BALANCE OF PAYMENT & BALANCE OF TRADE

Balance of Trade

Balance of trade is the difference between export earnings (which is received from exporting goods) and import payment (which is taking place due to import of goods).

Balance of Payments

BOP provides a systematic and complete record of all monetary/economic transactions between the residents of the reporting country and the residents of the rest of the world during a given period of time generally one year. It is a summary measure of all the transactions.

Residents mean individuals, business firms, farms, govt. agencies, other institutions or organizations legally established in the country under consideration.

The IMF Definition, "*The Balance of Payment is a statistical statement that summarizes transactions between residents and non residents during a period".*

Hence a subsidiary of a foreign firm legally established in Bangladesh would be treated as any other Bangladeshi enterprise for BOP purposes. The transactions of foreign embassies & military institutions within the country in which they are located are however, recorded in the BOP of their home country.

Importance of Balance of Payments

It is an important analytical tool, keeping elaborate records of international tra ncations for formulating appropriate fiscal & monetary policies

The current account of BOP influences National Income as

NY = C + I + G + X – M

Here increase in exports and decrease in imports will increase National Income and vice versa. So, the movement of exports & imports as revealed by BOP statistics adds to our understanding of the movement of National Income especially for countries whose foreign trade accounts are substantial portion of National Income.

A country's BOP accounts keep track of both its payments to and receipts from foreigners. The country's exports & imports of merchandise & services and also movement of financial capital as well as financial transfers determines the BOP.

The BOP consists of a series of debit & credit entries. Credit items are those items, which give rise to payment by foreign country to the home country – they are the plus entries.

The items, which give, rise to payment by home country to the foreign country are called debit items and they are minus entries. This sort of division between debits & credits is called **VERTICAL DIVISION**. Apart from that division BOP items can also be classified in another way, called the **HORIZONTAL DIVISION** which may be conveniently divided into four separate accounts--

1. Current Account
2. Capital Account
3. Unilateral Transfer Account
4. Gold Account/ Official Reserve Account

Each transaction is classified a either credit or debit. It reflects all payments and liabilities to foreigners (debit) and all payments and obligations received from foreigners (credit).

Credit Transactions

•Export of goods and services
•Unilateral transfer from foreigners
•Capital Inflows
All of these are entered with a positive sign.

Debit Transactions

•Import of goods and services
•Unilateral transfer to foreigners
•Capital outflows
All of these are entered with a negative sign.

Accounts of Balance of Payments

Current Account

This records all monetary transactions arising out of exports & imports of merchandise & services in addition to international flow of income & investments.
It is the net change in current assets from trade in goods and services, net factor income and net unilateral transfers from abroad.

For Example*: When an American consumer imports Bangladeshi garment product, this transaction is recorded as a credit item in Bangladeshi Balance of Payment. A Bangladeshi buying a ticket from Dhaka to London on British Airways, this transaction is recorded as a debit item in Bangladeshi Balance of Payment.*

These are the examples of typical current account transactions. Merchandise / Visible Trade includes transaction of all physical goods and Invisible Trade includes transactions of all types of services.

Importance of Current Account

1. It is usually the largest account.
2. Exports & imports of merchandise & services constitute the real substance of international economic substances.
3. Current account represents a part of National Income.

Components of Current Account

•Export and import of merchandise goods
•Export and import of services
•Net Factor Income (such as dividend and interest payments from abroad)
•Net Unilateral Transfers from abroad (such as foreign aid, grants, gifts, remittances, indemnities etc.)

Current Account of the BOP

Credit (+)	**Debit (-)**
1.Merchandise Exports (Sale of goods) e.g. RMG products, frozen foods, leather etc. 2.Invisible Exports (Sale of services) e.g. banking& insurance service, medical & education purposes, shipping, air & other transportation services, accomodation,tourism, brokerage fees & other services sold abroad. 3. Income received on loans & investments abroad. e.g. interests & dividends. 4.Unrequited Receipts e.g. gifts, indemnities, grants, donations, remittances etc	1. Merchandise Imports (Purchase of goods) e.g. apparels, capital machinery, food grain, oil, raw materials etc. 2.Invisible Imports (Purchase of services) e.g. banking& insurance service, medical & education purposes, shipping, air & other transportation services, ,accomodation,tourism, brokerage fees & other services bought from abroad. 3. Income paid on foreign loans & investments. e.g. interests & dividends. 4.Unrequited Payments e.g. gifts, indemnities, grants, donations, remittances etc.

If the balance of current account for a given year has a credit balance/ surplus, it means that the home country's receipts are higher than the payments and for debit balance/deficit vice versa.

In practice current account is divided into several subsidiary balances like

Balance of Visible Trade
Balance of Invisible Trade
Balance of Unilateral Transfers

Unilateral Transfer Account

This is the second category of account in BOP. It includes those items, which have no return in exchange. These are simply one-sided affairs.e.g. Remittances of private individuals to family, friends & relatives as well as govt. grants, development assistance, relief, gifts etc.

For Example*: When an American living in Bangladesh sends a cheque to his father in New York—a debit entry. Similarly if K.S.A. govt. donates to Red Crescent, Bangladesh-a credit entry.*

Unilateral Transfer Account of the BOP

Credit (+)	**Debit (-)**
1. Private remittance received from abroad. 2. Pension payments received from abroad. 3. Govt. grants received from abroad.	1. Private remittance paid to abroad. 2. Pension payments paid to abroad. 3. Govt. grants made to foreigners.

Capital Account

This account records all sorts of long & short-term international movement of capital. It measures transactions that involve the purchase or sale of assets.

According to the IMF's definition, *the capital account records the international flows of transfer payments relating to capital items.*

For Example: *When a Bangladeshi firm buys 30% of the outstanding shares of an Indian manufacturing unit, it is recorded as a debit item in the Bangladesh BOP, as it is a long-term outflow of private capital. Again if n Pakistani deposits a cheque in his account of South East Bank Ltd. it is going to be credited in the capital account as a short-term private capital inflow.*

It therefore records a country’s inflows & outflows of payments & transfers of ownership of fixed assets (capital goods).

Components of Capital Account:

- FDI (investment in fixed assets)
- Portfolio investment (investment in long term financial assets such a stocks and bonds)
- Foreign Loans
- Capital Flight

Capital Account of the BOP

Credit (+)	**Debit (-)**
1.Foreign long-term investment in home country. a) Direct foreign investment in home country. FDI b) Foreign investment in domestic securities. c) Other investments of foreigner d) Foreign govt. loans.	1. Long term investment abroad. a). Direct investment abroad. b) Domestic investment in foreign securities. c) Other investments abroad. d) Govt. loans to foreign countries.
2.Short capital inflow including deposits, increase in short term liabilities to foreigners	2. Short capital outflow including deposits, increase in short term liabilities of foreigners to the residents of the home country.
Basically capital receipts include borrowing from, capital repayments by& sale of assets to foreigners.	Basically capital payments include lending to, capital repayments to & purchase of assets from foreigners.

It may be noted that, unlike the current account the capital account has opposite sign. In the current account imports of merchandise & services are given as debit entry, whereas in the capital export of capital are given as debit entry.

Current account includes all the flow items.

Capital account includes all the stock items.

Official Reserve Account

In the BOP of a country for a particular year, if there is debit balance in the current account and the capital account surplus is not sufficient enough to meet that deficit then, to balance that BOP disequilibria the country must dispose off either its gold reserve or foreign exchange reserve(internationally acceptable currencies). These are classified as official reserves and constitute the holding by govt. agencies of gold and other means of payment that are readily available to meet the BOP deficit.

In that case, the independently motivated /active/autonomous/ex-ante transactions (current, capital & unilateral transfer accounts) showed a deficit and this has been addressed by the official reserves. These are called passive/ accommodating /compensating/ ex-post transactions (capital & official reserve accounts). Thus BOP is always in balance and the official reserve account is the balancing item.

Official reserve account records the change in stock of reserve assets at the country's monetary authority. It is the balancing item along with errors and omissions. It includes the following items:

•Official Gold Reserve
•Foreign Exchange Reserve
•IMF Special Drawing Rights (SDR)

Official Reserve Account of the BOP

Credit (+)	**Debit (-)**
1. Official sale of gold abroad. 2. Official sale of foreign currencies abroad.	1. Official purchase of gold from abroad. 2. Official purchase of foreign currencies from abroad.

We know that sum of the balances of all the accounts must equal to zero. That is:

C + K + U + R = 0

C= Current Account Balance
K= Capital Account Balance
U= Unilateral Transfers Account Balance
R= Official Reserve Account Balance

This means that if these three active accounts are balances(C, K, U) show a positive or negative balance, the compensating reserve account(R) will show a balance which is equal but opposite sign.

C + K + U = -R
Balance of Payment Identity

Current Account = Capital Account + Net errors and omissions

Most Common form,

Export - Import = Capital Outflow - Capital Inflow

The basic principle behind this identity is that a country consumes less than it can produce (current account surplus) if it supplies capital to abroad (capital account deficit).

Factors Affecting International Transactions

- Inflation
- National Income
- Government Restrictions
- Exchange Rates

(All of these mainly affect current account transactions).

- Reducing restrictions
- Privatizations
- Potential Economic Growth
- Tax Rates
- Interest Rates

All of these affect capital account transactions.

Each transaction is recorded as both a credit and debit. This is termed as “Double Entry Book Keeping”.

In case of Bangladesh, Bangladesh Bank formulates BOP as per 5th edition of the IMF Balance of Payments Manual.

Sources of Documents:

• Records of authorized dealers • Bangladesh Bank • Ministry of Food (import of food grains from govt. account) • Economic Relations Division of Ministry of Finance (imports financed through loans and grants) • Customs records • Ministry of Commerce • EPB