of Trade and Balance of Payments.

(i) Balance of Payments is a *broad* term. It includes balance of trade. The latter is relatively a *narrow* concept. It is a part of balance of payments.

(ii) Balance of Trade includes imports and exports of goods alone *i.e.* visible items. On the contrary, the balance of payments includes all kinds of items, that is imports and exports of goods, services and capital. In other words, it includes visible as well as invisible items. In brief, balance of trade is a part of balance of payments.

(iii) Balance of trade of a country can be favourable or unfavourable but balance of payment always balances.

(iv) Deficit of balance of trade can be met by balance of payments but deficit of balance of payments cannot be met by balance of trade.

(v) From the point of view of economic analysis balance of payments is more significant than balance of trade. Every country takes into account items of balance of payments, while formulating its foreign trade policy. If the liabilities (payments) of a country to other countries are large, it will have great impact on its national income, employment etc.

In short, the main difference between balance of payments and balance of trade is that the latter is a partial record of a country's international trade while the former is its complete record. Balance of trade is a part of balance of payments.

Q. Explain the components of BOP.

Ans. Components or Items of Balance of Payments.

Balance of payments has two main parts (1) Current account and (2) Capital account. The items included in both these accounts are called components or items of balance of payments. Components or items of each account are described as under :

I. Items of Current Account.

Following items are mainly included under current account :

(1) Export and Import of Visible Goods

Import and Export of visible material goods and precious metals. In other words, all goods included in balance of trade are the main items of current account.

(2) Invisible Items-Services

Import and Export of invisible goods, *i.e.*, different kinds of services are also included in current account. Main invisible items (services) are :

(i) **Services Rendered by Commercial Undertakings.** Commercial undertakings like shipping companies, insurance companies, banks, etc. belonging to a given country or different countries, exchange their services among different countries. Exchange of such services is included in current account.

(ii) **Services of Experts.** Every country avails mostly the services of foreign experts like doctors, engineers, soldiers, etc. and also puts the services of its experts at the disposal of other countries. The services received from abroad are like imports and the services rendered to foreign countries are like exports.

(3) Travellings. One of the main invisible items of balance of payments is travels. These travellings may be of any kind and on any account for instance, these may be in connection with business, education, health, conventions or pleasure trip, etc. The country visited to, for it these travels constitute exports and the country from which the visitors originate, for it these travels constitute imports.

(4) Transportation. Movement of goods from one country to the other is another invisible item influencing balance of payments on current account. Use of domestic transport by the foreigners amounts to exports and use of foreign transport by the natives amounts to imports.

(5) Investment Income. Interest, rent, dividend and profit also form an invisible item of balance of payments. When a country gets income from its investment abroad it is recorded under the head 'receipts'. On the other hand, when foreign investors earn income from the country where they make investment, then it is recorded under the head 'payments'.

(6) Governmental Transactions. Each government establishes its embassies, offices of high commissioners and other missions abroad and spends a lot on their maintenance. Such an expenditure is treated as 'payments'. Besides subscriptions etc. made to international institutions are also included in this category.

(7) Donations and Gifts. Donations are gifts etc. received from abroad are included under 'receipts' and donation and gifts etc. given to other countries are included under 'payments'.

(8) Miscellaneous. These include such invisible items as commission, advertisement, rent, patent fees, royalties, membership fees etc. The amount received from abroad on this count constitutes credit item and amount paid to other countries in this respect constitutes debit item.

II. Items of Capital Account

Main items of capital account are as follows :

(1) Private Foreign Loan Flow. Foreign loans received by the private sector are counted as 'credit item' and repayment of these loans is counted as 'debit item'.

(2) Movement in Banking Capital. Besides central bank, inflow of banking capital is counted as 'credit item' and outflow as 'debit item'.

(3) Official Capital Transactions. Loans received by the public sector from abroad or International Monetary Fund constitute "credit items" and loans repaid "debit items".

(4) Reserves, Monetary Gold and SDR. Foreign currency assets of the government, gold reserves of the central bank, SDR of IMF and similar capital transactions, etc. are included under 'credit items" and all kinds of payments under "debit items".

(5) Gold Movement. When the central bank of a country buys gold from abroad, it makes payment to foreign sellers. It is reflected under 'debit items". On the contrary, when it sells gold it is reflected under "credit items".

(6) Miscellaneous. Besides the above items, all other kinds of governmental capital receipts which also include receipts of the central bank are shown on "credit side" and all kinds of payments are shown on "debit side".

Balance of Payments (in *Rs. Crore*)

RECEIPTS OR CREDIT	PAYMENTS OR DEBIT
Items of Current Account	
(1) Export of Goods (2) Export of Services (*i*) Services rendered by Domestic Commercial companies (*ii*) Services of Domestic Experts. (3) Expenditures by Foreign Tourists.	(1) Import of Goods. (2) Import of Services. (*i*) Services rendered by Foreign Companies. (*ii*) Services of foreign experts. (3) Expenditure of country's Tourists abroad.
(4) Receipts from transportation services.	(4) Payments for the domestic use of Foreign Transportation.
(5) Income from foreign Investment.	(5) Income to foreigners from Investment made at home.
(6) Income from expenditure of foreign governments.	(6) Government expenditure on Foreign Countries.
(7) Gifts and Donations received from Foreign countries.	(7) Gifts and Donations to the foreigners.
(8) Mixed Expenditure by foreigners.	(8) Mixed Expenditure in foreign countries.
Items of Capital Account	
(9) Foreign Private loans.	(9) Repayment of Private loans from foreigners.
(10) Inflow of Banking capital.	(10) Outflow of Banking Capital.
(11) Loans received by the Government.	(11) Repayment of loans by Government Sector.
(12) Reserves and Monetary Gold Inflow.	(12) Reserves and monetary Gold transfer payment.
(13) International sale of gold.	(13) Purchase of Gold in International market.
(14) Capital Receipts.	(14) Capital Payments.

Q. Explain the statement—Balance of Payments always balance.

Ans. Balance of Payments always Balance

In the accounting sense, the balance of payments of a country is always in equilibrium. The statement of balance of payments is prepared in terms of credits and debits based on the system of double entry book-keeping. In the double-entry system, each transaction gives rise to two equal entries : a credit entry (*i.e.*, a receipt) and a debit entry (*i.e.*, payment). Thus the sum of all credits equals the sum of all debits. Similarly, an international transaction generates two equal entries : a credit (+) for an export of good or service, or for a foreign borrowing, or for the receipt of a unilateral transfer (gifts, donations, grants, etc.) ; and a debit (–) for an import of a good or service, or for a foreign lending, or for the making of a unilateral transfer. In other words, a country must pay for its imports of goods and services, or foreign borrowings, or receipts of unilateral transfers by the equal-valued export of goods and services or foreign lending, or making unilateral transfers. Thus, the

sum of all international receipts (credit items) always equals the sum all international payments (debit items).

While receipts and payments in the international transactions always must be equal or must balance in the accounting sense, they may not be equal or in equilibrium in operational sense. The accounting balance of a balance of payments account, which is merely a truism, should not be confused with the 'economic balance' which recognised the possibility of a deficit or a surplus in the balance of payments. When the current account of the balance of payments shows a deficit or a surplus, the balance is restored through changes in the capital account. In fact, the capital account is specially prepared to neutralise the imbalance in the current account. The deficit in the current account is neutralised by the equal amount of surplus in the capital account ; and the surplus in the current account is neutralised by the equal amount of deficit in the capital account. Thus, the current and capital accounts together balance each other and restore equilibrium in the balance of payments.

Suppose, a country experiences a deficit in the current account of its balance of payments statement due to excess of imports over exports. Such a deficit can be met by resorting to the following changes in the capital account :

(*i*) by raising loans and getting grants from other countries :

(*ii*) by drawing on past accumulated balances of the country which it may be keeping in the foreign countries ;

(*iii*) by exporting gold;

(*iv*) by drawings from IMF.

A Hypothetical Table
BOP Statement

(Rs. Crores)

Item	Credit (Receipts)	Debit (Payments)	Net
	I. Current Account		
Visibles			
1. Merchandise Trade	400	600	–200
Invisibles			
2. Services	200	400	–200
3. Investment Earnings	300	200	+ 100
4. Unilateral Receipts	400	300	+ 100
(a) Sub-Total	1300	1500	– 200
	II. Capital Account		
5. Long term Loans	400	350	50
6. Short term Loans	200	150	50
7. Gold Ornaments	200	100	100
(b) Sub-Total	800	600	200
Grand Total (a + b)	2100	2100	0

Table-1, which represents a hypothetical balance of payments statement, shows that the current and capital accounts together must necessarily balance. The deficit in the current account (excess of payments over receipts, *i.e.*, Rs. 1500 – 1300 = 200 crores) is equal to the surplus in the capital account (excess of receipts over payments, *i.e.*, Rs. 800 – 600 = 200 crores). Thus, the sum of all receipts are equal to the sum of all payments and the balance of payments account is balanced.

Foreign Exchange Rate

MEANING OF FOREIGN EXCHANGE RATE

The foreign exchange rate or exchange rate is the rate at which one currency is exchanged for another. It is the price of one currency in terms of another currency. It is customary to define the exchange rate as the price of one unit of the foreign currency in terms of the domestic currency. The exchange rate between the dollar and the pound refers to the number of dollars required to purchase a pound. Thus the exchange rate between the dollar and the pound from the US viewpoint is expressed as $ 2.50 = £ 1. The Britishers would express it as the number of pounds required to get one dollar, and the above exchange rate would be shown as £ 0.40 = $ 1.

The exchange rate of $ 2.50 = £ 1 or £ 0.40 = $ 1 will be maintained in the world foreign exchange market by arbitrage. *Arbitrage refers to the purchase of a foreign currency in a market where its price is low and to sell it in some other market where its price is high.* The effect of arbitrage is to remove differences in the foreign exchange rate of currencies so that there is a single exchange rate in the world foreign exchange market. If the exchange rate is $ 2.48 in the London exchange market and $ 2.50 in the New York exchange market, foreign exchange speculators, known as arbitrageurs, will buy pounds in London and sell them in New York, thereby making a profit of 2 cents on each pound. As a result, the price of pounds in terms of dollars rises in the London market and falls in the New York market. Ultimately, it will equal in both the markets and arbitrage comes to an end. If the exchange rate betwen the dollar and the pound rises to $ 2.60 = £ 1 through time, the dollar is said to depreciate with respect to the pound, because now more dollars are needed to buy one pound. When the rate of exchange between the dollar and the pound falls to $ 2.40 = £ 1, the value of the dollar is said to appreciate because now less dollars are required to purchase one pound. If the value of the first currency depreciates that of the other appreciates, and vice versa. Thus a depreciation of the dollar against the pound is the same thing as the appreciation of the pound against the dollar, and vice versa.

DETERMINATION OF EQUILIBRIUM EXCHANGE RATE

The exchange rate in a free market is determined by the demand for and the supply of foreign exchange. The equilibrium exchange rate is the rate at which the demand for foreign exchange equals to supply of foreign exchange. In other words, it is the rate which clears the market for foreign exchange. Ragner Nurkse defined the equilibrium exchange rate as, "that rate which over a certain period of time, keeps the balance of payments in equilibrium." There are two ways of determining the equilibrium exchange rate. The rate of exchange between dollars and pounds can be determined either by the demand and supply of dollars with the price of dollars in pounds, or by the demand and supply of pounds with the price of pounds in dollars. Whatever method is adopted, it yields the same result. The analysis that follows is based on the dollar price in terms of pounds.

The Demand for Foreign Exchange

The demand for foreign exchange is a derived demand from pounds. It arises from import of British goods and services into the US and from capital movements from the US to Britain. In fact, the demand for pounds implies a supply of dollars. When the US businessmen buy British goods and services and make capital transfers to Britain, they create demand for British pounds in exchange for US dollars because they cannot make payments to Britain in their currency, the US dollars.

The demand curve for pounds *DD* is downward sloping from left to right in Figure 1. It implies that the lower the exchange rate on pounds, the larger will be the quantity of pounds demanded in the foreign exchange (US) market, and vice versa. This is because a lower exchange rate on pounds make British exports of goods and services cheaper in terms of dollars. The opposite happens if the exchange rate on pound is higher. It will make British goods and services dearer in terms of dollars, and the demand for pounds will fall in the foreign exchange (US) market.

But the shape of the demand curve for foreign exchange will depend on the elasticity of demand for imports. "If a country imports necessities and raw materials, we may expect the elasticity of demand for imports to be low and the quantity imported to be insensitive to price changes. If, on the other hand, the country imported luxury goods and goods for which suitable substitutes exist, demand elasticities for imports might be high.... If the country has many well-developed import competing industries, the elasticity of demand for imports most certainly is high.... In the short run, elasticity of demand for imports may not be very high. In the long run, however it is much more probable that the production pattern will alter according to price changes, and the demand for imports, therefore, will be more elastic."[1]

1. Bo Sodersten, *op. cit.*, p. 211. Students who find it difficult to understand may leave this para without loss in continuity.

The Supply of Foreign Exchange

The supply of foreign exchange in our case is the supply of pounds. It arises from the US exports of goods and services and from capital movements from the US to Britain. Pounds are offered in exchange for dollars because British holders of pounds wish to make payments in dollars. Thus the supply of foreign exchange reflects the quantities of pounds that would be supplied in the foreign exchange market at various dollars prices of pounds.

The supply curve for pounds *SS* is an upward sloping curve, as shown in Fig. 58.1. It is a positive function of the exchange rate on pounds. As the exchange rate on pounds increases, the greater is the quantity of pounds supplied in the foreign exchange market. This is because with increase in the dollar price of pounds (lower pounds price of dollars), US goods, services and capital funds become better bargains to holders of pounds. Therefore the holders of pounds will offer larger quantities of pounds with the increase in the exchange rate.

But the shape of supply curve of foreign exchange will be determined by the elasticity of the supply curve. "As the value of the country's own currency increases, imports become relatively cheaper, and more is imported. As more is imported, more of the home currency is supplied on the foreign exchange market, provided elasticity is greater than unity. When imports become relatively cheap, new goods will start to be imported, and domestic import-competing industry will be gradually eliminated by imports. These are two important reasons why we expect the supply of foreign exchange to be quite elastic. Further, the larger the time perspective we take into account, the more elastic will be the supply."[2]

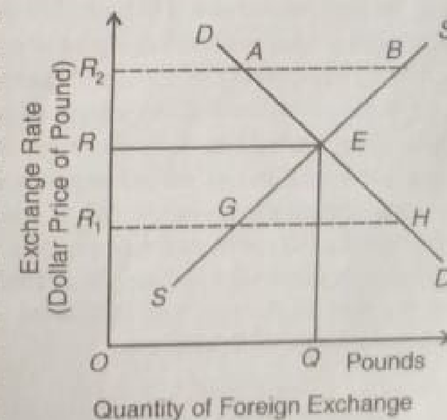

FIG. 58.1

Equilibrium Exchange Rate

Given the demand and supply curves of foreign exchange, the equilibrium exchange rate is determined where *DD*, the demand curve for pounds intersects *SS*, the supply curve of pounds. They cut each other at point *E* in Figure 1. The equilibrium rate is *OR* and *OQ* of foreign exchange is demanded, and supplied. At *OR* exchange rate the US demand for pounds equals the British supply of pounds, and the foreign exchange market is cleared. At any higher rate than this, the supply of pounds would be larger than the demand for pounds so that some

2. *Ibid.*, 214-15. Students who find it difficult may also leave this para.

some fixed date in future at a price agreed upon now. Thus, without transferring any currency, the forward contract makes it possible to ignore the likely change in the exchange rate and avoid the possible losses from such change.

MEANING RATE OF EXCHANGE

The rate at which one currency is exchanged for another is called the rate of exchange. The rate of exchange is the price of one currency stated in terms of another currency For example, if one U S dollar exchanges for 15 Indian rupees, then the rate of exchange is $ 1= Rs 15 or Re 1- 1/1-5 = 66 dollars It means that what 1 can purchase in America, Rs 15 can-purchase-in India In other words, the rate of exchange expresses the external purchasing power of a home currency.

According to Crowther, the rate of exchange "measures the number of units of one currency which will exchange in the foreign exchange market for another "In the words of Anatol Murad, "The ratio at which one country currency can be exchanged for another is the rate of exchange between these two currencies. "According to Sayers, "the prices of currencies in terms of each other are called foreign exchange rate."

TYPES OF EXCHANGE RATES

In the foreign exchange market, at a particular time there exists not one uiique exchange rate, but a variety of rates, depending upon 'the credit instruments used in the transfer function

Major types of exchange rates are as follows:

1. **Spot Rate.** Spot rate of exchange is the rate at which foreign exchange is made available on the spot It is also known as cable rate or telegraphic transfer rate because at this rate cable or telegraphic sale and purchase of foreign exchange can be arranged immediately. Spot rate is the day-to-day rate of exchange The spot rate is quoted differently for buyers and sellers. For example, $ 1= Rs 15.50 for buyers and $ 1= Rs 15.30 for the seller. This difference is due to the transport charges, insurance charges, dealer's commission, etc. These costs are to be born by the buyers.

2. **Forward Rate.** Forward rate of exchange is the rate at which the future contract for foreign currency is made The forward exchange rate is settled now but the actual sale and purchase of foreign exchange occurs in future The forward rate is quoted at a premium or discount over the spot rate
3. **Long Rate.** Long rate of exchange is the rate at which a bank purchase or sells foreign currency bills which are payable at a fixed future date. The basis of the long rite of exchange is the interest on the delayed payment. The long rate of exchange is calculated by adding premium to the spot rate of exchange in the case of credit purchase of foreign exchange and deducting premium from the spot rate in the case of credit sale. lithe spot rate is £1= $ 2.80 and the rate of interest is 6%, then on 30 days bill, $ 0.014 will be added per pound in case of credit purchase and deducted in case of credit sale of dollars.
4. **Fixed Rate.** Fixed or pegged exchange rate refers to the system in which the rate of exchange of a currency is fixed or pegged in terms of gold or another currency.
5. **Flexible Rate.** Flexible or floating exchange rate refers to the system in which the rate of exchange is determined by the forces of demand and supply in the foreign exchange market. It is free to fluctuate according to the changes in the demand and supply of foreign currency.
6. **Multiple Rate.** Multiple rates refer to a system in which a country adopts more than one rate of exchange for its currency. Different exchange rates are fixed for importers, exporters, and for different countries.
7. **Two-Tier Rate System.** Two-tier exchange rate system is form of multiple exchange rate system in which a country maintains two rates, a higher rate for commercial transactions and a lower rate for capital transactions.

Determination of Exchange Rate

Rate of exchange is the price of one currency in terms of another currency. Therefore, like other prices, the rate of exchange is also