An introduction to BOP

Definition

It records all economic transactions which take place internally and externally; it shows the inflows and outflows of money.

Inflows = CR

Outflows = DR

Components (mainly)

- Current Account
- Capital Account
- Financial Account

BOP is used to analyse trade performance of a country and allow for comparison between countries.

Structure of BOP

	CR $M	DR $M	BALANCES $M
Current Account			
Trade In Goods	500	700	(200)
Trade In Services	800	600	200
Primary Income	75	50	25
Secondary Income	10	25	(15)
Current Account Balance			**10**
Capital Account	80	75	**5**
Financial Account	60	100	**(40)**
Total			*(25)*
Official Financing			**24**
Net Errors & Omissions			**1**

Structure of BOP (cont)

25

BOP should be zero.

Current, Capital and Financial should balance each other out.

Current + Capital + Financial + Balancing item = 0

Current Account Surplus

Defn: **Value of credit entries > value of debit entries**

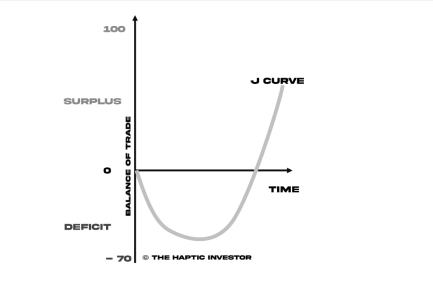
Causes:

- Higher demand of local products in foreign markets
- Greater share of export markets
- Productivity gains and greater trade competitiveness
- Develop import substitution industries - reduce expenditure on imports - weak currency policy - J curve effect
- Inflows of remittances from migrant workers

Consequences:

- Can lead to BOP disequilibrium
- Risk of retaliation from trading partners eg. USA v/s China
- Increase foreign currency reserve
- Repay external debt
- Shows good economic performance - attracts multinationals

J-curve



Capital Account

It records transactions pertaining to the **transfer of ownership, acquisition and disposal of assets**.

For example, if a government obtains a capital for construction of a college, it is recorded as an inflow of capital (CR)

The difference between inflows and outflows of capital is termed as the net capital flow

Financial Account

It records investments made overseas by the residents of a country (**domestic ownership of foreign assets**) and those carried out by foreigners in the country (**foreign ownership of domestic assets**)

Official Financing

It refers to the borrowing and reserves of a country. Governments borrow from financial institutions and existing reserves. The surplus arising from these is used for payment of external debts.

Net Errors and Omissions

It is simply a balancing item. The recording of transactions in a BOP is a very complex exercise and therefore, authorities need to cater for errors and omission that occur under this heading.

Current Account

It records the flow of goods and services in and out of a country.

Export = inflow = CR entry

Import = outflow = DR entry

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Current Account (cont)

The Current Account Balance is obtained from summation of Trade in Goods, Trade in Services, Primary income and Secondary income.

Correcting Current A/C Deficit

1. Expenditure Reducing Policy/ Expenditure Dampening Policy
- Policies implemented to reduce expenditure on imports.
- eg. increase in interest rates, increase in direct taxes.
- However it conflicts with macroeconomic objective of economic growth and full employment.

2. Expenditure Switching Policy (ESP)
- Policies to switch consumption from imported products to locally produced.
- eg. tariffs, devaluation.
- However there is a time lag and prevents economy from benefits of free trade.

3. Weak Current Policy (ESP)
- Makes exports cheaper and imports more expensive
- However if ped of exports is inelastic, economy receives less export revenue

4. Devaluation (ESP)
- J curve effect - devaluation will worsen current a/c deficit position before it improves at a later stage.
- Marshall Lerner condition: devaluation will lead to an improvement in the current account as long as the combined peds of exports and imports are greater than one in the long run.

Correcting Current A/C Deficit (cont)

- However it takes time and expenditure on imports can increase as ped of imports tend to be inelastic in the short run

Current Account Components

1. Trade In Goods
It includes *the import and export of tangible items*. The difference between the two is the Balance of Trade - either Balance of Trade deficit or surplus. Eg an Indian firm paying a Canadian firm for supplying raw materials will be recorded as a DR entry in India and CR entry in Canada.

2. Trade In Services
It includes *the export and import of intangible items* such as education, accountancy, health services. The difference between the two is the Balance of Invisible Trade. Eg a Canadian firm paying an Indian firm for accountancy services will be recorded as a DR entry in Canada and a CR entry in India.

3. Primary Income
It covers income earned by individuals and firms.

4. Secondary Income
Previously called Current Transfers,

Unlike the BOP (which should be equal to be 0), the Current Account balance is expected to theoretically run at a surplus or deficit.

When **value of inflows (CR entries) > value of outflows (DR entries)**, a Current Account **Surplus** is recorded.
When **value of outflows (DR entries) > value of inflows (CR entries)**, a Current Account **Deficit** is recorded.

Surplus - positive balance
Deficit - negative balance

Current Account Deficit

Defn: **Value of credit entries < value of debit entries**

Causes:
- Fall in export prices - caused by more suppliers leading to greater competition
- Fall in export market share - volume of export decreases eg. trade liberalization
- Rise in volume and value of imports leading to outflows in current a/c - due to industrialization and infrastructural development importing lots of machinery and know-how - economic growth - rise in GDP per head - rise in marginal propensity to import
- High rate of inflation - price of local products increase - rise in cost of production - decline in export competitiveness of export led industries - consumers demand more imported goods as they are cheaper - decline in export revenue
- Currency apprecaition

Consequences:
- BOP disequilibrium
- External debt
- Protectionist measures - risk of retaliation
- decline in trade flows
- Bad economic performance
- Currency depreciation

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Useful statistics

In 2021, according to UNCTAD,
- China had the highest current account surplus at US$317B
- USA had the highest current account deficit at -US$822B .

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