International Business
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Lecture - 27
BOP, Balance of Trade

Welcome friends to the course of International Business. Today, we are going to start with a new unit. So, in this unit, we will start this unit with the very with a very important concept called the Balance of Payment right.

So, today, we will be discussing about balance of payment, what it is; what it is, what is its meaning and how it affects right any economy or any country for that. So, all this we will cover it in this today's lecture right. So, let us start with the definition. What is balance of payment?

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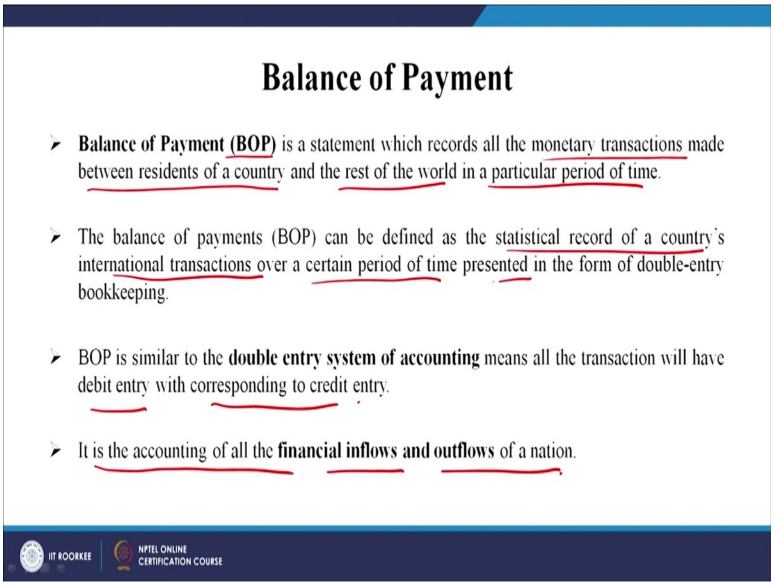

Balance of payment as it says largely you know BOP, as it said is a statement which records all the monetary transactions made between residents of a country and the rest of the world in a particular period of time.

So, it could be a year. The balance of payment can be defined as a statistical record of a country's international transactions over certain period of time presented in the form of double entry book keeping. Why it is called double entry? Because there is there are two sides and as you will see here, there is a debit entry with correspond to a credit entry right.

So, it is like any you know like a balance sheet ok. It is the accounting of all the financial inflows and outflows of a nation. Basically, if somebody ask in a simple term, somebody would like to understand it is the balance sheet of the country ok, the balance of payment can be understood that way.

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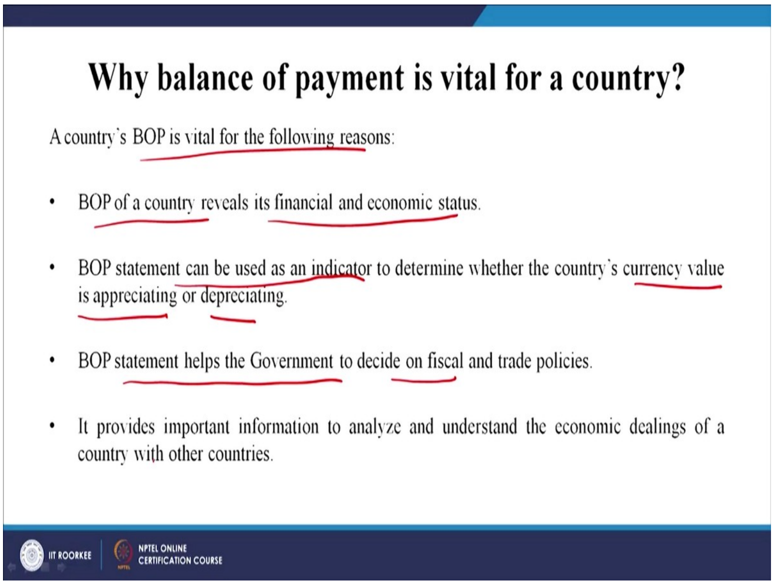

Why balance of payment is vital for a country? A country's BOP is vital for the following reasons. Let us see what are they? First, it reveals its financial and economic status because from the financial you know from the balance sheet, you can find out the country's financial and economic status. It can be used as an indicator to determine whether the country's currency value is appreciating or depreciating; both have their own consequences right. If it is appreciating, it has its some consequences; it is depreciating, it has own consequences.

The statement helps the government to decide on the fiscal and the trade policies. Now, what is fiscal policy and what is trade policy, monetary policy? We have to I think must be have I will show you also.

It provides important information to analyze and understand the economic dealings of a country with other countries. So, overall the balance of payment gives you a basic insight about the country’s economic health right. So, for example, let us talk before we get deep into it, let us understand these two terms; monetary policy and fiscal policy.

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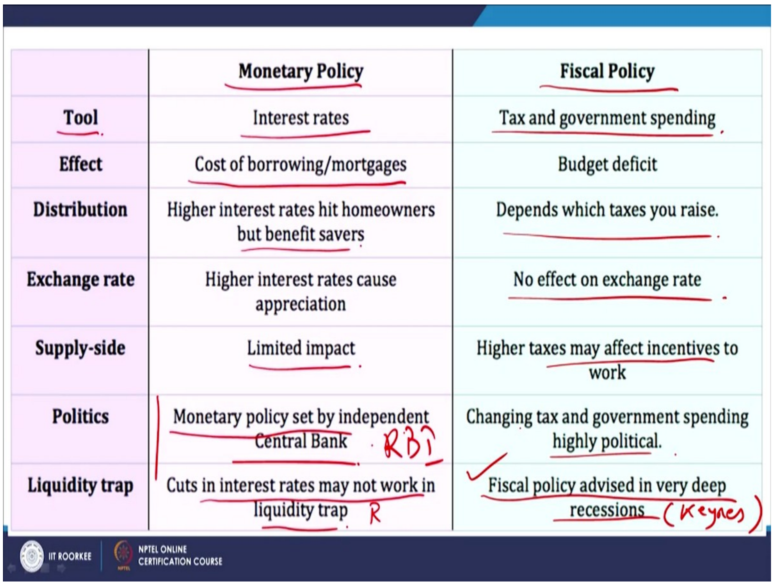

	Monetary Policy	Fiscal Policy
Tool	Interest rates	Tax and government spending
Effect	Cost of borrowing/mortgages	Budget deficit
Distribution	Higher interest rates hit homeowners but benefit savers	Depends which taxes you raise.
Exchange rate	Higher interest rates cause appreciation	No effect on exchange rate
Supply-side	Limited impact	Higher taxes may affect incentives to work
Politics	Monetary policy set by independent Central Bank RBI	Changing tax and government spending highly political.
Liquidity trap	Cuts in interest rates may not work in liquidity trap R	Fiscal policy advised in very deep recessions (Keynes)

And what is the difference because I have seen people are confused a lot on this. So, what is this monetary policy and what is fiscal policy. So, on basis of these attributes right, we have divided. So, on basis of the tool if you see it is nothing but it has the interest rate falls into the monetary policy. So, the government decides the interest rate and on in the other side, the fiscal policy is something which is basically connected with the tax and the governments spending right.

The government spends on different parameters and so, it levies taxes, different kinds of taxes. So, all this you know would levying taxes like sales and all these things that comes in. For example, in India, we talk about educational cess right. We talked about the Swatch Bharath Cess right. So, we have different kinds of taxes and we are coming up with different the GST for example right though and the government is spending, now there is at the GST is also a very controversial thing in India the moment.

Because different people, different economies are criticising in the different way. So, anyway; so, the spending and the tax this comes under the fiscal and the interest rate and the money, the printing and all that comes in the monetary policy right. The effect is basically on through the cost of borrowing and the mortgages.

So, the you know the bank, basically the monetary policy is decided by the Central Bank. If you can see here, it is it the monetary policy set by the independent Central Bank. In our case for example, the RBI.

But this is done by the changing tax and government spending is highly a political issue and it is done by the government right, the central government right. So, sometimes or largely the fiscal policy becomes a matter of a political issue because the government will tend to use it to make a benefit out of it for their you know future elections and all these things right.

So, they may change the tax structure, they may levy some new taxes or they might exempt some taxes. So, all these are a part of the fiscal policy which is there in the hand of the present government.

But the monetary policy is since is dictated by the RBI. So, it is less influenced politically. Yes, there is some influence, there is no doubt about it maybe there is some influence through the you know because the control is still with the government. But largely it is dominated or governed by the bank ok.

If you look at the distribution higher interest rates hit homeowners, but benefits the savers right. So, when there is a higher interest rate. So, you know somebody who takes a loan, he has to pay more; but for somebody who is saving the money you know, he will get higher interest rates, depends which taxes you raise right.

For example, if the taxes are increased, then the people have to shell out more money right. For example, at the current stage in India, there is a pressure in the government to drop the income tax rate a bit to bring it a bit down.

Exchange rate, higher interest rates cause appreciation; no effect on the exchange rate right, fiscal policy. Supply side, limited impact; higher taxes may affect incentives to work. So, if you levy a very higher tax, then people might not be interested to do some kind of a work because most of the money is going in the tax right. So, this affect also we have seen personally also ok.

So, fiscal policy is generally advised in very deep recessions because this was this concept of fiscal policy was brought in by Keynes; John Maynard Keynes right and

Keynes discussed how the government could use this structure to change the economic structure of the country or the condition of the people ok. Cut in interest rates may not work in liquidity trap right. So, all the time interest rate cuts might not work in for currents situation for example.

India has the RBI, in India the Reserve Bank of India has done a lot of changes connected to the interest rates right and the even the REPO rate right. So, all these things might all, might not work to uplift the economic mood of a country. So, but, fiscal policy is largely more related with the populism right. How popular that policy can be and how it affects the wood share wood bank of a government.

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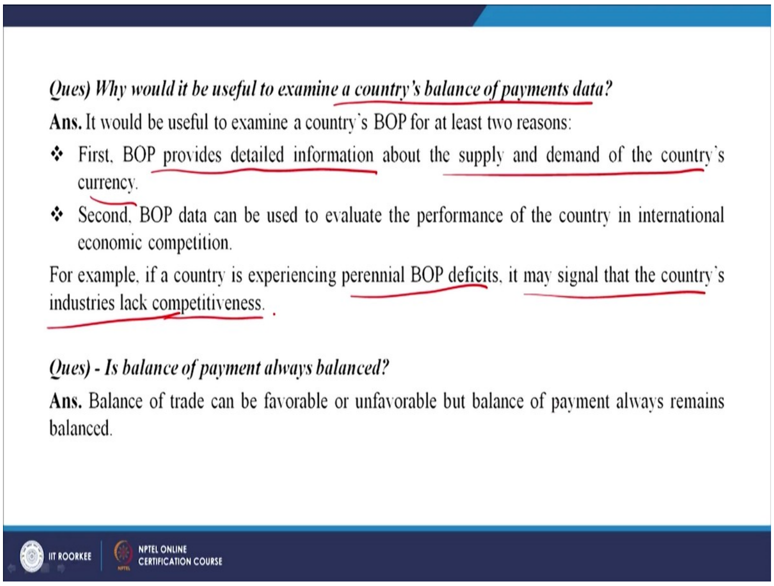

Why would it be useful? Now, let us go back to the economy the BOP to examine a country's balance of payments data. It would be useful for two reasons; first BOP provides detailed information about the supply and demand of a country's currency right.

Second, it can be used to evaluate the performance of the country in international economic situation or competition. For example, if a country is experiencing perennial BOP deficits, balance of payment deficit right, it may signal that the country's industries are lacking competitiveness.

Why? Because if there is a deficit; that means, you are not able to trade more, you are not exporting enough and you are rather importing more. That means, the a competitiveness is questioned here. Is balance of payment always balanced? Balance of trade can be favourable or unfavourable, but balance of payment always remains balanced, please remember this ok.

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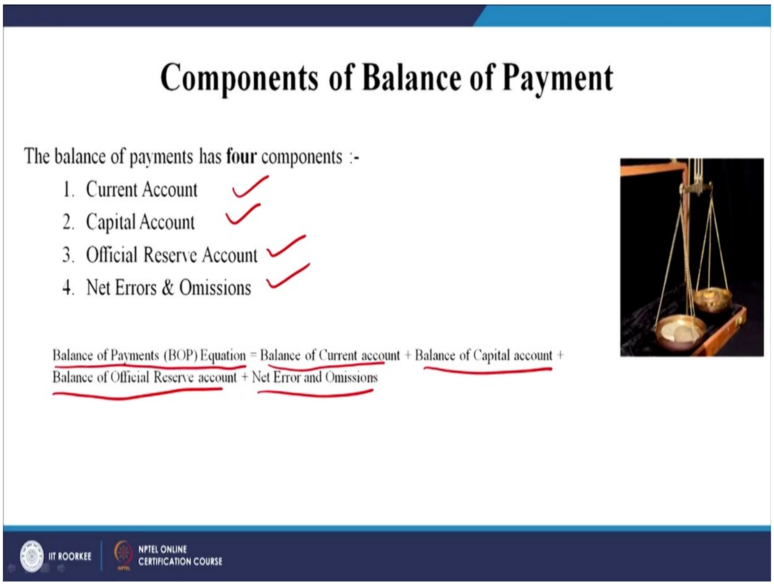

What are the components of the balance of payment? So, there are four components. So, right the current account, the capital account, the official reserve account, the net error and omissions.

So, balance of payment this is how it looks like is equal to the balance of the current account, the balance of the capital account, the balance of the official reserve account plus the net error and omissions. So, this is done in order to balance out. So, that it is a zero sum game right, it is like a it is a 0. It has to be balanced. Current account, let us go to the first one.

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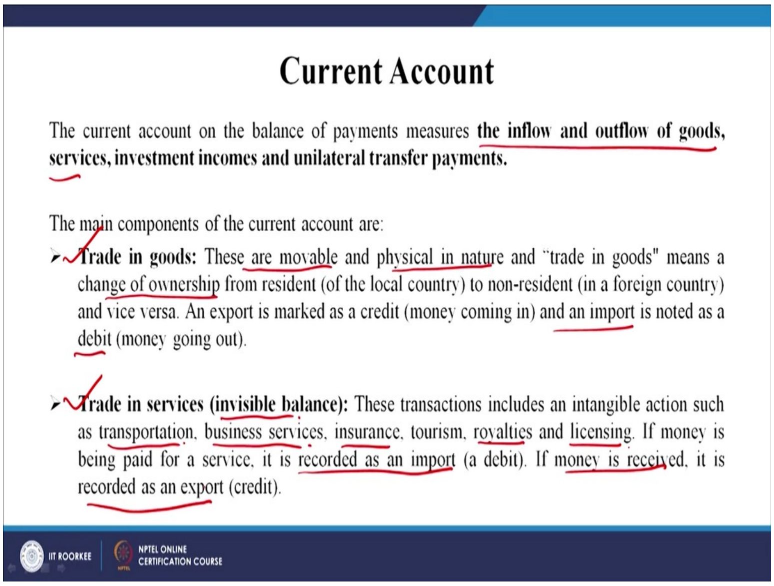

So, the what is the current account? The current account on the balance of payment measures the inflow and outflow of goods, services, investment incomes and unilateral transfer payments right. So, what are the main components in that current account? Trade in goods, trade in services.

So, when you say trade in goods, these are the movable and physical in nature and trade in goods means a change of ownership from resident that means, from the local country from, let us say from India to non resident in a and vice versa to some that means, we are import exporting from our country to some other country right and export is marked as a credit because money is coming in and in import is noted as a debit because money goes out.

So, when we are exporting, money flows into the country; when you are importing, the raw material is coming in, but the money goes out of the country right. Trade in services or invisible balance, these transactions include an intangible action such as transportation, business services, insurance, tourism, royalties and licensing. If money is being paid for a service, it is recorded as an import, a debit. If money is received, it is recorded as an export.

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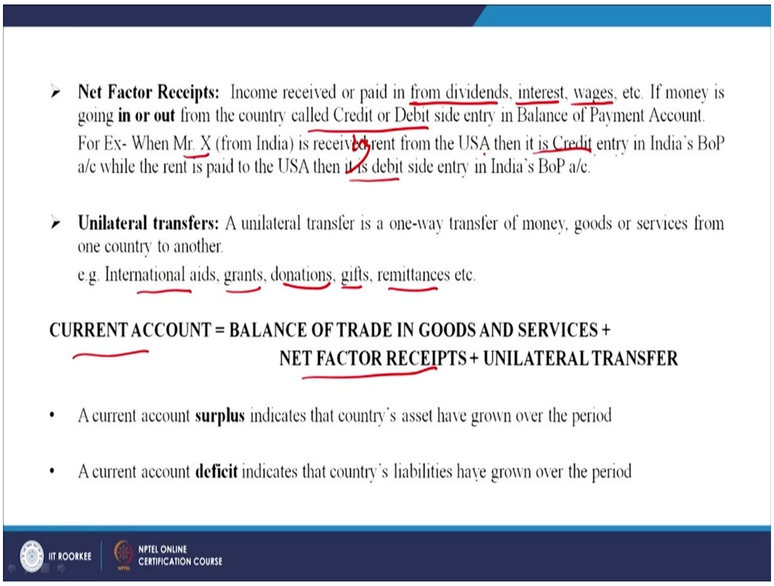

Net factor receipts, income received or paid in form in from dividends, interest, wages etcetera. If money is going in or out from the country called credit or debit side entry in balance of payment account; for example, when Mr. X, let us say from India is receiving rent; is receiving rent right from the USA, then it is credit.

Because it is a credit entry in India's BOP account. While the rent paid to the USA, some suppose we are paying to somebody in USA, then it is debit side entry in India's BOP account ok.

The last point is the unilateral transfers. A unilateral transfer is a one way transfer of money goods or services from one country to another right. International aids, grants, donations, gifts and remittances etcetera.

Now, so, how does this equation look like let us see. Current account is equal to balance of trade in goods and services plus net factor receipts plus unilateral transfer ok; a current account surplus. There could be two situations; there could be a surplus, there could be a deficit. A surplus indicates that the country's asset have grown over the period.

Obviously that means, your economic your export is increasing, your competitiveness is increasing in the world market; whereas, a current account deficit indicates that the country's liabilities have grown over the period and that means, we are not very competitive, we are not matching up to the world standards. That means, we are consuming more, but we are not able to produce more and give it to the world ok.

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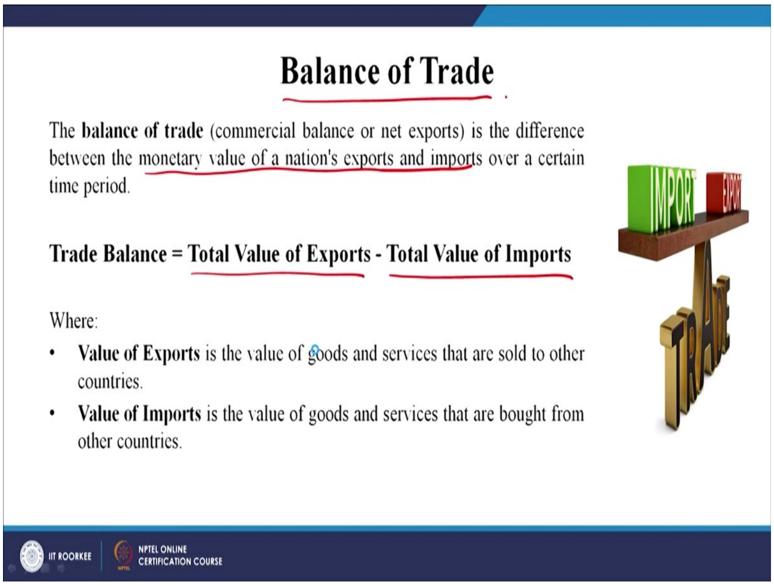

Now, there is another term called the balance of trade. Now, what is this balance of trade? So, we said here it could this might not be balanced right. It could be favourable or unfavourable. So, what is this balance of trade; commercial balance or net exports? The balance of trade is the difference between the monetary value of a nations exports and imports over a certain time period.

So, what did I say? Balance of trade is the difference between the monetary value of a nation's export and imports over a certain time period. So, trade balance is equal to total value of experts exports minus total value of imports ok, where what is this value of exports?

Value of exports is the value of the goods and services that are sold to the other countries. Value of imports is the value of goods and services that are bought from other countries so right. So, this is the trade balance right.

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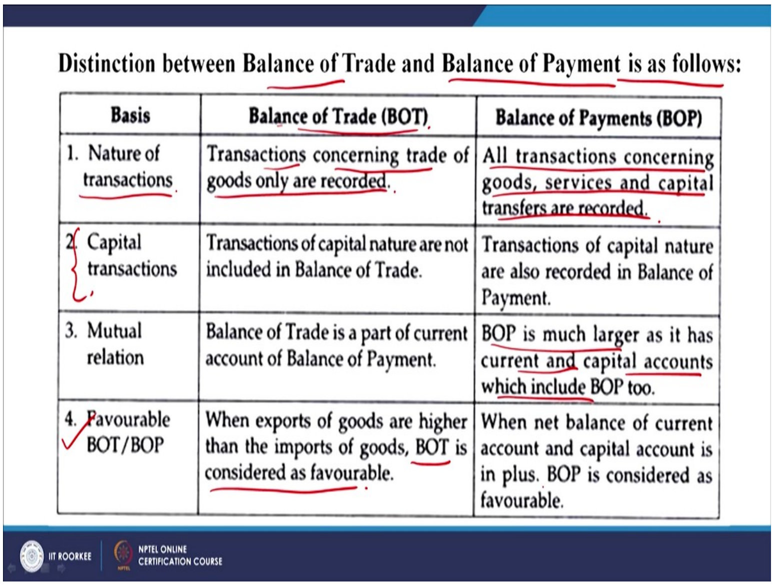

Distinction between Balance of Trade and Balance of Payment is as follows:

Basis	Balance of Trade (BOT)	Balance of Payments (BOP)
1. Nature of transactions	Transactions concerning trade of goods only are recorded.	All transactions concerning goods, services and capital transfers are recorded.
2. Capital transactions	Transactions of capital nature are not included in Balance of Trade.	Transactions of capital nature are also recorded in Balance of Payment.
3. Mutual relation	Balance of Trade is a part of current account of Balance of Payment.	BOP is much larger as it has current and capital accounts which include BOP too.
4. Favourable BOT/BOP	When exports of goods are higher than the imports of goods, BOT is considered as favourable.	When net balance of current account and capital account is in plus, BOP is considered as favourable.

Now, what is the distinction? Let us see this distinction between balance of trade and balance of payment because again, this is a you know kind of a confusion which people always hold in their mind. So, and basis of the you know this four points, let us discuss it. First, the nature of transaction; so, when you talk about balance of trade, the transactions concerning trade of goods only are recorded right; whereas, in the balance of payment, if you see all the transactions, concerning goods, services and capital transfers are recorded ok.

Now, coming to the capital transactions right; so, first was the nature of transaction, now the capital transactions. The transactions of capital nature are not included in the balance of trade, the capital once right; but transactions of capital nature are also recorded in the balance of payment right, the BOP.

Mutual relation, the balance of trade is a part of the current account of the balance of payment it is a part of the current account. So, we had current, capital; let us see the four. So, what are these four; current account, capital account, official reserve and net error right. So, it is a part of the only the current account right. BOP is much larger as it has current and capital account which includes the BOP right, in the BOP.

Favourable balance of trade or balance of payment, when export of the goods are higher than the import of the goods, the balance of trade is considered favourable otherwise unfavourable. If suppose, the balance of export of goods is lower than the you know import of goods, then it is a unfavourable situation.

On the other hand, when net balance of current account and capital account is in plus, BOP is considered as favourable. So, the net balance right and at the end the BOP will always be equated and it will be you know the both side the debit and the credit side because it is like a balance sheet, it has to be equal right that is the condition.

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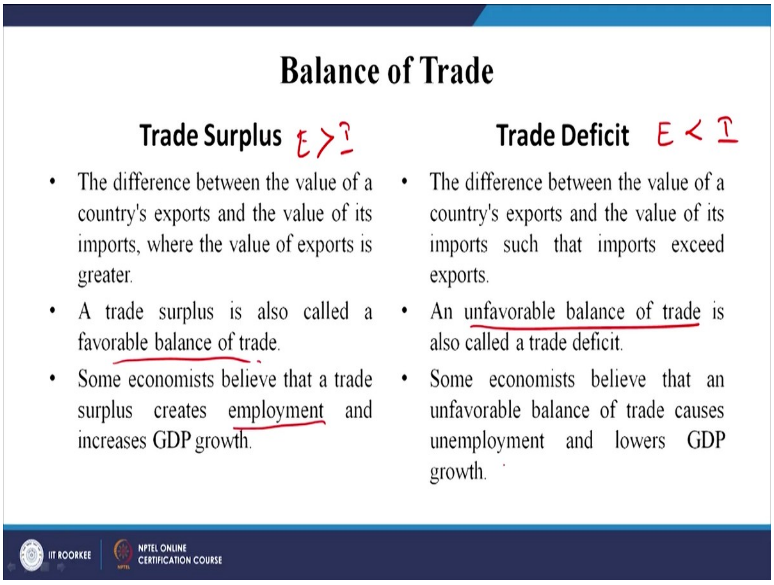

Balance of trade, trade surplus; now, let us continue with that. The difference between the value of a country's exports and the value of its imports, where the value of exports is greater. So, if it is in a surplus case the country's exports is greater than the country's imports right.

In case of a deficit, the difference between the value of a country's exports and the value of its imports is such that the import exceeds the exports. That means, in this case, the exports is less than the imports ok. A trade surplus is also called a favourable balance of trade and this is called an unfavourable balance of trade right in a trade deficit case.

Some economists believe that a trade surplus creates employment and increases GDP growth. So, that is generally it is understood that if the export is more, that means more consumption, more production is happening, so more jobs are coming up, so more the economy is in a better situation.

So, it is creating more employment and the GDP is growing; but some economists believe that an unfavourable balance of traded trade causes unemployment and lower GDP. Same thing that means, the economists generally believe that if balance of trade is positive right that means, more job is created and the GDP of the nation is growing.

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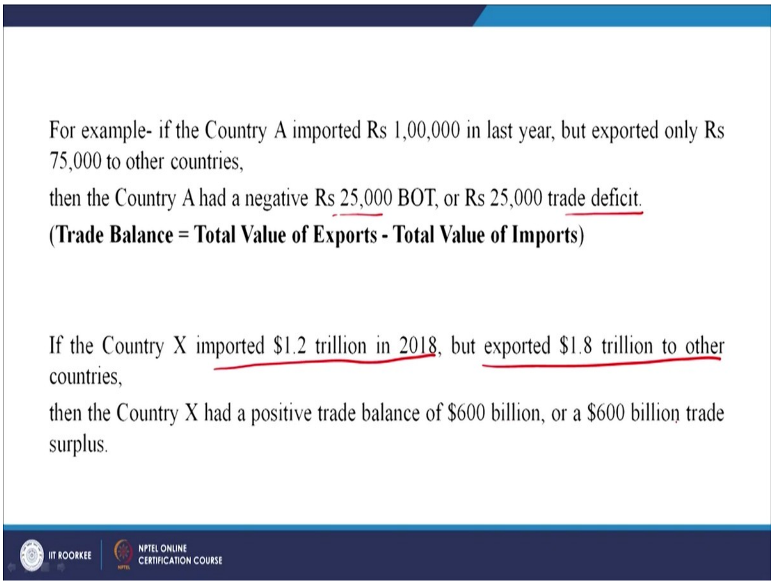

But if it is deficit, it is a reverse thing right. Let us say take an example if a country A imported rupees 1,00,000 in last year, but exported only rupees 75,000 worth of goods to other countries; then, the country has a negative rupees 25,000 right; balance of trade or rupees 25,000 trade deficit. This is how it is to be understood. Trade balance is equal to total value of the exports minus total value of the imports.

If the country export x imported 1.2 trillion in 2018, but exported 1.8 trillion to other countries; then, the country X has a positive trade balance of 600 billion or a 600 billion trade surplus. Now, it is very important to understand the health of economy by understanding the surplus and then, deficit ok.

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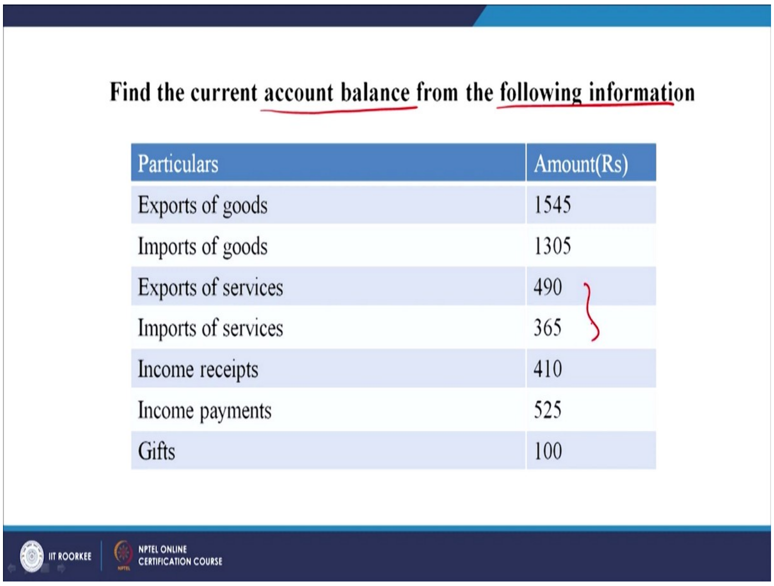

Let us take this example. Find the current account balance from the following information. [FL] the particulars are exports of goods worth, it is all in crores let us say 1545, import of goods 1305, exports of services 490, import of services 365, income receipts 410, income payments 525, gifts 100. Can you do the current account balance? Can you find the current account balance? Try to do it on your own ok. So, now, let us take look at the solution.

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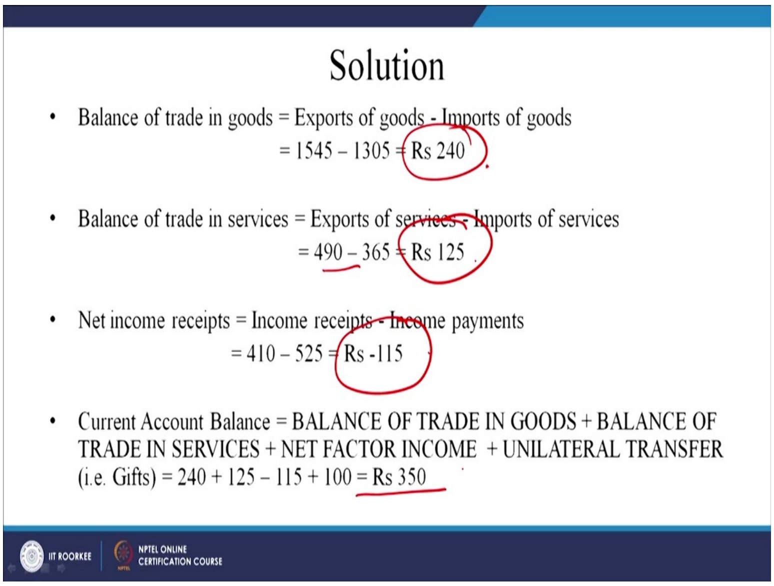

So, the balance of trade in goods, export of goods minus import of goods. So, 1545 minus 1305. So, that is equal to 240 balance of trade in services right; so, these two right. So, 490 minus 365, 125. Net income receipts is 410 minus payment 525. So, this is a minus rupees 115 ok. So, now, the current account balance is equal to balance of trade in goods plus balance of trade in services plus net factor income plus unilateral transfer that is gifts.

So, that is equal to 240 + 125 - 115. This is actually it should all be plus, but because this is a minus, it is minus plus 100 the gifts. So, that is equal to 350. So, the current account balance is in a 350. This is a positive right.

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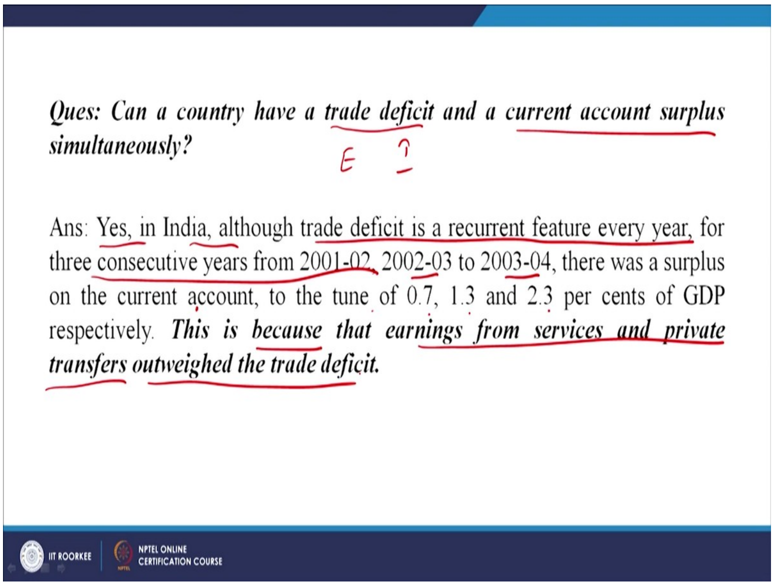

Can a country this is a question, can a country have a trade deficit and a current account surplus simultaneously? Now, this is a question for thinking. So, what are you saying can a country have a trade deficit that means, trade deficit means their surplus. That means, you are exporting less and importing more right.

So, you are paying more and maybe earning less and a current account surplus. Answer yes, in India although trade deficit is a recurrent feature every year trade deficit, from three consecutive years from 2001 to 2002, 2002- 2003, 2003-2004.

But there was a surplus on the current account as a same time to the tune of 0.7, 1.3 and 2.3 percents of the GDP respectively. This is because that earnings from services and private transfers outweighed the trade deficit which was not considered right in the trade.

So, this is what you know is a very important understanding and finding which will help you to clear out your doubts. For example, this question, can a country have a trade deficit and a current account surplus? Yes, it is possible, it has happened already in India ok.

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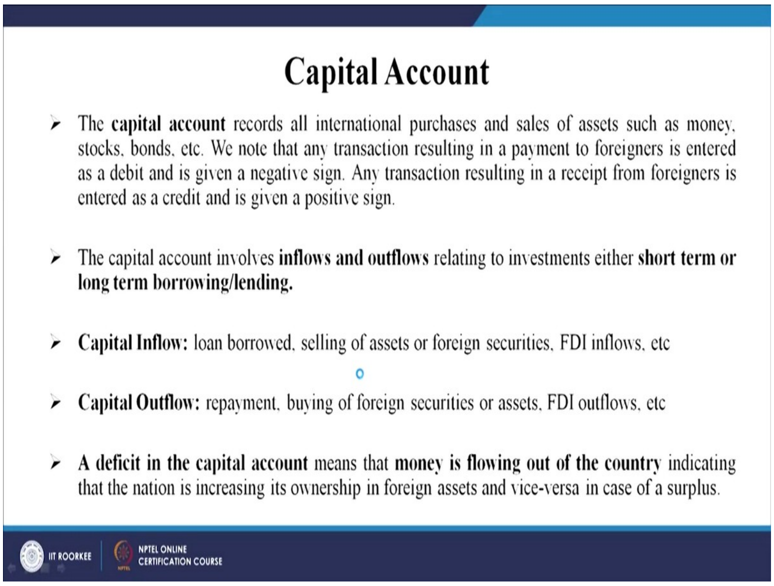

Now, what I will do is will start will wind up today here and maybe we will continue this in the next session from the capital account and will cover up the other parts of the balance of payment right. So, that is all for today.

Thank you very much. Have a nice day.